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PREFACE

This year's edition of *The Investment Treaty Arbitration Review* boasts a number of new chapters. The result is greater coverage and a resource that is even more useful to practitioners.

As before, this new edition provides an up-to-date panorama of the field. This is no small feat given the constant flow of new awards, decisions and other developments in investment treaty arbitration.

Although many useful treatises on investment treaty arbitration have been written, the relentless rate of change in the field rapidly leaves them out of date.

In this environment of constant change, *The Investment Treaty Arbitration Review* fulfils an essential function. Updated every year, it provides a current perspective on a quickly evolving topic. Organised by topic rather than by jurisdiction, it allows readers to access rapidly not only the most recent developments on a given subject, but also the debate that led to those developments and the context behind them.

This eighth edition represents an important achievement in the field of investment treaty arbitration. I thank the contributors for their fine work in developing the content for this volume.

Barton Legum
Honlet Legum Arbitration
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Chapter 33

CONTRIBUTORY FAULT, MITIGATION AND OTHER DEFENCES TO DAMAGES

Simon Barrie Sasmoyo Adiwidagdo[1]

I INTRODUCTION

From 1987 to 2021, at least 807 investor-state dispute settlement (ISDS) proceedings on the merits have been concluded.[2] Of these, 61 per cent of the cases were decided in favour of the investors (with breaches found and damages granted, or breaches established but no damages awarded), and 39 per cent in favour of the states (with the cases being dismissed were dismissed on the merits).[3]

During the same period, the Working Group III of the United Nations Commission on International Trade Law (UNCITRAL) reported that the cumulative awards on damages has grown significantly. The cumulative awards of damages reached US$10 billion in the 21 years since the first investment case, which then doubled in 2006 and subsequently reached US$40 billion in 2010.[4] On 30 March 2023, it was reported a record treaty claim was filed against Australia, demanding damages of US$200 billion in a single claim.[5]

Claimants commonly make claims that are, on average, five times the amount they are actually awarded.[6] This phenomenon is called the 'anchoring effect', where claimants 'tend to make exaggerated claims as a legal tactic, thereby counting on a possible cognitive bias of tribunals where exaggerated claims are used as a basis for the calculation of compensation.'[7] These high claims are made in the hope that a less exaggerated yet indefensible amount will seem reasonable by comparison.[8]

States have called for a better mechanism to verify the claimant's valuation of their damages to produce just and accurate awards on damages, especially to expel claims arising from claimant's unreasonable conducts. For instance, the Indonesian government has stated

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2 United Nations Commission on Trade and Development (UNCTAD), 'Facts on investor–State arbitrations in 2021: With a special focus on tax-related ISDS cases', IIA Issues Note, Issue 1, July 2022, p. 4.

3 ibid.

4 United Nations Commission on International Trade Law (UNCITRAL), Working Group III, 43rd session. Vienna, 5–16 September 2022, 'Assessment of damages and compensation', A/CN.9/WG.III/WP.220 (UNCITRAL, Working Group III, 43rd session), Paragraph 67.

5 Toby Fisher, 'Mining magnate launches US$200 billion treaty claim against Australia', 30 March 2023, www.globalarbitrationreview.com/article/mining-magnate-launches-us200-billion-treaty-claim-against-australia (accessed 17 May 2023).

6 UNCITRAL, Working Group III, 43rd session, Paragraph 71.

7 ibid., Paragraph 72.

8 UNCITRAL, Working Group III, 37th session, New York, 1–5 April 2019, 'Comments by the Government of Indonesia', Paragraph 8.

that there is a huge gap between the disputing parties' valuation of damages, especially in natural resources cases, and the government calls for a 'better checks-and-balances' system by the arbitrators to curb the risk of abuses.[9]

In response to this anchoring effect, states are attempting to rebalance the scale by making good on their threats by terminating or withdrawing from investment treaties[10] and reformulating some older generation treaties. These are all designed to strengthen state's defences against claims and rebalance existing rights and obligations. Specifically, states are also fortifying available defences, especially with regard to contributory fault, mitigation, necessity and security exceptions because they all operate to either limit or exclude damages claims.

The above types of defences have been in place since the early days of investment arbitration. Since then, tribunals have had differing views in deciding them, resulting in a lack of predictability and coherency, especially regarding the amount of compensation granted.[11]

These differing views are primarily attributed to the lack of regulations and parameters on how tribunals should approach these assertions. As a result, there are ongoing protests to the ISDS system, which include calls to scrutinise how decisions on the defences are being made against the host country. There are also calls to reform the system, which can affect the future direction of tribunals in considering the defences. UNCITRAL Working Group III is planning to draft guidelines on the issue of claimant misconduct, which is aimed at limiting the amount of compensation.

This chapter discusses the positions of contributory fault, mitigation, necessity and security interest exception clauses as decided by the investment treaty arbitral tribunals ,and how they may be affected by the rebalancing efforts from the host country.

II CONTRIBUTORY FAULT, MITIGATION AND OTHER DEFENCES

i Contributory fault

Developments regarding contributory fault are part of the ongoing ISDS reform. States have taken interest of this concept given the increasing number of investment claims being made against them. UNCITRAL Working Group III has recently stated that, in practice, investor's misconduct is not being considered properly in tribunals' calculations of compensation.[12]

The difficulty seems to stem from the fact that contributory fault had not been sufficiently regulated, leaving a great deal of discretion for tribunals in rendering decisions. This allows a tribunal to factor in the claimant's misconduct pursuant to its own unbounded wisdom.

9 ibid., Paragraph 8.

10 For instance, Venezuela, Bolivia and Indonesia have, at least, terminated almost half of their respective bilateral investment treaties (BITs). Many countries have also stipulated their intention to leave the Energy Charter Treaty (ECT).

11 UNCITRAL, Working Group III, 43rd session, Paragraphs 64–65, ('the current practice of assessment of compensation shows a high degree of complexity, which may partially be due to the lack of regulation of the main parameters of damage calculation as well as different factual circumstances. This complexity contributes to increase in costs of ISDS proceedings and may negatively impact the correctness, consistency and predictability of awards related to the calculation of compensation').

12 ibid, Paragraph 68

Irrespective of the great deal of discretion that tribunals enjoy, as a rule, a tribunal should first investigate the treaty clause on contributory fault, as it is the primary source of law in investment arbitration. In practice, however, there are not many provisions regarding the existing treaties on contributory fault.

The tribunal can then apply Article 39 of the Draft articles on Responsibility of States for Internationally Wrongful Acts (the ILC Draft articles), as well as rely on precedents. Article 39 provides guidelines on what is considered as contributory fault: '[i]n the determination of reparation, account shall be taken of the contribution to the injury by wilful or negligent action or omission of the injured State or any person or entity in relation to whom reparation is sought.'[13]

Contributory fault is a defence that generally authorises a tribunal to reduce damages as a result of a claimant's misconduct. A contributory fault is not to be confused with mitigation duty, as the former is committed prior to the respondent's breach while the latter is performed after.

For a host state to successfully assert defences on contributory fault, it must establish that the claimant's own act or omission (misconduct) (1) is wilful or negligent and (2)contributes to its own loss. This defence must also be subjected to an analysis of causation. After assessing all these elements, the tribunal will then decide the scale of the decrease to the damages or whether the host state's liability is precluded entirely because of the claimant's misconduct.

To date, tribunals have reduced investors' claims because of the claimants' own misconduct. The types of misconduct vary and can be classified as follows:

a investor's provocation on the host country's breach of treaty: for example, in the *Occidental* case, the tribunal determined that the claimant contributed to 25 per cent of its own injury because it breached a contract.[14] The investor's breach later triggered Ecuador to issue the Caducidad Decree, which amounted to a breach of investment treaty.

b investor's mismanagement of risks: in *Maffezini*, the tribunal viewed that investors must appreciate business risks inherent in any investment, and that Spain 'cannot be held responsible for the losses Mr. Maffezini may have sustained any more than would any private entity under similar circumstances'.[15] In *MTD*, the tribunal reduced the damages because the investors failed to consider the inherent business risk[16] and that they 'should bear the consequences of their own actions as experienced businessmen'.[17]

c investor's illegal activity: in the *Copper Mesa* case,[18] the tribunal reduced the damages by 30 per cent because of the claimant's illegal activity of using armed men to fire and spray mace at civilians.

13 Draft articles on Responsibility of States for Internationally Wrongful Acts (the ILC Draft articles), Article 39.

14 *Occidental Petroleum Corporation and Occidental Exploration and Production Company v. Republic of Ecuador (II)*, ICSID Case No. ARB/06/11, Award, 5 October 2012, Paragraph 687.

15 *Emilio Agustín Maffezini v. The Kingdom of Spain*, ICSID Case No. ARB/97/7, Award, 13 November 2000, Paragraph 64; see also UNCITRAL, Working Group III, 43rd session, Paragraph 58.

16 *MTD Equity Sdn Bhd and MTD Chile SA v. Chile*, ICSID Case No. ARB/01/7 (*MTD*), Award, 25 May 2004, Paragraph 245.

17 ibid., Paragraph 178.

18 *Copper Mesa Mining Corporation v. Republic of Ecuador*, PCA Case No. 2012-02, Award, Paragraph 6.102.

In contrast, tribunals have also denied host state's pleas to reduce damages. In the *Glencore* case, the tribunal held that Colombia had breached the treaty and rejected Colombia's argument to reduce the damages by 75 per cent.[19] In *Caratube*, the tribunal adopted a restrictive approach that mere contribution to causation itself is insufficient in the absence of wilful or negligent, reproachable claimant's behaviour that materially contributed to the damages.[20] Applying this approach, while the tribunal acknowledged that the claimant's performance was 'sub-standard' and perhaps had some degree of contribution, it was not a material breach of contract;[21] therefore, no reduction was awarded. In *Bear Creek*, the tribunal also concluded that there was no contributory fault.[22] A dissenting arbitrator, however, reduced the damages by 50 per cent on the basis that the investor's contribution was 'blindingly obvious'.[23]

An issue regarding contributory fault is whether it empowers tribunals to completely deny damages. In *Burlington*, the tribunal acknowledged this as it viewed that a claimant's conduct may justify an exclusion or reduction of damages if it contributed to the injury.[24] Regarding this issue, the commentary to Article 39 of the ILC Draft articles suggests that contributory fault is focused on situations that in national law systems are referred to as 'contributory negligence', 'comparative fault' and 'faute de la victim'.[25] For instance, under English law, the Law Reform (Contributory Negligence) Act 1945 provides that a claimant's claim for damages 'shall not be defeated by reason of the fault of the person suffering the damage, but . . . shall be reduced to such extent as the court thinks just and equitable'.[26] Under other legal systems, however, a claimant's contribution to its own loss does not exclusively lead to reduction; rather, it also allows a dismissal of a claim for damages.[27]

In the sphere of investment treaty arbitration, the reduction and exclusion of damages are governed by different but interrelated provisions. The tribunal in *Burlington* deemed that Article 39 of the ILC Draft articles must be read in conjunction with Article 31.[28] Article 39 is a provision that accommodates the reduction of damages, but if the degree of the investor's contribution to the injury reaches a certain level, there will be no reparation given (that situation will be covered by Article 31).[29]

In this regard, analysis is needed to ascertain whether the wrongful act is a proximate cause[30] to the damage and whether the damage is too remote or consequential to be subject to

19 *Glencore Finance (Bermuda) Ltd. v. Plurinational State of Bolivia*, PCA Case No. 2016-39, Final Award, Paragraph 1686.

20 *Caratube International Oil Company LLP and Devincci Salah Hourani v. Republic of Kazakhstan (II)*, ICSID Case No. ARB/13/13, Award, 27 September 2017, Paragraphs 1191–1192.

21 ibid., Paragraph 1193.

22 *Bear Creek Mining Corporation v. Republic of Peru*, ICSID Case No. ARB/14/21, Award, 30 November 2017, Paragraphs 565–569.

23 ibid., Partial Dissenting Opinion of Professor Philippe Sands QC, 30 November 2017, Paragraph 6.

24 *Burlington Resources, Inc v. Republic of Ecuador*, ICSID Case No. ARB/08/5, Decision on Reconsideration and Award, 7 February 2017 (*Burlington*), Paragraph 572.

25 ILC Draft commentary on Article 39, Paragraph 1 of the commentary.

26 Law Reform (Contributory Negligence) Act 1945, Article 1(1).

27 See, e.g., Principles of European Tort Law, Article 8:101; United Nations Convention on Contracts for the International Sales of Goods, Article 80.

28 *Burlington*, Paragraph 574.

29 Commentary to the ILC Draft articles, footnote 627, '[i]t is possible to envisage situations where the injury in question is entirely attributable to the conduct of the victim and not at all to that of the "responsible" State.'.

30 Proximate cause is relatively narrower in scope than factual cause as it works to limit or preclude one's liability owing to certain policy considerations.

reparation.[31] In *Micula*, the tribunal considered that the degree of the investor's contribution (not paying the tax) had reached the necessary level to serve as a basis to exclude the country's liability.[32]

Other main issues with contributory fault are predictability and coherency. It is hard to predict the considerations that tribunals will wield and the extent of the reduction that a tribunal will apply to the claims of damages (to date, the range is from 20 per cent to 50 per cent).[33] This is because either (1) the treaty is not instructive on the matter, therefore leaving the tribunal with extensive discretion, or (2) the investor's misconduct and the country's wrongful act are often incommensurable.[34]

The issue of coherency, including the lack of elaboration, is also a concern. For instance, in *MTD*, there is a lack of elaboration on the tribunal's reasoning for reducing 50 per cent of the damages.[35] The annulment committee viewed that lack of reason as insufficient as a ground to annul the award.[36]

Predictability and coherency are essential points in the evolution of ISDS. While the current trend of reform may not immediately give rise to predictability of the range of reduction percentages of tribunals (because of the incommensurable nature of the state's breach and an investor's misconduct), a country's rebalancing efforts can have a significant increase on investors' standards of conduct in managing their investments and, therefore, the direction of the tribunal's decisions on contributory fault.

In this regard, the ongoing reform includes developments regarding a state's efforts to clarify what it wants from the new investment treaties. In recent years, states have gradually abandoned the old-generation treaties[37] and have focused on prioritising on critical sectors such as environment, social, health and human rights in either the preamble or body of the treaty, specifying those sectors as the main purposes of entering the investment treaties.[38] For instance, the South African Development Community Model Bilateral Investment

31 Commentary to the ILC Draft articles, Article 31, Paragraph 10.

32 *Ioan Micula, Viorel Micula and others v. Romania (I)*, Award, 11 December 2013, Paragraphs 1154–1155.

33 *Yukos Universal Limited (Isle of Man) v. The Russian Federation*, PCA Case No. 2005-04/AA227, Final Award, 18 July 2014, Paragraph 1637.

34 *MTD*, Annulment Committee, Decision on Annulment, 21 March 2007, Paragraph 101.

35 *MTD*, Award, 25 May 2004, Paragraph 246.

36 *MTD*, Annulment Committee, Decision on Annulment, 21 March 2007, Paragraph 101.

37 According to the United Nations Conference on Trade and Development (UNCTAD), 'The International Investment Treaty Regime and Climate Action', September 2022, p. 3, some 3,300 treaties were concluded between 1959 and 2009, representing 85 per cent of all such treaties being signed. About 2,300 are still in force, and these old-generation treaties do not contain explicit provisions to preserve state's regulatory space for environmental protection or climate action.

38 Many countries have announced their intentions to leave the ECT because of the environmental targets in the Paris Agreement, including Poland, Spain, Luxembourg, France, Slovenia, Germany and the Netherlands. In the proposal to revise the ECT, there is notion to strengthen a state's right to regulate in accordance with the Paris Agreement on climate change. As at 22 March 2023, the Depositary of the ECT, Portugal has confirmed receipt of written withdrawals from France, Germany and Poland. Climate Change Counsel reported that ECT investor protections are drafted broadly, leaving it up to arbitral tribunals to set the boundaries (Climate Change Counsel, 'The Energy Charter Treaty, Climate Change and Clean Energy Transition: a Study of the Jurisprudence', 2022, p. 74). States may find that, to ensure certainty, withdrawal or revision is necessary.

Treaty (the SA Model BIT),[39] the Nigeria–Canada bilateral investment treaty (BIT),[40] the Netherlands Model BIT 2019[41] and many others[42] have all added those priorities and inserted explicit obligations for the investor to comply with local or international regulations related to the aforementioned sectors (e.g., various standards of corporate social responsibility, the Organisation for Economic Co-operation and Development's Guidelines for multinational enterprises and Developments and the Responsible Business Conduct standards).[43] The 2020 EU-UK Trade and Cooperation Agreement, the 2019 Myanmar–Singapore BIT and the 2021 Colombia–Spain BIT have added an environmental priority in the preamble.

As states become more vocal about their transitions and priorities in the newly formulated treaties, there will be an increase in the foreseeability requirement on the part of investors on the inherent business and regulatory risks in investing in that country. Further, incorporating explicit legal obligations in the treaty in relation to those sectors will invariably increase more active participation from the investors.

As participation and foreseeability increase, the investors' standard of conduct will rise, which, in turn, increases the possibility of investors' exposure to contribute to their own loss.[44] It may be inevitable that the nexus between the misconduct (e.g., non-compliance and failure to foresee) and the damage will become much closer. It is expected that there will be an increase in the frequency of tribunals deciding contributory fault arguments while taking into account more considerations, to the extent of further reducing risks on the part of the states.

ii Mitigation

In general commercial arbitration, the duty to mitigate does not always arise as parties and tribunals must look on the applicable law; however, in an investment treaty arbitration, this duty is established by the general principles of international law, as confirmed by precedents.

The main reason why this duty is imposed is to encourage efficiency and to minimise the consequences of unlawful conduct (e.g., a breach of treaty).[45] It is the respondent that has the burden of proof to establish that the claimant had failed to conduct mitigation efforts after the state breached the treaty.

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39 The BIT includes clauses such as requiring investors or their investments to comply with environmental and social assessment screening criteria before the establishment of their investment.

40 The preamble and Article 15 states that the core treaty objective is to pursue the promotion of sustainable development goals and that states should not compromise health, safety and environmental standards to attract foreign investments.

41 Article 23 contains a specific contributory fault provision on this, specifying that non-compliance with the United Nations Guiding Principles on Business and Human Rights and the Organisation for Economic Co-operation and Development's Guidelines for multinational enterprises must be taken into account by tribunals when determining the amount of compensation.

42 China-Switzerland Free Trade Agreement 2013, Article 12; Belarus–Hungary BIT 2019, Article 2; Canada-EU Comprehensive Economic and Trade Agreement 2016, Article 8; Morocco–Nigeria BIT 2016, Article 14; US-Mexico-Canada Agreement 2018, Article 24; Canada–Mongolia BIT 2016, Article 14; Morocco–Nigeria BIT 2016, Article 24; Serbia–Turkey BIT 2018, Article 11.

43 UNCTAD, p. 11.

44 UNCTAD, p. 3 states that new generation treaties fare better relatively in safeguarding a state's right to regulate and in incorporating specific provisions on the protection of environment, climate action and sustainable development.

45 *William Ralph Clayton, William Douglas Clayton, Daniel Clayton and Bilcon of Delaware, Inc v. Government of Canada*, PCA Case No. 2009-04. Award on Damages, 10 January 2019 (*Clayton et al.*), Paragraph 204.

As a rule, the tribunal must first observe whether the treaty regulates on the duty to mitigate; otherwise, reference will be made to the general rules of the state's responsibility.[46] This duty is acknowledged as part of the international law rules in *Middle East Cement*, where the tribunal stated that even if the duty to mitigate is not expressly mentioned in the BIT, it is part of the rules of international law.[47]

The duty to mitigate is not a legal obligation that gives rise to responsibility; rather, a failure to mitigate by the injured party may preclude recovery to a certain extent.[48] In this regard, the International Court of Justice in *Gabcikovo-Nagymaros Project* stated that:

> *It would follow from such a principle that an injured State which has failed to take the necessary measures to limit the damage sustained would not be entitled to claim compensation for that damage which could have been avoided.*[49]

In 2019, the tribunal in *Clayton et al. v. Canada* laid out the circumstances that allow the application of mitigation duty: '(i) a claimant is unreasonably inactive following a breach of treaty; or (ii) a claimant engages in unreasonable conduct following a breach of treaty.'[50] It goes further to say the following:

> *The first limb of the mitigation principle concerns the unreasonable failure by the claimant to act subsequent to a breach of treaty, where it could have reduced the damages arising (including by incurring certain additional expenses). The second limb, conversely, concerns the unreasonable incurring of expenses by the claimant subsequent to a treaty breach, which results in increasing the size of its claim.*[51]

The scope of mitigation is also relatively limited as the claimant is not required to perform certain actions that are too speculative in nature[52] or actions that go as far as to undo the injury, such as going through local remedies.[53]

Tribunals have both accepted and rejected reductions of damages. For instance, in *Achmea*, the tribunal accepted that the claimant had conducted its duty to mitigate the losses, stating the following:

> *the suspension (or "hibernation") of its operations in Slovakia was a reasonable response to that situation, and one that does not break the chain of causation and responsibility in this case. The suspension was a reasonable defensive measure, intended to minimise the risk of further losses.*[54]

46 ibid., Paragraph 202.

47 *Middle East Cement Shipping and Handling Co v. Arab Republic of Egypt*, ICSID Case No. ARB/99/6, Award, 12 April 2002, Paragraph 167.

48 Commentary to the ILC Draft articles, Article 31, Paragraph 11.

49 *Gabčíkovo-Nagymaros Project (Hungary/Slovakia)*, Court of International Justice, Judgment of 25 September 1997, Paragraph 80.

50 *Clayton et al.*, Paragraph 204.

51 ibid., Paragraph 205.

52 *Magyar Farming Company Ltd, Kintyre Kft and Inicia Zrt v. Hungary,* ICSID Case No. ARB/17/27, Award, 13 November 2019, Paragraph 427.

53 ibid., Paragraph 214.

54 *Achmea BV v. The Slovak Republic*, UNCITRAL, PCA Case No. 2008-13, 7 December 2012, Paragraph 320.

The tribunal in *EDF* reduced the damages because of the claimant's failure to mitigate, stating the following:

> *It would be patently unfair to allow Claimants to recover damages for loss that could have been avoided by taking reasonable steps. In other words, the injured party must be held responsible for its own contribution to the loss.*[55]
>
> . . .
>
> *By failing to take into account the renegotiation process in the [share purchase agreement], Claimants failed to comply with their duty to minimize damages. Respondent is, thus, not liable for any loss attributable to Claimants' failure to take reasonable steps.*[56]
>
> . . .
>
> *Consequently, the Tribunal considers that an amount equivalent to the 50% of the value of their participation in [Empresa Distribuidora de Energía de Mendoza SA], as evidenced by the 2007 sale, must be subtracted from the amount of damages to be awarded by the Tribunal.*[57]

Similar to contributory fault, mitigation is also under the spotlight of the ongoing ISDS reform, given that treaties' provisions on this matter are scant and also because it is a useful feature to reduce the amount of a claimant's damages as a result of the anchoring effect. This relates to the second limb of circumstances outlined in *Clayton*, in cases where the claimant is barred from inflating the damages with unreasonable expenses.[58]

In modernising investment treaties, it appears that states are conscious of the possibilities of claimants committing unreasonable conduct following a breach of a treaty. In the efforts to steer the course of future cases, states are taking steps to have more control over the substance of the treaty to ensure the reduction of damages because of this unreasonable conduct. Signs of this effort include the 2018 India–Belarus BIT and the 2015 Indian Model BIT, both of which provide a broader range of 'mitigating factors' on which compensation may be reduced, including 'any unremedied harm or damage that the investor has caused to the environment or local community or other relevant considerations regarding the need to balance public interest and the interests of the investor'.[59]

It is projected, therefore, that more detailed provisions on mitigation are to be added in future treaties.

iii Necessity

Generally, states are obliged to protect their nationals' interests, whether it be in the context of health, environment, national security or human rights. A state's measures to preserve these interests often manifest in the form of issuing legislation or decrees.

In the framework of necessity defence, such measures are not enacted in the context of normal day-to-day administrative operation but more as a reaction to abnormal and incidental situations. Coincidentally or deliberately, these measures are often enacted at the expense of the interests of a particular group, including investors. In this context, states prioritise their

55 *EDF International SA, SAUR International SA and León Participaciones Argentinas SA v. Argentine Republic*, ICSID Case No. ARB/03/23, Award (*EDF*), 11 June 2012, Paragraph 1301.

56 ibid., Paragraph 1310.

57 ibid., Paragraph 1312.

58 *Clayton et al.*, Paragraph 204.

59 India–Belarus BIT2018, Article 26.3.

essential interests over other international obligations embedded in the investment treaty, therefore depriving investors of their rights. This then triggers investment claims against the host country.

When facing investment claims, the host country can choose to invoke either the necessity or the security interest exception defence, or both; however, if the state opts to rely on the necessity defence, it must satisfy a high threshold. This high standard exists for several reasons: first, the effect of successfully establishing this defence can ultimately preclude a country from any wrongfulness because of its action; second, the state's measure trumps other international obligations under the treaty.

Necessity is quite an interesting defence because it puts a state's action on trial. Its existence has been challenged in the past, where Paragraph 10 of the commentary to Article 25 of the ILC Draft articles states the following:

> *In the 'Rainbow Warrior' arbitration, the arbitral tribunal expressed doubt as to the existence of the excuse of necessity. It noted that the Commission's draft article 'allegedly authorizes a State to take unlawful action invoking a state of necessity' and described the Commission's proposal as 'controversial'.*

However, to date, the necessity defence is still intact and is invoked by states at times.

Articles 25 and 27 of the ILC Draft articles, which constitutes customary international law (CIL), govern necessity and its consequence; however, these articles are not initially formed or designed to cover investment arbitration cases. Article 25 and its commentary provide limited grounds for establishing necessity: (1) the country's action is the 'only way'[60] to anticipate or 'safeguard an essential interest' against potential risks, which amount to 'a grave and imminent peril',[61] and (2) the action must not seriously impair an essential interest of other states or the international community.[62] The provisions further regulate that a state cannot rely on the necessity defence if the international obligation (that was allegedly being violated because of its action) excludes it from invoking the necessity defence and in the event that the state contributed to the situation of necessity. These grounds to bar necessity are there to prevent any potential abuse from the acting state.

Article 27 of the ILC Draft articles sets out the consequences of invoking the necessity defence, especially with respect to the compliance status of the state's international obligation and compensation. It prescribes that the state must continue performing its international obligations (e.g., those arising from the investment treaty) after the circumstances precluding wrongfulness cease to exist.

Article 27 also states that the necessity defence is without prejudice to the question of compensation for any material loss caused by the country's action. Many tribunals agreed that the duty to provide compensation is at least not precluded in times of necessity; the *EDF* tribunal stated that 'successful invocation of the necessity defense does not per se preclude payment of compensation to the injured investor for any damage suffered as a result of the necessity measures enacted by the State'.[63]

60 Commentary to the ILC Draft articles, Article 25, Paragraph 15.

61 ibid.

62 Commentary to the ILC Draft articles, Article 5, Paragraph 17.

63 *EDF*, Paragraph 1177.

The ILC Draft mandates that the state should not be the sole judge over the action or measure in question.[64] From this, the first crucial issue to be resolved is how an arbitral tribunal can manage hindsight. In deciding whether a country's action is justified, a tribunal will have to put itself in the shoes of a state. This will be particularly challenging if the tribunal has already seen how the country's action and the peril ran their course. This is in contrast with a state that had to deal with uncertainties when taking the measure. Hindsight presents a risk of perceiving past events to be more predictable than they were, hence the potential bias.

The risk of hindsight may creep into the tribunal's decision-making process compared to the state's. Unlike a state when it took the measure, any tribunal will be exposed to all materials that have been vetted, redesigned, restructured and reframed for the sole purpose of the arbitration. This will generate a different quality of materials (which tend to be different and better in many aspects, such as in terms of coherency, validity and legitimacy) to those that the state had to rely on when it issued the measure. This different, and arguably 'better', quality of information can significantly downplay the difficulties that the state experienced, which can mistakenly suggest that the state could have easily opted for a better measure.

Hindsight must also be prevented from affecting the assessment of whether the state's action is 'the only way'. A tribunal is guided to consider that 'any conduct going beyond what is strictly necessary for the purpose will not be covered'.[65] In this regard, there may be differences regarding what may be considered a 'necessary' means to solve a particular situation, let alone what is 'strictly necessary'. For instance, economic experts often have different opinions on how a country should have appropriately responded to an economic crisis. One camp states that a drastic measure is strictly necessary, while the other believes that smaller action will suffice. The former would say that a smaller measure will not be appropriate as not only does it merely operate to delay the inevitable, but it will also likely cause a series of even graver problems that could have been avoided had the drastic measure has been taken.

In addition, when the crisis occurs, and the country's action is brought before an arbitral tribunal, experts will produce scientific and robust studies on the actions that should have and should not have been taken. A rigorous comparison between the already taken action and alternatives to the state's actions is inevitable. In this exercise, there is a risk of hindsight bias in leaning towards a more 'obvious' alternative way that received a robust justification over the state's action that was already taken (in some cases, a country's measure may be less convincing because it was taken in haste to respond to an emergency and because of the need to make political, social and economic compromises).

Apart from issues regarding hindsight, other issues also arise from the requirement to judge the state's action based on 'the evidence reasonably available at the time'.[66] First, unlike an arbitral tribunal, in responding to an actual public emergency, state officials are exposed to tremendous political, social, organizational and economic pressure, whether directed towards the states or themselves personally. The effects of these factors may not be too apparent during arbitration proceedings and can often be overlooked. Secondly, state officials often base their actions on highly sensitive and confidential data that cannot be revealed to entities outside the country (especially in matters of national security). At times, states must act based on decisive, intelligent information that may lead to catastrophic consequences, or at least be inadmissible, if presented as evidence before an arbitral tribunal.

64 Commentary to the ILC Draft articles, Article 25, Paragraph 11.

65 ibid., Article 25, Paragraph 15.

66 ibid., Article 25, Paragraph 16.

iv Security interest exception

Some commentators have stated that the security exception clause includes elements of the necessity defence. Although there is some similarity between the two concepts, at least to the extent that they require proving essential interest, the necessity defence is not fully covered by the security interest exception clause; there are key differences between the two.

While necessity is governed by Article 25 of the ILC Draft articles, which constitutes CIL, the security interest exception is embodied as an express clause in the investment treaty.[67] Necessity is a defence for the host country to preclude its wrongfulness, while the security interest exception can be viewed as a means of limiting the scope of the investor's protection under a treaty.

Regarding the security interest exception, the *CMS* annulment committee decided that once the requirements of the exception clause are met, the treaty's substantive protection is not applicable to the investor.[68] This means that there will be no breach of the treaty[69] because the subject matter falls outside the ambit of the treaty; however, by contrast, necessity is a defence that is only relevant once it has been decided that there has otherwise been a breach of the treaty's obligation.[70]

A question then arose on how exactly, in terms of hierarchy, these two concepts should be argued before an arbitral tribunal. On this, examination of CIL's necessity defence is made only insofar as to assist with the interpretation of the investment treaty.[71] It is necessary for a tribunal to first and foremost apply the provisions of the investment treaty in light of the agreement between the parties[72] because the consent to submit to international dispute resolution is predicated on the very terms of the treaty.[73] The tribunal can subsequently examine the necessity defence if it determines that the requirements of the security exception are not satisfied.[74] The *Sempra* annulment committee confirmed the position by rejecting the tribunal's determination that CIL's necessity defence 'trumps' the security exception clause in providing the legal norm to be applied.[75] The committee decided that the tribunal failed to conduct its review on the basis that the legal applicable legal norm is to be found in the security exception clause.[76]

67 *CMS Gas Transmission Company v. The Republic of Argentina*, ICSID Case No. ARB/01/8 (*CMS*), Decision of the ad hoc Committee on the Application for Annulment of the Argentine Republic, 25 September 2007, Paragraph 130, where the committee stated that the security exception requirements are different from those under customary international law as codified by Article 25 of the ILC Draft articles.

68 ibid., Paragraph 129.

69 ibid., Paragraph 133.

70 ibid., Paragraph 129.

71 *Continental Casualty Company v. Argentine Republic*, ICSID Case No. ARB/03/9 (*Continental Casualty*), Final Award, 5 September 2008, Paragraph 168.

72 *Sempra Energy International v. Argentine Republic*, ICSID Case No. ARB/02/16 (*Sempra*), Decision on the Argentine Republic's Application for Annulment of the Award, 29 June 2010, Paragraph 189.

73 ibid.

74 *CMS*, Decision of the ad hoc Committee on the Application for Annulment of the Argentine Republic, 25 September 2007, Paragraph 134.

75 *Sempra*, Decision on the Argentine Republic's Application for Annulment of the Award, 29 June 2010, Paragraph 208.

76 ibid., Paragraph 209.

In the past decade alone, states have been accelerating their efforts to incorporate security interest exceptions in their treaties. This acceleration is mainly driven by several factors: first, necessity is not a straightforward defence to establish as it holds a very high threshold that has been quite set in stone by customary international law; second, there are intricate issues surrounding necessity.

Although the two defences can be similar, the threshold to invoke the security exception clause tends to be lower. For instance, in *LG&E*, the tribunal did not apply CIL's necessity standard on 'the only way' requirement as the security interest exception clause contains a different standard (it 'refers to situations in which a State has no choice but to act').[77] The tribunal conceded that although Argentina's action was not the only available means to respond to the economic crisis (as a country may have several responses at its disposal), it was a necessary and legitimate measure.[78]

Besides the lower threshold, it is suggested that one feature of the security interest exception clause that can distinguish it from CIL's necessity defence is that, if triggered, there should be no duty of compensation. The *CMS* annulment committee stated the following:

> *the Tribunal should have considered what would have been the possibility of compensation under the BIT if the measures taken by Argentina had been covered by Article XI. The answer to that question is clear enough: Article XI, if and for so long as it applied, excluded the operation of the substantive provisions of the BIT. That being so, there could be no possibility of compensation being payable during that period.*[79]

Having an exception clause that covers the state's measure, however, does not necessarily guarantee the exclusion of the compensation duty. In *Eco Oro*, a claim arose with regard to the Canada–Colombia Free Trade Agreement (FTA). The tribunal considered that Colombia had breached Articles 805 and 811 of the FTA. The tribunal considered Colombia's environmental exception defence but viewed that the exception was a defence in the merits in response to whether it would exclude the requirement to pay compensation once the liability had been established. The tribunal decided that the exception would not operate to exclude the respondent host state's obligation to pay compensation, notwithstanding express statements by the treaty parties, including Canada's non-disputing party's submissions. The tribunal stated the following:

> *had it been the intention of the Contracting Parties that a measure could be taken pursuant to Article 2201(3) without any liability for compensation, the Article would have been drafted in similar terms as Annex 811(2)(b), namely making explicit that the taking of such a measure would not give rise to any right to seek compensation under Chapter Eight.*[80]

77 *LG&E Energy Corp., LG&E Capital Cor. and LG&E International Inc v. Argentine Republic*, ICSID Case No. ARB/02/1, Decision on Liability, 3 October 2006 (*LG&E*), Paragraphs 239–240.

78 ibid.

79 *CMS*, Decision of the ad hoc Committee on the Application for Annulment of the Argentine Republic, 25 September 2007, Paragraph 146.

80 *Eco Oro Minerals Corp v. Republic of Colombia*, ICSID Case No. ARB/16/41, Decision on Jurisdiction, Liability and Directions on Quantum, 9 September 2021, Paragraph 829.

In this respect, the scope of the exception clause will determine whether the duty of compensation is intact even when the clause is triggered. For instance, Article 24 of the Energy Charter Treaty on the security interest exception states that the clause is not applicable to the compensation provision in Article 12. This provision seems to be designed to protect investors in that it retains the possibility to request compensation even when the country's measure is in effect.

Another aspect worthy of attention is the development of tribunals' involvement to review states' measures in relation to the security exception. This relates to CIL's necessity requirement that a country cannot be the sole judge of its action. The development starts with efforts to impose certain limitations on the extent of an arbitral tribunal's jurisdiction by phrasing 'self-judging' language in the exception clause. The rationale of self-judging is to affirm a country's power to deem on its own what is necessary to respond to public emergencies that have occurred in their territories.

The question on whether a host country can rely on a self-judging exception clause depends on how the clause is worded in the treaty. The *Sempra* tribunal decided that the security exception is not self-judging,[81] reasoning that 'not even in the context of GATT Article XXI is the issue considered to be settled in favor of a self-judging interpretation, and the very fact that such article has not been excluded from dispute settlement is indicative of its non-self-judging nature'.[82] Further, the *Continental Casualty*,[83] *CMS*,[84] *LG&E*[85] and *Enron*[86] tribunals all agreed to the non-self-judging nature of security exception clauses. In 2019, a World Trade Organization panel also considered the General Agreement on Tariffs and Trade's Article XXI(b) security interest exception and decided that it is not non-justiciable.[87]

However, many treaties include a self-judging phrase in their security exception clause. In *Continental Casualty*, the tribunal acknowledged that the US Model BIT 2004 adopts this view.[88] Article 18 of the Canada Model Foreign Investment Promotion and Protection Agreement 2014 also contains the wording 'it considers necessary', which implies the existence of a self-judging clause. Nevertheless, even if the security exception clause is self-judging, it may not completely oust tribunals' jurisdiction to review the country's measure. The result of establishing a self-judging clause appears only to put some limitation on the power of tribunals to assess the merits of a state's action.

On this issue, *Eco Oro*, *Sempra* and other cases seem to offer guidance to states in drafting future treaties, providing suggestions on how to ensure greater clarity on the scope of the security exception clause. This provides particular insight regarding to how states will modify their treaties in the future (e.g., by excluding compensation or jurisdiction).

81 *Sempra*, Award, 28 September 2007, Paragraph 388.

82 ibid., Paragraph 384.

83 *Continental Casualty*, Final Award, 5 September 2008, Paragraph 188.

84 *CMS*, Award, 12 May 2005, Paragraph 359.

85 *LG&E*, Paragraphs 212–213.

86 *Enron Creditors Recovery Corporation (formerly Enron Corporation) and Ponderosa Assets, LP v. Argentine Republic*, ICSID Case No. ARB/01/3, Award, 22 May 2007, Paragraph 339.

87 World Trade Organization,' Russia – Measures Concerning Traffic in Transit', 5 April 2019, Paragraphs 7.102–7.103.

88 *Continental Casualty*, Award, Paragraph 186.

Tribunals' rejection of self-judgement that was predicated on the lack of explicit wording to exclude their jurisdiction may have triggered recent innovations. This is manifested, for instance, in the India–Kyrgyzstan BIT 2019, which contains a non-justiciable clause, as follows:

> *Where the Party asserts as a defence that conduct alleged to be a breach of its obligations under this Treaty is for the protection of its essential security interests protected by Article 33, any decision of such Party taken on such security considerations and its decision to invoke Article 33 at any time, whether before or after the commencement of arbitral proceedings shall be non-justiciable. It shall not be open to any arbitral tribunal constituted under Chapter IV or Chapter V of this Treaty to review any such decision, even where the arbitral proceedings concern an assessment of any claim for damages and/or compensation, or an adjudication of any other issues referred to the Tribunal.*[89]

The same provision also exists in Article 6.12(4) of the India–Singapore Comprehensive Economic Cooperation Agreement, which states that the security exception is non-justiciable.

In the immediate future, there is much room for similar security exception clauses to proliferate. The United Nations Commission on Trade and Development reported that only 15 per cent of treaties include exception clauses. According to UNCTAD:

> *Most of these [international investment agreements] grant covered investors direct access to international arbitration in case of treaty violations. Some 15 per cent of them include exceptions that could help countries ward off ISDS claims related to emergency measures taken for the protection of essential security interests.*[90]

One expectation is for states to remedy and insert wording into treaties to limit the jurisdiction of tribunals to a certain extent; however, only time will tell the extent of the impact of such wording.

It is crucial to strike a balance on the scope of the security exception with regard to whether the state's action is reviewable by a tribunal. Naturally, states will wish to insert strong wording to oust the jurisdiction of tribunals; however, if an arbitral tribunal cannot review a country's action, it may raise investors' concerns about the proper checks and balance forum, although the host country's local court will be one of the potential forums in which to conduct the review. Nevertheless, investors may have a lower level of confidence if they have to litigate before a local forum instead of proceeding before an arbitration tribunal outside the host country's jurisdiction.

III CONCLUSION

The outlook on contributory fault and mitigation is that there will be gradual improvement in predictability and coherency. In the future, tribunals are expected to have to factor in more considerations when apportioning the liability of the parties. This is because of continuing efforts to involve and integrate investors to even deeper roles to help states achieve their targets on critical sectors, such as the environment, health, social issues and human rights.

89 India–Kyrgyzstan BIT 2019, Annex 1, Paragraph b(ii).

90 UNCTAD, p. 2.

Further, given the rebalancing efforts by states, there is a general sense that there will likely be an increase in investors' standard of conduct and, conversely, a reduction in states' risks in relation to damages claims (especially claims for large amounts).

Only 15 per cent of existing investment treaties have a security interest exception clause.[91] Consequently, states that will be involved in future investment arbitrations arising from older generation treaties are projected to rely more on the necessity defence. This can be problematic given the great pressure on states to achieve modern ambitious targets in critical sectors while being forced to resort to CIL's old necessity requirements under Article 25 of the ILC Draft articles, which were not designed for investment arbitration cases.

States are still trying to strike the right balance in security interest exception clauses, aiming to ensure the smooth flow of foreign direct investment while maintaining their right to regulate. In these efforts, the expectation is that the issue of self-judgement will be further experimented and tweaked, either to impose limitations on tribunals' scope of review of the state's action or to completely exclude the tribunals' jurisdiction.

91 ibid.