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Addressing Issues of Corruption in Commercial and Investment Arbitration

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Chapter 11

The Effects of a Positive Finding of Corruption

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1. This paper explores the effects of an arbitral tribunal finding corruption in the procurement or performance of a contract, or in the making of an investment — corruption being defined as a request or offer of a bribe or any other undue advantage in the public or private sector[1].

2. The consequences of corruption differ significantly between contractual arbitrations, where the tribunal's jurisdiction derives from the arbitration agreement entered into by the parties (A) and investment arbitrations, where jurisdiction arises from an international treaty (B).

A CONTRACTUAL ARBITRATION

3. Corruption can impact contracts in two ways: in some cases the contract is a mere simulation used to provide a veil of legality to corrupt payments (contracts providing for corruption), while in others the contract formalizes a proper business transaction, but the contract was procured by corrupt payments or in the course of its performance one of the parties resorts to corruption (contracts tainted by corruption).

a) Contracts Providing for Corruption

4. Contracts providing for corruption are ancillary agreements that facilitate a separate case of corruption. Parties prepared to incur in corrupt practices often face difficulties in accessing illicit moneys, with which to fund the bribes. Since most parties are audited or supervised entities, a legal cover for the irregular payments must be procured. In this type of situation it is frequently the case that corrupting parties enter into simulated service, brokerage or similar contracts, either directly with the beneficiaries of the corruption, or with intermediaries, who then channel the funds to the final recipients. These sham agreements pretend to formalize non-existing commitments, and to create payment obligations in favour of the counterparty. But in fact there is no *quid pro quo*: no services or goods are actually delivered in exchange for the payment received (or the prices charged for good or services are grossly inflated).

5. In contracts providing for corruption both parties are equally at fault (*pari in delicto*), since both the corrupting and the corrupted party consent in executing a simulated contract, without legitimate purpose, which hides an illicit payment, and both act with full knowledge of the illegality of their transaction.

6. Contracts providing for corruption seem frequent in practice and apparently give rise to high level of contention: most published arbitration awards

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involving corruption arise from this type of arrangements (the most frequent dispute being that the payer repudiates the deal and refuses to pay, and that the recipient sues for the monies promised)[2].

7. In accordance with the principle of separability, the validity of the arbitration clause is not affected by the illegality of the underlying transaction; consequently arbitral tribunals have jurisdiction to decide disputes arising from contracts providing for corruption[3].

Avoidance

8. A contract that provides for corrupt payments is null and void; this is a universal principle of international law[4], one of the few undisputed rules of transnational public policy, and is confirmed by Art. 8 (1) CLCC:

> Each party shall provide in its internal law for any contract or clause of a contract providing for corruption to be null and void.

9. Legal systems use different legal concepts to justify the declaration of voidance: the traditional civil law view is to include corruption in the category of contracts with illicit cause[5]. More modern legislations tend to create a specific provision, declaring contracts that violate legal prohibitions[6] or fundamental principles[7] are null and void. Whichever the legal reasoning, contracts that hide corrupt payments are universally considered null and void. Should a legal system fail to establish this principle, voidance would still derive as a matter of transnational public polic[8]. The law cannot support a simulated contract that pretends to give an appearance of legality to a deeply irregular conduct

The Tribunal's Duty to Investigate

10. Arbitrators have a duty to combat corruption. In many cases the parties who have entered into a contract providing for corruption will arduously deny the illegality; they will allege that the contract is not a sham, but that it remunerates properly performed activities. If there is suspicion that the contract may hide corrupt payments, arbitrators are bound to investigate[9]. If they reach the conclusion that the contract is a sham, they must declare nullity *sua sponte*, no request from the parties being required. The test to be applied is whether the contract served a legitimate purpose, i.e. whether services or goods were actually performed or delivered, and whether they were valued at arm's length — a test easy to describe in words but difficult to apply in the face of non-cooperating parties.

11. A recurring problem is the standard of proof. Historically, tribunals required a high standard of proof — beyond any doubt[10]. In recent times this (erroneous) attitude seems to have been abandoned, tribunals being satisfied with the adequacy of indirect or circumstantial evidence[11] and prepared to use adverse inferences to sanction reticent or obstructive behaviour of one of the parties — plausible evidence of corruption, offered by the party alleging illegality, should require an adequate evidentiary showing by the party denying the allegation[12]. Where an inference is a reasonable conclusion to draw from the known facts, tribunals should be willing to draw such inference to prove allegations of bribery, as they would any other allegation[13].

12. The principle that contracts providing for corruption are inescapably null and void has important consequences for the remedies available to the parties. There are none. No party is entitled to request performance of the corrupt contract[14]. There is also no action for restitution (not even for illicit enrichment) and no action for damages. Both parties are equally at fault. None has the right to successfully challenge the other in arbitration: *ex turpi causa non oritur actio*. This principle may result in apparently unjust consequences: a party who has paid will be unable to recover the amounts disbursed, even if the recipient was perfectly aware of the illegality or has not put the funds to the agreed use. The law accepts this inequitable outcome, in order to further a higher value: the fight against corruption.

b) Contracts Tainted by Corruption

13. The second category includes those contracts tainted by corruption. In this case there is a proper business transaction, which is formalized in an actual contract, which is then duly performed. But the deal is tainted by corrupt payments either at the procurement or at the performance stage: the corrupting party bribes an officer of (or other person related to) the corrupted party, to enhance the chances of procurement or to facilitate the execution of the deal.

14. Well known examples of transactions tainted by corruption which have become public are the *Siemens'* contracts with the Republic of Argentina for the electronic identification of citizens[15]; Siemens was eventually forced to admit in a U.S. investigation that there had been corruption in the procurement, or *World Duty Free's* contract with Kenya for the establishment of duty free shops at Kenyan airports, in which the claimant acknowledged payment of a bribe to the President of Kenya[16]. Other examples are the "free carry" of between 10% and 30% of the value of certain Indonesian infrastructure projects given to local partners in return for their "liaison" services[17].

Liability

15. There is a fundamental difference between contracts providing for corruption and contracts simply tainted by corruption. In the first category parties are *pari in delicto*; in the second not.

16. In contracts tainted by corruption fault lies predominantly with the corrupting party. The corrupted party is not to be blamed: it is unaware of the existence of corruption and does not benefit from it. Its officers (or other related persons), who have not created or added any value to the deal, are the only ones to benefit. Corruption is not only morally odious; it is also highly detrimental to the corrupted party: via inflated prices or worsened conditions the corrupted party is forced to assume the (hidden) additional expense required to fund the bribe; scarce funds are misdirected to enriching well connected individuals, at the expense of the common good (in public contracts) or of legitimate owners (in private contracts).

17. The corrupting party's fault is not reduced by the (alleged or proven) existence of widespread corruption in the recipient country[18]. If procurement of a deal requires corrupt payments, there is only one recipe for would-be offerors to avoid responsibility: abstention.

18. A *caveat*: there may be unusual circumstances when officers of the corrupted party extort payments with threats or violence[19], and there may be situations where the corrupted party knew (or must have known) of the existence of corruption, and did not take any action, incurring in *culpa in vigilando* when supervising its officers and related persons. In such cases tribunals will have to balance the misconduct of both parties[20].

Arbitral jurisdiction

19. Allegations that the contract was tainted by corruption do not affect the tribunal's jurisdiction: in accordance with the principle of separability, the arbitration agreement between the parties remains valid and effective, and the arbitral tribunal retains jurisdiction to adjudicate any civil dispute[21].

Is the Contract Void?

20. Contracts providing for corruption are necessarily and inescapably null and void. The same rule does not apply to contracts tainted by corruption[22].

21. There is no law, no treaty, no rule of transnational public policy which mandates that contracts tainted by corruption be *ipso iure* and *ab initio* null and void[23]. And there is good reason for the inexistence of such rule: avoidance could result in benefit to the corrupting party and prejudice to the innocent party. Assume an infrastructure construction contract is procured by a bribe to a minister of the local government. The government may prefer that the contract be completed, notwithstanding the corruption, albeit at a reduced price, and the constructor should not be permitted to use its own malfeasance to walk away from its obligations.

22. In fact, the proper legal reaction to a contract procured or executed with corruption should be the full protection of the innocent party — and the punishment of the corrupting party. The innocent party must be shielded from the negative consequences of the counterparty's wrongdoing, but it must also have the option to reap the benefits of the contract, if it so prefers. This implies that the innocent party must be offered an array of alternative remedies, depending on the circumstances[24]. And the tribunal's reaction must represent an "appropriate and proportional response to the infringement"[25] — performance or voidance of the contract, or any other appropriate remedy, should be for the innocent party to request and for the tribunal to adjudicate.

Alternatives Available to the Innocent Party

23. As a first alternative an innocent parties, which finds itself embroiled in a contract tainted by corruption, may insist that the contract be performed as agreed, subject to be fully compensated by the corrupting party for all loss and damage suffered. Art. 3 CLCC provides:

> Each Party shall provide in its internal law for persons who have suffered damage as a result of corruption to have the right to initiate an action in order to obtain full compensation for such damage.

The compensation includes "material damage, loss of profits and non pecuniary loss"[26] and will at least amount to the difference between the consideration actually paid or agreed, inflated by corruption, and the proper arm's-length price for the good or services promised or delivered. The corrupting party must have "committed or authorized the act of corruption,

or failed to take reasonable steps to prevent" it, there must be "a causal link between the act of corruption and the damage", and if there are several defendants, they "shall be jointly and severally liable" [27].

24. Compensation for damages covers the additional expense incurred by the innocent party in the past. It does not solve the problem towards the future. This is only achieved if the innocent party is authorized to request from the tribunal an equitable adaptation of the contract, expurgating all terms and conditions affected by the bribery. Is this legally possible? The answer depends on the availability of such a remedy under applicable law[28] and on the difficulties in identifying the precise terms and conditions which, absent bribery, would have been differently agreed. Assuming that both questions can be answered in the affirmative, adaptation of the contract by the tribunal may represent a valuable formula to wipe out the effects of bribery towards the future, while preserving the benefits of the contract.

25. A second alternative available to innocent parties (but not to the corrupting party) upon becoming aware of the corruption, is to request voidance of the contract[29]. Art. 8 (2) CLCC establishes this principle:

> Each Party shall provide in its internal law for the possibility for all parties to a contract whose consent has been undermined by an act of corruption to be able to apply to the court for the contract to be declared void, notwithstanding their right to claim damages.

26. A question which cannot be answered in the abstract, but which is case specific, is whether the proof that one contract has been fraudulently obtained, permits the innocent party to ask for voidance of all existing contracts with the same party[30].

27. If voidance is declared before the contract has been performed, both parties will be exempted from complying with the obligations assumed. If performance of the contract has already commenced (or if performance has been concluded), the innocent party (but not the corrupting party) may ask for restitution, and the tribunal, if it deems it appropriate in the given circumstances, may award such relief[31].

28. Voidance will always comprise the innocent party's right to claim loss for damages, normally limited to its negative interest (i.e. the amount required to restore it to the position it would have been in, if the contract had not been executed)[32].

Actions Available to the Corrupting Party

29. A party that procures or executes a contract incurring acts of corruption forfeits any right to request the support of the legal system to protect its legal position. There is no action for enforcement, avoidance or restitution: *nemo auditur turpitudinem suam allegans*[33]. And when both parties are equally at fault, *potior est conditio defendentis*[34]. The impossibility for the corrupting party to file any action may of course result in an advantage to a respondent who has appropriated a disproportionate benefit from the contract. But this advantage is an ancillary result: the principle of inadmissibility of claims is not established in the interest of the defendant, but of general principles of policy[35]

30. The *nemo auditur* rule can lead to very inequitable results. A corrupting party which has properly performed, but which has not been paid, would

forfeit any right to collect, while the innocent party would receive the goods or services for free. This type of situations gives rise to two open issues:

- The first is whether an action for unjustified enrichment arises, if voidance of the contract provokes an unreasonable enrichment for the innocent party, and the corrupting party suffers a corresponding loss[36],
- The second is whether there should be a *de minimis* rule, which would exclude (or at least mitigate) sanctions where the illegal acts are of minor relevance[37].

B INVESTMENT ARBITRATION

31. The approach to bribery is different in investment arbitrations, where jurisdiction does not derive from a contract, but rather from an investment treaty. In these cases validity of contracts is not the question. The issue is whether an investor who has incurred in corrupt practices when making or performing the investment can still enjoy protection under the relevant investment treaty. And the answer is a clear no.[38] Investment arbitration has initiated and led the movement of zero tolerance towards corruption.

32. Many treaties include a specific requirement that the investment be implemented in accordance with domestic legislation; since bribery is an illicit activity under all legislations, investments procured or performed with corruption do not meet this requirement and the investor's claims become inadmissible for lack of consent by the host state, with the result that the tribunal is deprived of jurisdiction[39].

33. But even if the applicable treaty does not include such specific reference, the requirement that the investor abstain from grave violations of the host state's legal order or of international public policy is a tacit condition, contained in any investment treaty. No state can be understood to be offering the privilege of legal protection to investments made in violation of its laws or of international public policy[40].

34. It is now undisputed that a finding of corruption when making or performing an investment will lead to dismissal of claimant's claims and to a loss of any protection afforded by the treaty[41]. The issue under discussion has shifted from the general principle to its practical application, and more concretely, to the difficulties faced by states when actually trying to prove the existence of corruption[42].

NOTES

1 art. 2 Civil Law Convention on Corruption ("CLCC")

2 Raeschke-Kessler, Hilmar/Gottwald, Dorothee: "Corruption" in "The Oxford Handbook of International Investment Law" (Muchlinski, Peter *et al.* eds.) ("Raeschke-Kessler") p.584, state that out of 36 cases studied, 25 belong to this category; Crivellaro, Antonio: "The courses of action available to international arbitrators to address issues of bribery and corruption", in "Corruzione nazionale e internazionale" (Bonelli, Franco and Mantovani, Massimo eds.), contains an updated list of published cases involving corruption ("Crivellaro").

3 Except if the agreement to arbitrate itself is tainted by corruption; *contra* however Judge Lagergren's famous decision in ICC case 1110; this doctrine today has become obsolete; see Raeschke-Kessler, p.611, Crivellaro p.255

4 Kreindler, Richard: "Die international Investitionsschiedsgerichtsbarkeit und die Korruption", in SchiedsVZ 2010/1 p.3 ("Kreindler"); *Niko v Bangladesh* at 433.

5 See *e.g.* Art. 1.131 French *Code Civile*: *"L'obligation sans cause, ou sur une cause illicite, ne peut avoir aucun effet"*

6 See *e.g.* § 134 BGB: *„Ein Rechtsgeschäft, das gegen ein gesetzliches Verbot verstößt ist nichtig, wenn sich nicht aus dem Gesetz ein anderes ergibt"*

7 PECL 15:101: *"A contract is of no effect to the extent that it is contrary to the principles recognized as fundamental in the laws of the Member States of the European Union"*.

8 Raeschke-Kessler p.600, 609

9 In agreement: Crivellaro p.261

10 See historic case law in Crivellaro p.245, 260, including some rather unfortunate decisions.

11 See ICC Case no. 15.668, *Middle-East agent v European contractor*, award dated 23 March 2011, quoted by Crivellaro p.242. A very convincing approach is that adopted in *Metal-Tech v Uzbekistan*, where the tribunal concluded that the claimant was unable to justify the payments made to fictitious consultants; the tribunal used circumstantial evidence like the amount of the payments, their modalities, the absence of services, the lack of qualification of the consultants, the lack of transparency of the recipient and the connections with public officials in charge of the claimant's investment. The tribunal found this circumstantial evidence sufficient to prove corruption and to deny jurisdiction.

12 *Flughafen Zürich v Venezuela* at 154; see also Crivellaro p.261;

13 Partasides, Constantine: "Proving corruption in international Arbitration: a balanced standard for the real world", ICSID Review, 25/1, p.61.

14 Raeschke-Kessler p.601; Crivellaro p.264.

15 Crivellaro p.247.

16 *World Duty Free v Kenya*; a full list of cases is provided by Crivellaro.

17 Mills, Karen: "Corruption and other illegality in the formation and performance of contracts and in the conduct of arbitration relating thereto," ICCA "International Commercial Arbitration: important contemporary questions", p.293

18 Kreindler p.5-6.

19 For an (alleged) situation of this type see *EDF v Romania*

20 See art. 6 CLCC; see also Kreindler p.9.

21 *World Duty Free* at 187; Raeschke-Kessler p.603

22 This is also the rule under English law, as Ramsey J. said in *Honeywell v Meydan Group* [2014] EWHC 1344 (TCC) at 185: *"It follows that whilst bribery is clearly contrary to English public policy and contracts to bribe are unenforceable, as a matter of English public policy, contracts which have been procured by bribes are not unenforceable"*

23 Raeschke-Kessler p.595

24 PECL 15:102 (2): *"Where the mandatory rule does not expressly prescribe the effects of an infringement upon a contract, the contract may be declared to have full effect, to have some effect, to have no effect or to be subject to modification"*

Unidroit 3.3.1 (2): *"Where the mandatory rule does not expressly prescribe the effects of an infringement upon a contract, the parties have the right to exercise*

such remedies under the contract as in the circumstances are reasonable" Unidroit 3.3.1. (3) gives a number of criteria which the adjudicator may take into consideration.

25 PECL 15:102 (3).

26 Art. 3.2 CLCC.

27 Art. 4 CLCC

28 Raeschke-Kessler p.599

29 see § 139 BGB; art. 15:102 (2) PECL.

30 The issue arose in *Niko v Bangladesh* and the tribunal concluded that the execution of a subsequent contract was not affected by the corrupt procurement of a former agreement, the state, when executing the second contract, being aware of the corruption affecting the first contract.

31 Unidroit art. 3.3.2 (1): *"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"*; in ICC case no. 11.307 (2003) the tribunal took a contractor's admission of bribery made before a local court as irrevocable confession also for purposes of the arbitration, declared the termination of one of the contracts, but dismissed the claims for full restitution, ordering the contractor to only reimburse the balance between payments received and bribe paid by way of a commission to the intermediary; see also Crivellaro p.245.

32 Unidroit art. 3.2.16: *"Irrespective of whether or not the contract has been voided, the party who knew or ought to have known of the ground of avoidance is liable for damages so as to put the other party in the same position in which it would have been if it had not concluded the contract"*

33 *World Duty Free* at 157: *"[B]ribery is contrary to .. transnational public policy. Claims based on contracts of corruption or on contracts obtained by corruption cannot be upheld by this Arbitral Tribunal"*

34 Kreindler p.9

35 *World Duty Free* at 181

36 The issue was left open by *World Duty Free* at 156.

37 Tribunals may have some discretion; see art. 3.3.1 (3) (d) Unidroit and art. 15:102 (3) (d) PECL

38 See for a recent decision *e.g. Flughafen Zürich v Venezuela* at 129-132; emphatically at 153

39 This was the case in *Metal-Tech v Uzbekistan.*

40 See *Plama v Bulgaria,* at 138; *Phoenix v Czech Republic* at 101*; Saur v Argentina* (Decision on Jurisdiction and Liability) at 308.

41 There are several legal routes which support this finding, including lack of jurisdiction, lack of admissibility and the clean hands doctrine, see Kreindler p.6-8, 11-12 and more specifically Kreindler, Richard: "Corruption in international investment arbitration: jurisdiction and the unclean hands doctrine" in LA Franke, p.313.

42 See *e.g. Flughafen Zürich v Venezuela* at 134-155 analyzes the evidentiary difficulties that arise when a municipal criminal court is investigating the same alleged incident of corruption, the burden of proof, the standard of evidence and negative inferences for lack of cooperation of the counterparty.