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The Legal Consequences of Corruption in International Arbitration: Towards a More Flexible Approach?

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The legal consequences of a breach of a contract tainted by corruption are better understood through a hypothetical:

> Contractor A of country X enters into negotiations with B, the Minister of Economics and Development of country Y, with a view to concluding an agreement on a large infrastructure project ("the Contract"). B requests the payment of a "commission" of 7.5% of the contract price in order to conclude the Contract. A pays the requested "commission" and the Contract is concluded. After A has fulfilled all of its obligations under the Contract, a new Government comes to power in country Y and the new Minister of Economics and Development, invoking the payment of the "commission", refuses to pay the remaining contract price [see Comment 2, Illustrations 2, Art. 3.3.2. UNIDROIT Principles 2010].

In such scenario, arbitrators are requested to answer a straightforward question: Is Contractor A entitled to any legal remedy?

The Traditional Approach

In both the civil law and the common law systems, it is a well-settled principle of law that no judicial remedy may be granted when the claim arises from an illicit contract.

The idea that it is not possible to recognize the existence of rights arising from an illegal act finds its roots in Roman law, where this principle was summarized in the famous Latin maxim: "*ex turpi causa non oritur actio*".

This principle has been widely accepted in international arbitration as well.

To put it in an overly simplified fashion, it is possible to say that, if corruption is established in an International Commercial Arbitration proceeding, the contract is declared "invalid" and "void" and no legal remedy is granted to the claimant [*see*, e.g., ICC Case No. 15668, Award dated 23 March 2011].

On the other hand, if corruption is established in an Investment Treaty Arbitration, either *a)* the

arbitral tribunal declines its jurisdiction [*see*, e.g., *Inceysa Vallisoletana S.l. v. Republic of El Salvador*, ICSID Case No. ARB/03/26] or *b)* the claim is considered inadmissible [*see*, e.g., *Phoenix Action Ltd. v. The Czech Republic*, ICSID Case No. ARB/06/5].

The Consequence of the Traditional Approach

Given the above, a very material consequence derives: «Where *both* the claimant and the respondent are blameworthy, the respondent will invariably be in the stronger position» [*see* R. Kreindler, Competence-Competence in the Face of Illegality in Contracts and Arbitration Agreements, 433 (2013)].

Accordingly, as a result of the respondent successfully triggering the "illegality defense", arbitral tribunals systematically exonerate him from any contractual obligation (even in a case where he has promoted and/or actively participated in the corruption scheme).

In view of the exceptional practical importance of the described legal effect (encapsulated in the Latin maxims: "*In pari causa turpitudinis melior est condicio possidentis"* and "*In pari delicto potior est conditio possidentis*"), it is of paramount importance to understand its rationale.

The Rationale of the Traditional Approach

As stated by Lord Mansfield in the notorious English contract case *Holman v. Johnson* (1775), what justifies that the respondent has always an advantage is the fact that he is in the position of respondent "accidentally".

In other words, if the claimant and respondent were to change sides, and the respondent was to bring his action against the claimant, the latter would then have the advantage of the "illegality defense".

It must be noted that this rationale takes for granted a fundamental assumption: ex-ante (at the time when they enter into the corruption scheme) parties to the contract do not know whether they will be acting as claimant or as respondent.

More explicitly, the traditional approach implies a *symmetrical scenario*, where parties may end up in either of the two positions and, therefore, cannot opportunistically anticipate whether they will be in the position of freely walking away from the contract thanks to the use of the "illegality defense".

The Problem of the Traditional Approach in Asymmetrical Scenarios

In light of the above considerations, it is apparent that the traditional approach (*In pari delicto potior est conditio possidentis*) does not create the right incentives in those cases – *asymmetrical scenarios* – where one party knows ex-ante that he will invariably be in the position of respondent.

Knowing from the outset that only the other party is in the position to commence an arbitration represents an incentive for the future respondent to promote a corruption scheme in order to establish in advance the "illegality defense".

This is the case in Investment Treaty Arbitration, where the host State always acts as respondent: Contrary to the rationale of *Holman v. Johnson* (1775), in Investment Treaty Arbitration the host

State is not in the position of respondent “accidentally” but “structurally”.

It is therefore evident that the traditional approach – according to which parties should be left where they stand and no legal remedy should be granted to the claimant – results in unsatisfactory and inefficient outcomes in *asymmetrical scenarios*, where the “illegality defense” may represent for the host State an incentive to favor a corruption scheme.

Toward a More Flexible Approach

In order to put the right incentives on both parties (the investor and the host State), arbitral tribunals should consider a more flexible approach, departing from the traditional idea that no legal remedy should be granted to the claimant in case of an illegal activity.

Accordingly, some arbitral tribunals have contemplated the possibility of recognizing, in favor of the claimant, some sort of legal protection (other than contractual remedies), notwithstanding his participation to a corruption scheme.

In World Duty Free v. Kenya (2006), the arbitral tribunal affirmed that: «illegal contract’s non-contractual legal effects are significant under English law in regard to possible *restitutionary and proprietary consequences*» [*see World Duty Free Company Limited v. Republic of Kenya*, ICSID Case No. ARB/00/7, para. 162].

Also, in Metal Tech LTD v. Uzbekistan (2013), the arbitral tribunal concluded that: «That does not mean, however, that the State has not participated in creating the situation that leads to the dismissal of the claims. Because of this participation, which is implicit in the very nature of corruption, it appears fair that the Parties *share in the costs*» [*see Metal-Tech Ltd. v. Republic of Uzbekistan*, ICSID Case No. ARB/10/, para. 422].

The possibility for an arbitral tribunal to resort to legal remedies other than contractual ones finds significant support in the UNIDROIT Principles 2010, which suggest recognizing restitutionary remedies when reasonable under the circumstances.

According to Comment 1 to Article 3.3.2 UNIDROIT Principles 2010: «Even where as a consequence of the infringement of a mandatory rule the parties are denied any remedies under the contract, it remains to be seen whether they may at least claim restitution of what they have rendered in performing the contract».

According to Article 3.3.2 (1) UNIDROIT Principles 2010: «Where there has been performance under a contract infringing a mandatory rule under Article 3.3.1, restitution may be granted where this would be reasonable in the circumstances».

Conclusions

Going back to the hypothetical scenario described above – in which, after the contractor has fulfilled all of its obligations under the contract, the respondent (invoking the “illegality defense”) refuses to pay the remaining contract price – it seems reasonable to argue that an arbitral tribunal, departing from the traditional approach that denies any legal remedy to the claimant, should consider the possibility of granting an allowance in money for the work done, corresponding to the value of the infrastructure project (i.e., a restitutionary remedy).

The suggested solution not only grants arbitral tribunals enough flexibility to achieve the objective of fairness but it also accomplishes greater efficiency.

By way of conclusion, it is possible to argue from the above considerations that, in case of *asymmetrical scenarios*, in order to avoid wrong ex-ante incentives on the future respondent, the arbitral tribunals should resort to a broader spectrum of remedies.

In particular, when reasonable under the circumstances (e.g., in case of an *asymmetrical scenario*), arbitral tribunals should not be afraid of resorting to non-contractual remedies such as restitutionary remedies and proprietary remedies.

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