Availability of Counterclaims to Host States for Moral Damages Sustained

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ABSTRACT

The availability of moral damages to investors has been a topic of discussion for considerable time and continues to be so even after the seminal Desert Line v. Yemen decision. The position is unsettled and probably will be for some time. Another unclear matter is whether such damages should be available to States. In other words, should host States be permitted to bring moral damages claims as a counterclaim in investment arbitration proceedings commenced against them? This is a difficult question that has no clear answer. Case law and scholarly opinion fail to provide a definitive answer. This article considers the relevant awards and scholarly opinions and seeks to comment on their acceptability.

I. INTRODUCTION

The availability of moral damages in investor-State arbitration is not a new phenomenon. In fact, it surfaced in 2008 with the arbitral tribunal’s award in Desert Line v. Yemen. Whether investors should be entitled to claim moral damages for treaty violations committed by host States, in breach of bilateral investment treaties (BITs) and/or other international investment agreements (IIAs) that seek to protect investors’ investments in foreign countries, remains, however, a subject of debate.

While the debate there continues — and is likely to continue in the foreseeable future — another hot topic has arisen, contributing to the uncertainties in the field of investment arbitration. It is whether host States should also be entitled to assert moral damages by way of counterclaims. It is not an insignificant issue, particularly considering that States have begun to consistently raise counterclaims in investment arbitrations. Unsurprisingly, moral damages claims have been made by States before arbitral tribunals. However, to date no moral damages have been awarded in favour of States. In fact, the

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1 Desert Line Projects v. Republic of Yemen, ICSID Case No. ARB/05/17, Award, 6 February 2008.


absence of sufficient precedent on the matter was made express by the arbitral tribunal in Saluka Investments v. Czech Republic.\(^4\) A thorough review of the authorities and scholarly views on the issue is therefore much needed.

This article seeks to explore arguments for and against the proposition that States should be entitled to moral damages by examining the reasoning behind such contentions and analysing the current state of the law on this matter. Whilst doing so, it relies on the assumption that as a matter of right investors are entitled to assert claims for moral damages. The article concludes by suggesting an approach for arbitral tribunals that will adjudicate host States’ counterclaims for moral damages in the future.

II. ARGUMENTS AGAINST STATES’ ENTITLEMENT TO MORAL DAMAGES

a) Purpose and Object of BITs

The fundamental reason behind dismissing counterclaims raised by States seeking moral damages is that permitting such claims would contradict the very purpose sought by BITs. It is said that BITs aim to regulate the relationship between investors and host States and provide a framework of protections to the investor with respect to its investment, with no rights afforded to States.\(^5\) To support such contention reliance is placed upon the wording and structure of BITs. For instance, the introduction of the Canada 2004 Model BIT (Canada BIT) provides that '[r]ecognizing that the promotion and the protection of investments of investors of one Party in the territory of the other Party will be conducive to the stimulation of mutually beneficial business activity...’\(^6\) and Article 20 states: 'An investor of a Party may submit to arbitration under this Section a claim that the other Party has breached an obligation under Section B, and that the investor has incurred loss or damage by reason of, or arising out of, that breach.'\(^7\) (Emphasis added)

The wording and structure of the Canada BIT suggests that the main purpose sought by the execution of the BIT is the protection of investors’ investments. In fact, Article 28(1) of the Canada BIT stipulates that '[e]ach Party consents to the submission of a claim to arbitration in accordance with the procedures set out in this Agreement.'\(^8\) In essence, this provision states that arbitration proceedings cannot be commenced under the Canada BIT if they do not comply with the procedures foreseen therein.

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\(^4\) *Saluka Investments BV v. The Czech Republic*, UNCITRAL, Decision on Jurisdiction over the Czech Republic’s Counterclaim, 7 May 2004, para. 37.


\(^7\) *Id.*, Art. 22.

\(^8\) *Id.*, Art. 28(1).
Considering that the procedure envisioned by the Canada BIT is the commencement of proceedings by the investor only, State counterclaims should not be viable under this BIT. Similarly, the Germany 2008 Model BIT provides that a dispute shall be submitted to arbitration upon ‘the request of the investor’.\(^9\) It should be noted that most other model BITs and BITs that are currently in force contain very similar wording.

Consequently, it is argued, States should be disentitled from bringing counterclaims against investors as such would fall foul of requirements and limitations foreseen in BITs.\(^9\) In addition to scholarly criticisms, the point has been made subject to investment arbitration awards and some tribunals have sided with those who dismiss the entitlement of States to moral damages by way of counterclaims. Two cases are worth noting for the purposes of this article: \textit{AMTO v. Ukraine} and \textit{Cementownia v. Turkey}.

In \textit{AMTO v. Ukraine}, the investor brought a claim against Ukraine under the Energy Charter Treaty 1994 (ECT) alleging various breaches of the Treaty.\(^11\) Ukraine responded with a counterclaim in the amount of EUR 25,000, arguing that the unfounded allegations asserted by the investor harmed its investment reputation.\(^12\) The investor, in response, requested the dismissal of the counterclaim for the two following reasons: (1) the arbitral tribunal lacked jurisdiction on the counterclaim as such did not have basis in the ECT; and (2) no harm had been suffered by Ukraine.\(^13\) In dismissing the counterclaim, the arbitral tribunal ruled as follows:

\begin{quote}
Article 26(6) ECT provides that the applicable law to an ECT dispute is the Treaty itself and ‘the applicable rules and principles of international law.’ The Respondent has not presented any basis in this applicable law for a claim of nonmaterial injury to reputation based on the allegations made before an Arbitral Tribunal. Accordingly, the Arbitral Tribunal finds that there is no basis for counterclaim of this nature and it is accordingly dismissed.\(^14\)
\end{quote}

In \textit{Cementownia v. Turkey}, Turkey requested moral damages to be awarded in its favour, basing its request on the investor’s egregious and malicious conduct in the proceedings.\(^15\) Contrary to the investor’s defence in \textit{AMTO}, the investor in \textit{Cementownia} did not object to the arbitral tribunal’s jurisdiction with respect to the awarding of moral damages, but rather argued that the exceptional circumstances that are required


\(^{12}\) \textit{Id.}, para. 116.

\(^{13}\) \textit{Id.}, para. 117.

\(^{14}\) \textit{Id.}, para. 118.

\(^{15}\) \textit{Cementownia “NowaHuta” SA v. Turkey}, ICSID Case No ARB (AF)/06/2, Award, 17 September 2009, para. 165.
for the award of such damages were not present - "exceptional circumstances being a requirement of the test as articulated by the arbitral tribunal in Desert Line."

As to what circumstances would constitute exceptional circumstances, the arbitral tribunal in Desert Line did not say. However, particular emphasis was made in the Desert Line award on the fact that "the violation of the BIT by [Yemen], in particular the physical duress exerted on the executives of the Claimant, was malicious and is therefore constitutive of a fault-based liability." (Emphasis added) Reference was also made to siege by armed tribesmen with heavy artillery.

The arbitral tribunal in Cementownia dismissed the counterclaim, reasoning that:

"The Respondent requests, in the case at hand, that the Arbitral Tribunal grant compensation for moral damages based merely on a general principle, i.e., abuse of process. It is doubtful that such a general principle may constitute a sufficient legal basis for granting compensation for moral damages."

Note that the arbitral tribunal in Cementownia refused the request since it was based on a general principle of law, and not on the ECT or some other source of international law. However, slightly contradictorily, the arbitral tribunal did express that "[a] symbolic compensation for moral damages may indeed aim at indicating a condemnation for abuse of process." This comment raises difficulties since while the tribunal dismissed the availability of moral damages as part of general principles of law on the one hand, it later indicated its approval for moral damages under certain circumstances including an abuse of process. Yet, for the purposes of the present case, the arbitral tribunal decided that it was more appropriate to sanction the investor with respect to the allocation of costs.

What the above two cases demonstrate is that State counterclaims founded on moral damages will rarely be awarded. Even if they are to be awarded, it cannot be as a matter of principle; but a matter of express wording in the applicable treaty under which the claim for moral damages is brought. It is submitted that this is a correct analysis; arbitrators should not find in themselves an inherent jurisdiction to award moral damages to States, unless it can be shown that the contracting States to the BIT intended differently. If arbitrators were to grant moral damages to States in the absence of any clear treaty wording, they would most probably be acting ultra vires and the enforceability of the award would be risked. Arbitrators should therefore be very

16 Id., para. 166.
17 Desert Line v. Yemen, para. 289.
18 Id., para. 290.
19 Id., para. 166.
20 Cementownia v. Turkey, para. 170.
21 Id., para. 171.
22 Id., para. 171.
cautious to avoid any excess of jurisdiction. The point that arbitrators’ jurisdiction is tied to the wording of the applicable investment treaty was expressly acknowledged by the arbitral tribunal in AMTO as follows:

The jurisdiction of an Arbitral Tribunal over a State party counterclaim under an investment treaty depends upon the terms of the dispute resolution provisions of the treaty, the nature of the counterclaim, and the relationship of the counterclaims with the claims in the arbitration.\(^{23}\) (Emphasis added)

b) No Harm to Reputation

A further reason put forward to justify the dismissal of State counterclaims for moral damages is that States in essence lack any substantive grounds for bringing moral damages claims. It is argued that the commencement of a fraudulent or frivolous claim by an investor will not cause any substantial material or moral harm to the host State so as to justify a moral damages award in favour of the State. It is said that if a fraudulent or frivolous claim is commenced, the State’s reputation will remain unimpaired given that an award in its favour will settle any doubts as to its treatment of investments and/or investors.\(^{24}\) If the claim is allowed, however, then it means that the claim was not fraudulent or frivolous and that the State has no grounds to complain. In such cases any reputational harm is due to the State’s own doing.\(^{25}\) Thus, Dumberry notes, ‘the situations where an investor could commit a breach resulting in any sort of moral damages for the host State will be very rare’.\(^{26}\)

It is also worth noting that case law lends support to this line of reasoning. For instance, in Europe Cement v. Turkey, the arbitral tribunal, in dismissing Turkey’s moral damages claim, held that any reputational damage caused to Turkey through the commencement of the fraudulent proceedings would be ‘remedied by the reasoning and conclusions set out in this Award, including an award of costs’.\(^{27}\)

\(^{23}\) AMTO v. Ukraine, para. 118.


\(^{25}\) Ibid.

\(^{26}\) Ibid.

\(^{27}\) Europe Cement Investment & Trade SA v. Turkey, ICSID Case No. ARB(AF)/07/2, Award 13 August 2009, para. 181. On damages that may have been sustained by Turkey for having to defend a claim lacking any jurisdictional basis, the arbitral tribunal noted in paragraph 185 as follows:

In the circumstances of this case, where the Tribunal has reached the conclusion that the claim to jurisdiction is based on an assertion of ownership which the evidence suggests was fraudulent, an award to the Respondent of full costs will go some way towards compensating the Respondent for having to defend a claim that had no jurisdictional basis and discourage others from pursuing such unmeritorious claims.

One cannot help but notice that one of the reasons the arbitral tribunal awarded costs in favour of the State was the deterrence of future unmeritorious claims. Further, note that the default rule in investment arbitrations is not the ‘loser pays’. Thus, it may not be simply said that Turkey was entitled to the costs in any event and that therefore the reasoning was not a sufficient remedy for Turkey. See J. Gill, J. Freeman & T. Hara, ‘Investment Treaty Tribunals’ Divergent Approaches to Costs: Reflections Following Decisions in Two Cases Commenced Against the Republic of Turkey’, Turkish Commercial Law Review 1 (2015), 8 et seq. However, as authors do accept, such default rule has indeed been challenged in several awards.
The above reasoning appears both sensible and logical. Reputational damage should simply be cured by an award in the host State’s favour. Although it may be said that there may be harm to a State’s reputation, and therefore to the inflow of foreign direct investment (FDI) into that State during the few years when proceedings are ongoing affecting investors’ decision to invest, there is no hard data to suggest such temporary adverse effect capable of permitting a quantification of moral damages in the award. In fact, Allee and Peinhardt, whose research reveals that States’ reputation is tarnished to a certain extent by the mere commencement of arbitral proceedings against such State, concede that their findings are preliminary and that what matters most is whether States are seen to uphold their BIT commitments.

It is submitted that a reputation for not upholding BIT commitments would not be built solely on a single claim against a State. There may be various reasons as to why the dispute in question arose in the first place. Further, the State’s attitude may only be sector or investor focused for various reasons as opposed to being widespread or systemic. Consequently, it may be said that a State’s reputation for upholding BIT commitments should ideally only be affected by the commencement of a substantial number of proceedings, the majority of which are decided against the State. In this respect, it is worth noting that according to Dumberry, ‘one of the only cases where the “investment reputation” of a State will truly be tarnished is in the (rare) event it simply refuses to pay the investor the amount allocated by a tribunal’. Dumberry also adds that 17 out of 81 States against whom investment proceedings have been commenced are developed countries and that there is no evidence to demonstrate that the investment atmosphere in such countries have been adversely impacted.

III. ARGUMENTS IN FAVOUR OF STATES’ ENTITLEMENT TO MORAL DAMAGES

a) Equality and Justice

There are several strands of reasoning relied upon to justify State counterclaims for moral damages. The primary justification is the well established principle of equality and justice. It is argued that precluding State counterclaims for moral damages in such circumstances would contravene the fundamental notions of equality and justice. One of the key proponents of this argument is Kryvoi. He argues that a greater degree of equality would be achieved if State counterclaims for moral damages are permitted.


30 Id., 8, 22.

31 Dumberry, Satisfaction as a Form of Reparation, 239.

32 Id., 238-239.

33 Kryvoi, Counterclaims, 30.
In support of his arguments he relies on the award rendered in *SGS Société Générale v. Pakistan*, where the arbitral tribunal had held that:

> It would be inequitable if, by reason of the invocation of ICSID jurisdiction, the Claimant could on the one hand elevate its side of the dispute to international adjudication and, on the other, preclude the Respondent from pursuing its own claim for damages by obtaining a stay of those proceedings for the pendency of the international proceedings, if such international proceedings could not encompass the Respondent’s claim.34

Kryvoi is not alone in voicing concerns that preclusion of State counterclaims would violate principles of equality and justice. Uchkunova and Temnikov are two scholars who agree with Kryvoi, expressing that ‘if the remedy of moral damages is available to the investors, then it should be likewise available to States’.35

Albeit well formulated, the argument appears to disregard the fact that parties in international investment law are not ‘in the majority of cases’ on an equal footing. Investors are generally at the mercy of the host State with respect to their investments. Indeed, the international legal set of rules relating to investments, i.e. international investment law, was created to provide a level playing field between States and investors.36 It may be that certain multinational companies acting as investors may have a better hand in negotiations and that they may be in a position to protect their own interests; however, even in such cases, following realisation of the investment, the balance in most cases would shift considerably in favour of the host State. Leading from the above, the argument based on equality and justice is regarded as unpersuasive and too artificial to warrant permissibility of State counterclaims for moral damages.

**b) Efficiency of Proceedings**

The desired aim of making arbitral proceedings as efficient as possible is another factor that is relied upon in support of State counterclaims. Although this is an argument of general applicability and seeks to justify host State counterclaims generally, such does not prevent the argument being used to particularly advance the contention that permitting State counterclaims for moral damages would also strive for efficiency.

It is said that proceedings would be significantly more efficient if States were permitted to raise counterclaims in the same proceedings commenced against them, thus not necessitating the commencement of fresh proceedings. Kryvoi is one such scholar who contends that State counterclaims would ensure procedural efficiency.37 However, he does acknowledge that BITs are primarily designed to enable claims to be brought by investors against States since BITs afford investors rights without imposing

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any obligations on them. Lalive and Halonen concur with Kryvoi’s line of contention and emphasise the importance of striving for efficiency.

It would indeed be imprudent for one to resist an attempt to make a system more cost and time efficient, particularly in an area where costs are counted in the millions and proceedings continue for several years. That said, efficiency should not be made to seem as the only decisive factor. Efficiency should be considered along with other relevant considerations and a balancing exercise needs to be undertaken. In line with the above explanations regarding the purpose and object of BITs, it is submitted that efficiency alone does not suffice to justify departure from the general rule that BITs are there to protect investments and investor interests. The limit on arbitrators’ jurisdiction regarding the grant of moral damages to States is another counter factor that carries significant weight.

c) Harm to Reputation

Lastly, it is said that States should be entitled to moral damages by way of counterclaims in cases where investors bring frivolous or fraudulent claims against the State concerned, as such harm the State’s investment reputation. Parish et al., for instance, reject the availability of moral damages exclusively to investors and contend that States too should be entitled to it, particularly in cases of egregious or frivolous claims. Parish et al. underline the fact that the availability of moral damages to States has been confirmed in the Draft Articles on Responsibility of States for Intentionally Wrongful Acts, adopted by the International Law Commission (ILC).

The ILC Draft Articles are a set of rules that sought to codify the law relating to State responsibility. It is the product of almost 50 years’ of work, commissioned by the UN General Assembly in 1953 and finalised in 2001. Caron, as to the importance and relevance of the ILC Draft Articles in international law, notes that it is ‘a proposed piece of legislation; it looks like a law, it reads like a law, it might even be mistaken for a law’. Similarly, the arbitral tribunal in Noble Ventures v. Romania expressed that, ‘While those Draft Articles are not binding, they are widely regarded as a codification of customary

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38 Id., 9.


40 Parish et al., Awarding Moral Damages, 234-240.

41 Id., 230. The ILC Draft Articles were adopted by the ILC on 31 May and 3 August 2001. The ILC was established by the UN General Assembly in 1947 to ‘initiate studies and make recommendations for the purpose of ... encouraging the progressive development of international law and its codification’ (Article 13(1)(a), Charter of the United Nations). For more see B. Sahahi, Compensation and Restitution in Investor-State Arbitration, Principles and Practice (New York: Oxford University Press, 2011), 53.


international law.'  

The ILC Draft Articles are therefore significant for any discussion concerning customary international law. Considering that BITs are a source of customary international law and that, further, when interpreting BITs one must have regard to customary international law, regard must naturally be made for the provisions of the ILC Draft Articles.

In this respect it is worth noting that, contrary to Parish et al.’s assertion, the availability of moral damages to States has been excluded by the ILC Draft Articles. The commentary to Article 36 of the ILC Draft Articles expressly provides that, ‘[t] he qualification “financially assessable” is intended to exclude compensation for what is sometimes referred to as “moral damage” to a State’.

Parish et al.’s interpretation of the commentary to Article 37 is considered inaccurate as it fails to address satisfactorily the explicit wording in the commentary to Article 36 referred to above.

Further, as discussed above at II(b), unless concrete evidence is shown that the commencement of a single fraudulent or frivolous arbitration is sufficient to harm a State’s reputation, this argument is not a persuasive one.

**IV. CONCLUSION**

In conclusion, the majority opinion appears to favour disentitling States from being able to seek moral damages in investment arbitrations commenced against them by investors. To permit such claims, it is rightly argued, would be to disregard the very purpose and object of BITs. Further, there is no concrete evidence available to suggest that fraudulent or frivolous claims by investors harm host States’ reputation and have an adverse impact on the inflow of FDI. Finally, and most importantly, any award of moral damages in the absence of clear treaty wording may be deemed as excess of jurisdiction on the part of the arbitrators and such may risk the enforceability of the award rendered.

The counter arguments relating to fairness and procedural efficiency fail to justify a departure from rules that are closely tied to the very foundation of the investor-State arbitration framework and by which arbitrators’ jurisdiction is restricted.

That said, if the wording of the applicable treaty is clear and it can be concluded with confidence that the arbitral tribunal is empowered to award moral damages to

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44 Noble Ventures, Inc v. Romania, ICSID Case No. ARB/01/11, Award, 12 October 2005, para. 69.
45 Ibid. See also, S. Ripinsky & K. Williams, Damages in International Investment Law (British Institute of International and Comparative Law 2008), 25.
46 ILC Draft Articles, Art. 36, Commentary (1).
47 For the sake of completeness, Art. 37, Commentary (9) provides, in full, as follows: ‘In accordance with paragraph 2 of article 31, the injury for which a responsible State is obliged to make full reparation embraces “any damage, whether material or moral, caused by the internationally wrongful act of a State”. Material and moral damage resulting from an internationally wrongful act will normally be financially assessable and hence covered by the remedy of compensation. Satisfaction, on the other hand, is the remedy for those injuries, not financially assessable, which amount to an affront to the State. These injuries are frequently of a symbolic character, arising from the very fact of the breach of the obligation, irrespective of its material consequences for the State concerned.’
States by party intention, such party intention should be given effect to. Ultimately, it is all a matter of construction of the applicable treaty wording.