STATE OBJECTIONS TO THE ILLEGALITY OF INVESTMENT IN INVESTOR-STATE ARBITRATION

Dr
Mohamed Aboubakr Abdelmaqsoud Abdelhadi
Assistant professor of Public law, Faculty of Law
Mansoura University & Sultan Qaboos University

Abstract

Illegality objections in investor-state arbitration raise several issues in jurisprudence. It cantered on the extent to which the state can use the mechanism of illegality objection in domestic courts can justify their failure to accord international protections to an investor by evoking the illegality objection. Similarly, states can use the illegality objection as a defence against claims brought against it by an investor, with the aim of depriving the jurisdiction of an arbitral tribunal due to the illegalities of the contract or its performance. Therefore, the extent to which the illegality objection is a strong defence or whether the state can successfully raise the objection is a matter that requires further research and analysis of the jurisprudential views and judicial principles used by courts in investor-state arbitrations.

The paper discusses the concept of illegality objection, the condition of the legality of investments as the basis of the arbitral tribunal's jurisdiction, as well as the procedural and substantive requirements for illegality objections and the legal effects resulting from accepting illegality objections, through discussing and analysing the jurisprudential issues of the arbitral tribunal's rulings.

Key Words: Corrupt Conduct, Illegality Objections, Investor-State Arbitration, Jurisdiction, Unclean Hands.

الملخص

اعتراضات الدولة على عدم مشروعية الاستثمار في التحكيم بين المستثمر والدولة

تثير الاعتراضات المقدمة من الدولة في التحكيم بين المستثمر والدولة المبنية على عدم مشروعية الاستثمار عدة إشكالات قانونية، تتمحور حول مدى إمكانية الدولة استخدام آلية الاعتراض على عدم المشروعية أمام المحاكم الوطنية كأساس لنفي مسئوليتها في تعويض المستثمر عن الاخلال في منح الحماية الدولية، وكذلك حدود استخدام الآلية ذاتها كدفاع ضد المطالبات المرفوعة من قبل المستثمر وذلك بهدف حرمان هيئة التحكيم من اختصاصها بسبب عدم المشروعية في ابرام العقد أو تنفيذه. لذا، فإن المدى الذي يعد فيه الاعتراض على عدم المشروعية دفاعًا قويًا أو إمكانية نجاح الدولة في إثارة الاعتراض هي مسألة تتطلب المزيد من البحث والتحليل لآراء الفقه والمبادئ القضائية التي تستخدمها المحاكم في التحكيم بين المستثمرين والدولة.

يناقش البحث مفهوم الاعتراض على عدم المشروعية، وشرط مشروعية الاستثمارات كأساس لاختصاص هيئة التحكيم، وكذلك المتطلبات الإجرائية والموضوعية للاعتراضات على عدم المشروعية، والآثار القانونية المترتبة على قبول الاعتراضات المقدم من الدولية حول عدم مشروعية الاستثمار، وذلك من خلال تحليل السوابق التحكيمية في تسوية النزاعات بين المستثمر والدولة.

الكلمات المفتاحية: السلوك الفاسد، الاعتراضات على عدم المشروعية، التحكيم بين المستثمر والدولة، الاختصاص، الأيدي غير النظيفة.

Introduction

Investor-state arbitration entails a system or mechanism of dispute resolution between sovereign states and private investors. The system is built around the Convention on the Settlement of Investment Disputes between States and Nationals of Other States, commonly referred to as the ICSID Convention[1]. Several scholars attempt to trace the roots of investor-state arbitration to when it first emerged. In many cases, it is held that the investor-state dispute settlement first appeared in 1968 bilateral trade agreement between Indonesia and the Netherlands[2]. Since then, over 120 countries have been respondents in one or more cases involving investor-state dispute settlement. In other cases, the roots of investor-state arbitration are traced to the 1965 Washington Convention, which replaced the politically fraught interstate conflicts with a peaceful mechanism of resolving disputes arising from capital investments[3]. However, it is essential to emphasize

[1] Faure M. and Ma W., 'Investor-State Arbitration: Economic and Empirical and Empirical Perspectives' (2020) 41(1) Michigan Journal of International Law 1.
[2] Calvert J., Rommerskirchen C., and Heide A., 'Does Ownership Matter? Claimant Characteristics and Case Outcomes in Investor-State Arbitration' (2022) 27(5) New Political Economy 788.
[3] Resar A. and Cheng T., 'Investor State Arbitration in a Changing World Order' (Brill 2021), 13:27.

that the two concepts have different origins despite investor-state arbitration being primarily built around the ICSID Convention. This caveat explains why the rise of INVESTOR-STATE ARBITRATION is considered a process with two phases, the first involving the ICSID Convention creation and the second phase involving the elicitation of state consent to the investor-state dispute system (ISDS)[1].

Understanding the legal foundations of investor-state arbitration before exploring the illegality objection is essential. The main legal components of investor-state arbitration are three-fold. The first component involves the protection assured by signatory governments to foreign investors and their investments enforceable through international agreements. The second component involves the provision that arbitration enforces the protection following institutional or ad hoc arbitration rules, international conventions, or national arbitral legislation. The third component is the acceptance of the fact that awards of past tribunals are not formally binding, but they remain influential in

[1] John T., 'the Rise of Investor-State Arbitration: Politics, Law, and Unintended Consequences' (Oxford Academic 2018), 1.

the application and interpretation of similar investment agreements[1]. In other words, these components define the contractual expectations of all parties under the defined arbitration laws. Specifically, international investment agreements (IIAs) resemble the ordinary contracts governing the parties' obligations. Most importantly, IIAs present investor-state contracts that express state consent to stated protocols and procedures in investment-related arbitrations.

The past decade has seen an increase in investment tribunals wrestling with investor illegality and corrupt conduct allegations. While much has been written regarding corruption in investment arbitration, there remain massive gaps regarding the treatment of illegality objections in investor-state arbitration[2]. Much has changed since the 2006 case involving Inceysa Vallisoletana and the Republic of El Salvador.[3] There has been observed a trend where states are increasingly objecting to jurisdiction based on alleged violations of their national law[4]. The

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[1] Ibid 15.

[2] Mouawad and others, 'The Illegality objection in Investor-State Arbitration' (2021) 37(1) Arbitration International 57.

[3] Inceysa Vallisoletana S.L. v El Salvador, ICSID Case No. ARB/03/26.

[4] Luttrell S., 'Fall of the Phoenix: A New Approach to Illegality Objections in Investment Treaty Arbitration' (2018) 44(2), University of Western Australia Law Review, 120.

scope of the illegality objections increased after the 2009 case involving Phoenix Action and Czech Republic[1], which ruled that states cannot be deemed to provide access to dispute mechanisms to investment disputes if investments violate the established national laws, even implicitly, when the laws are not expressly stated in the relevant bilateral investment treaty (BIT). The main problem arises from the observation that investment tribunals are now grappling with increasingly complex issues regarding interpreting the requirement of 'in accordance with the law' found in most BITs. Additionally, the illegality objection raises the need to clarify the circumstances under which such objections are valid, such as corruption and other instances deemed violations of the national law.

The importance of this research emanates from criticism facing investor-state arbitrations and the problems involving the interpretation of domestic and international laws regarding investment. The nature of the problem presented above reveals a need for an analytical approach that would lead to practical solutions that help smoothen investor-state arbitrations. The

[1] Phoenix Action, Ltd. v. The Czech Republic, ICSID Case No. ARB/06/5.

number of BITs has grown exponentially without giving rise to a unified and overarching multilateral system. Even so, some observers believe that investor-state arbitration is undeniably inextricably linked to international law[1]. Under such circumstances, jurisdiction issues are bound to arise, which requires clarity on how such issues should be resolved. An analytical approach to the problem of illegality objection in investor-state arbitration helps shed light on the status of legal and judicial principles and underlying legal problems in applying such principles. The analysis should also help recommend courses of action for states and investors when faced with the problem of illegality objection.

This research analyses the legal problem of illegality objection in investor-state arbitration. To achieve this objective, research offers an in-depth discussion of investor-state arbitration and the illegality objection, focusing on various types of illegality. Illegality objections are also examined alongside the issues of judicial principles and approach to jurisprudence. Based on this

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[1] Bruno Rodrigues, 'Treaty Interpretation in Investor-State Arbitration' (2020) 17(65) Revista Brasileira de Arbitragem.

analysis, the research will make several recommendations on balancing competition and transparency in government procurement. Before analysing the judicial principles and approaches to jurisprudence, a case study will be presented to set the foundation for analysis.

This study is analytical research that evaluates information and facts relative to the research being conducted. Analytical research seeks to identify the causes and mechanisms underlying the research problem to develop new ideas or solutions to the problem. In this case, the analytical approach is designed to critically examine facts and information revolving around the issue of illegality objection and find solutions that address the underlying legal problems. Specifically, the research will rely on the textual analysis of legislation and other legal texts used in investor-state arbitration. The research also uses a case study design because a real-life case sets the context and basis for the research. The selected case for this research is the 2009 Phoenix Action, Ltd. v. The Czech Republic due to its significance to investor-state arbitrations, precisely because it opened doors to many illegality objections in cases brought against states. This

case should help explore issues of judicial principles and approaches to jurisprudence.

The article is structure into four sections. The study will first set out Concept of Illegality Objection. Section two explores Typologies of Illegality Objections, as the requirement of legality of investments is the basis of the arbitral tribunal's jurisdiction. The third chapter will be devoted to the Case Law of Illegality Objections through discussion and analysis of jurisprudential issues of arbitral tribunal awards. Lastly, the paper examines considerations for the jurisprudence of illegality objections, distinguishing between illegality objection and counterclaim, as well as procedural and substantive requirements of illegality objections and the legal consequences of accepting illegality objections.

1- Conceptual Framework of Illegality Objection

Determining the conceptual framework of the research topic requires a statement of the Concept of Illegality Objection, as well as the distinction between Illegality Objection and Counterclaim.

1-1- Concept of Illegality Objection

There is no universal legal definition of the concept of "illegality objection" based on the analysed materials in this research. However, the textual analysis revealed two aspects of illegality objection. The first involves objections to jurisdiction, where a state claims that a tribunal does not have jurisdiction because the investments made by a claimant violate the laws of the state. The second aspect is that a state uses the illegality objection as a defence against a claim by a foreign investor seeking to have the case dismissed or denied because of the illegality of the claimant's investment. Either way, states can establish that the illegality of the investment or its performance denies a tribunal the jurisdiction to arbitrate in the conflict. In Phoenix v. Czech Republic, the Czech government successfully used the illegality objection against Phoenix by proving that the company had violated the Czech Republic's domestic laws and that the investment was not made in good faith. The two companies, Benet Praha and Benet Group, were in legal battles in the Czech Republic. Therefore, establishing a foreign company to transfer ownership of assets to a new jurisdiction was illegal.

Today, international investment tribunals frequently face illegality objections from states involved in investor-state arbitration. Modern international investment law can be described as a network of multiple (several hundred) IIAs that seek to attract and promote foreign investment by states. They have majorly emerged as BITs and comprise bilateral and multilateral free trade agreements (FTAs) with investment chapters[1]. The international investment laws are designed to protect foreign investors in various areas, for example, protection from discrimination, assurances of fair and equitable treatment, protection against expropriation, and full protection and security. Under these circumstances, states often find themselves in disputes with foreign investors due to claims of states' non-performance of their obligations under these treaties and agreements. Essentially, many tribunals must address claims by the host country that a foreign investor bribed a government official or engaged in other illegal activity[2]. In such cases, the states represent themselves as victims of the illegal acts that occurred when making the initial

[1] Vera Korzun, 'The Right to Regulate in Investor-State Arbitration: Slicing and Dicing Regulatory Carve-Outs' (2017) 50(2) Vanderbilt Journal of Transnational Law 355.
[2] Reisman D., 'Apportioning Fault for Performance Corruption in Investment Arbitration' (2021) 37(1) Arbitration International 1.

investment. Under such circumstances, the case should be terminated without considering the merits if the illegal activity is proven. Phoenix was proven to have engaged in an illegal activity during the initial investment. Hence, the case was terminated.

To understand the illegality objections, exploring the provisions of 'in accordance with the law' or the 'legality requirements' in investor-state arbitration is essential. A textual interpretation of these provisions should understand the various forms in which they exist and are evoked in BITs and IIAs. Some sources claim that the two provisions were initially introduced into the Treaties of Friendship, Commerce, and Navigation (FCN) and have become a common feature in modern BITs and multilateral instruments. Among the first cases in which an arbitral award was given regarding the legality requirement was the definition of investments in the Italy-Morocco BIT rendered in 2001 in the Salini case[1]. In this case, the Tribunal awarded that the relevant provision referred to the validity of the investment and not its definition, which allowed the disqualification from

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[1] Protopsaltis P., 'Investors' Illegality in Investor-State Arbitration: An Overview of Some Contentious Issues' (2017) RGNUL Student Research Review, 2.

protection investments considered illegal under the national law of the host country. Article 25 of the ICSID Convention does not define investment, leading many to assume that the founders of the Convention deemed it fit to leave the definition and interpretation of the arbitral jurisdiction of the tribunals[1]. This could explain why the Phoenix v. Czech Republic tribunal devised its own criteria for qualifying investments.

The Salini test often refers to the Salini v. Morocco, a 2001 case involving a 1994 agreement entered into by two Italian companies, Salini Construttori S.P.A and Italstrade SPA ("Salini”) as one party and the State-controlled Moroccan firm, Societe Nationale des Autoroutes du Maroc (“ADM”), as the other party[2]. In 1999, Salini completed its construction work and submitted claims for compensation to ADM, who rejected the claims in entirety. In 2000, Salini requested for arbitration from ICSID. The main issue that the Tribunal was expected to decide was regarding the investment, a decision that created the now famous Salini test. As explained earlier, one of the leading legal components of

[1] Aman Prasad, ‘Salini Criteria: A Strict-Deductive Approach Against the Principles of Article 25 ICSID’ (2020) SSRN 3639087.

[2] Salini Costruttori S.p.A. and Italstrade S.p.A. v. Kingdom of Morocco, ICSID Case No. ARB/00/4.

investor-state arbitration is that awards of past tribunals are not binding but should inform decisions in the current cases. In this case, the Salini test remains a valid tool for determining the legality requirement of an investment. In Phoenix v. Czech Republic, the Tribunal applied this test to its discretion and used it as a basis for qualifying investments.

To qualify for ICSID proceedings, investments must pass the legality requirement, failure to which a state can successfully make an illegality objection. The legality requirements under the ICSID Convention are simple, but they focus primarily on the legal definition of investment. The first requirement is that there should be an applicable IIA, and the IAA should contain a provision defining an investment[1]. This requirement also extends to satisfying the definition of investment in the IIA. However, it is essential to note that meeting the IIA definition does not mean that a transaction meets the definition of investment under Article 25 of the ICSID Convention. The second legality requirement under the ICSID Convention is that the definition of investment must

[1] Darius Chan and Justin Lai, 'Two Decades after Salini v Morocco: The Case for Retaining the Salini Test with Modifications (2023) 39(1) Arbitration International 63.

meet the Salini test. This requirement goes against the earlier claims that awards of past tribunals are not legally binding in current cases. However, the tribunals established under the ICSID Convention are bound by the rules of the Convention. If the Convention requires the Salini test, the tribunals must follow the test.

So far, respondent states can claim the illegality of investment because the investment does meet the legality requirements of the ICSID. However, the illegality objection goes beyond this requirement as states can also evoke national laws as the basis of the illegality claims. In this regard, some scholars believe there is a massive gap since corruption is the only form of illegality addressed in the literature. Allegations of investor misconduct are highly diverse and could involve such actions as wilful disregard of local foreign investment restrictions or even inadvertent administrative omissions that a host state knowingly decided not to enforce[1]. A textual analysis of the ICSID Convention and other legal frameworks does not reveal all typologies of illegalities that a host country can claim. Therefore,

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[1] Mouawad and others, P.R. 57

this gap can be plugged by resorting to literature and, where possible, past investor-state arbitration tribunal awards.

1-2- Illegality Objection and Counterclaim

A textual analysis of illegality objection and counterclaim may reveal various conceptual differences and explain why the two may not be used interchangeably. Essentially, a counterclaim can be described as a separate claim by a defendant in response to a claim made by a plaintiff against them. Such a claim is made on the basis that the defendant is entitled to relief due to some problems with claims, such as a breach of contract. Illegality objections are, therefore, an effective form of defence against investor's claims against states. Many cases have successfully used illegality objections against the investors, especially where investors are considered to have acted in bad faith. The Phoenix v. Czech Republic[1] is a perfect example of a successful counterclaim against an investor.

Illegality objection can be described as a legal argument made by a defendant that a contract or the performance of the contract is illegal, goes against public policy, or is unenforceable because of the legal constraints underlying the lawsuit. In this

[1] Phoenix v. Czech Republic

case, illegality objections are not separate claims but legal responses challenging the validity of a lawsuit to prevent the enforcement of agreements deemed contrary to law or public policy. This explains why the illegality objection is often used by states sued by investors seeking to have the host countries perform their legal obligations under the contractual agreements within IIAs and BITs. For example, suppose a host country fails to offer an investor international protection under the ICSID Convention. In that case, an investor may request an arbitral tribunal, in which case the country can defend itself on the ground that the investor or the performance of the investment is illegal.

Besides the apparent conceptual differences between counterclaims and illegality objections, they both mount formidable defences for states against investors. Additionally, the ability of the arbitral tribunals to have jurisdiction to determine states' objections is a crucial observation. However, the most important observation from a textual analysis of IIAs, BITs, and the investor-state arbitration conventions is that the extent to which the illegality objection is tenable depends primarily on the text of the treaty under which the investors bring their claims. The rationale is that it is such treaties that record the agreement by

parties to arbitrate and the conditions on which to arbitrate[1]. The implication is that only where the treaty contains language that clearly links the host state's law to the conditions of jurisdiction that an objection to jurisdiction based on illegality is available to the respondent state. States can only successfully object to a tribunal's jurisdiction with such express language. Under such circumstances, counterclaims are a state's best chance of a successful defence against an investor's claims. The primary foundation for this argument is that tribunals can evoke the conditions of the ICSID Convention regarding the legality requirements of an investment, where violations of a host state's laws make an investment illegal.

2- Typologies of Illegality Objections

The requirement of the legality of investments as a basis for the jurisdiction of the arbitral tribunal depends on the type of illegal objections that would prevent the seat of the court from being determined or lead to the cancellation of the objections altogether. The first category of illegality results from the illegal behaviour of the investor to commit corruption or fraud when concluding investment contracts with the host state. The second

[1] Sam Luttrell, 'Fall of the Phoenix' 122.

category of illegality is violating local laws. Finally, the third category is violation of international legal principles.

2-1- Corruption and Fraud

Corruption remains the most common defence by states in investor-state arbitration. Countries across the world acknowledge that while the social and economic development benefits of foreign investment are an enticing proposition, investments tainted by corruption can have adverse effects, for example, rising costs of transactions and reduced confidence in the business climate[1]. As such, countries are morally and legally justified to hold investors accountable should they engage in corruption. The current text on corruption explores how corruption acts as a basis for objecting to jurisdiction and as a challenge to the admissibility of investor's claims. In both applications, corruption is an effective defence when and if a country can prove that an investment is shrouded in corruption.

Very few documents offer a legal definition of corruption. In investment arbitration, corruption can be perceived as an abuse

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[1] Dao Anh, 'Use of Corruption Defense by Host States in Investor-State Arbitration' (2023) 39(1) VNU Journal of Science: Legal Studies 19; Abdelhadi, M. 'Disclosure in Public Procurement, A Comparative Study in EU and German Law' (2024) 45(36) Journal of Jurisprudential and Legal Research, 101.

of duty owned. This definition carries an underlying notion of a relationship between an investor and a public official, who is a repository of public trust, and illegal payments to the official in exchange for favourable decisions[1]. A broader definition of corruption is knowing, applying, or refusing to apply laws in a manner that befits private demands at the expense of public need. This definition carries two notions of corruption: bribery and extortion[2]. As such, corruption should be legally treated as a consensus between the parties to commit an illegal act for their mutual benefit.

Given the definitions of corruption above, the question that presents the biggest challenge in investor-state arbitration is how to prove that corruption has occurred and whose burden it is for such proof. Understandably, an investor filing claims against the government cannot have the burden of proof. On the contrary, a government that refutes an investor's claims based on corruption is expected to bear the burden of proof. The main reason for exploring the burden of proof is that in modern investment

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[1] A. K. Aronov, 'Corruption in International Investment Arbitration' (2019) 126(1) bulletin of L.N. Gumilyov Eurasian National University LAW Series 48

[2] Alysius Llamzon, Corruption in International Investment Arbitration (Oxford University Press 2014)

practices, parties have a hard time demonstrating corruption because the true nature of corruption is usually concealed behind seemingly legal transactions[1]. Additionally, parties are keen not to leave any incriminating evidence of corruption activities. Even when such evidence is available, tribunals tend to have difficulty accessing it due to their limited investigative powers.

For example, in Unión Fenosa Gas, S.A. v. Arab Republic of Egypt, the host country made serious allegations about the supposed use of a local partner to exert influence on the Egyptian Minister of Petroleum in negotiations over the gas sale and purchase agreement. Although the court found evidence that the local partner exercised influence, it was not the kind of "back channel influence" that characterizes influence peddling, and the court ultimately dismissed the corruption allegations in Egypt for lack of evidence[2].

The question of how tribunals should apportion fault for performance corruption has been explored in great depth, with some scholars and experts proposing that the fault should be

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[1] Olivier Caprasse and Maxime Tecqmenne, 'The Evidence of Corruption in Investment Arbitration' (2022) 39(4) Journal of International Arbitration 519

[2] Unión Fenosa Gas, S.A. v. Arab Republic of Egypt, ICSID Case No. ARB/14/4, Award of the Tribunal: August 31, 2028.

shared between the state and the foreign investor[1]. The rationale for such an argument is that, per definition of corruption, parties have a consensus to engage in corruption activity for mutual benefit.

However, the question of who should be held at fault for corruption is less critical than that of the burden of proof and the effect of corruption on the investor-state arbitration. Essentially, the ICSID Convention only protects bona fide legal investments that do not violate national or international law. Therefore, regardless of whose fault it is that corruption occurred, proving corruption makes an investment illegal, and hence, the tribunals lack the jurisdiction to arbitrate in such cases. Corruption allows governments to erect a strong defence against the investor's claims. The general practice is that investors found to be tainted with corruption do not qualify for international protection by the Tribunal[2]. All forms of illegality receive the same treatment, meaning that if investors are embroiled in actions considered illegal under national laws, states can use such illegality to deny

[1] Reisman D., P. R. 1

[2] Caroline Kago and others, 'International Public Policy, Corruption and Investor to State Arbitration' (2020) 17(2) Manchester Journal of International Economic Law 122

the jurisdiction of an arbitral tribunal[1]. The same can work against a government in cases where a state requests an arbitral tribunal by levying claims against an investor. In such a scenario, investors can claim that a state's action against it is illegal, and if proven, the investor immediately qualifies for international protection by evoking such principles as equitable treatment.

Fraud is another form of illegality in investor-state arbitration and is often discussed alongside corruption. Few examples exist regarding how arbitral tribunals in investor-state arbitration handle fraud claims. In Plama v. Bulgaria[2], the Tribunal found the investor's conduct was a deliberate concealment amounting to fraud. Additionally, the Tribunal established that fraudulent concealment breached local laws and the principles of international law, especially the principle of good faith. Other cases separate fraud from corruption, for example, Churchill Mining and Planet Mining v. Indonesia[3] involved fraud and forgery. The Tribunal, in this case, awarded that even though the

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[1] Khayat D. and Ahern W., 'Allegations of Illegality in Investor-State Arbitration and the Presumption of Innocence' (2017) 6 Indian Journal of Arbitration Law 43

[2] Plama Consortium Limited v. Republic of Bulgaria, ICSID Case No. ARB/03/24.

[3] Churchill Mining PLC and Planet Mining Pty Ltd v. Republic of Indonesia, ICSID Case No. ARB/12/14 and 12/40.

investment was sound, there was evidence of massive fraud during the performance of the investment. Like corruption, all cases where fraud has been proven have resulted in a successful objection of jurisdiction, even when fraud was not directly linked to the investor. A case example is Churchill Mining and Planet Mining v. Indonesia, where the Tribunal ruled that the investor could have identified fraud had it carried out due diligence[1]. Therefore, fraud proves to be an effective tool for successful illegality objection.

2-2- Breach of Domestic Laws

The breach of domestic laws is a more encompassing legal provision that covers most illegalities. Today, some reforms in IIAs have resulted in many BITs having illegality clauses that generalize breaches of domestic laws. For example, the 2016 Iran-Slovakia BIT expressly stated that ISDS tribunals lack jurisdiction when the investor violates the host country's laws. BIT singled out corruption, fraud, and tax evasion[2]. At the same time, the application of domestic law as a basis for illegality objection has

[1] Jarrett M., Puig S., and Ratner S., P.R. 259.
[2] Ibid 264

been somewhat inconsistent since domestic laws differ from state to state. Some experts believe there is a lack of enforceable obligations on the investor under the IIAs, forcing states to base their illegality objections on their domestic laws. An interesting scenario arises when the domestic law is not part of the IIA agreement signed between the parties. The arbitral tribunals have no jurisdiction to give awards based on a country's domestic laws. Therefore, the only reason that tribunals consider states' illegality objections based on domestic law is a breach of contract or noncompliance with the domestic law if the applicable law allows it[1]. The factors for a primary application of the national law include the international nature of the claim and the argument for the superiority of the international law over the national law[2]. The failure of states to expressly state that an investor must adhere to domestic laws does not give investors the right to violate the laws. In such situations, the contractual obligations on the part of the

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[1] Mees Brenninkmeijer and Fabien Gelinas, 'Counterclaims in Investment Arbitration: Towards an Integrated Approach (2023) 38(3) 567-594 ICSID Review – Foreign Investment Law Journal 567.

[2] Hege Kjos, Applicable Law in Investor-State Arbitration: The Interplay between National and International Law (Oxford University Press 2013).

investor are implied because no host country can allow foreign investors to engage in illegal activities.

The default rule of article 42 of the ICSID Convention expresses that a tribunal "shall decide a dispute in accordance with the rules of law as may be agreed by the parties. In the absence of such agreement, the Tribunal shall apply the law of the contracting state party to the dispute (including its rules on the conflict of laws) and such rules of international law as may be applicable[1]." The text of this rule indicates that an investor signing an IIA contract with a host nation is expected to agree on the applicable laws in an arbitral tribunal if a conflict arises. In case such an agreement is missing, the BIT between the two countries is expected to contain clauses on arbitration of disputes between the investor and the host country. If such rules do not appear in the BIT, then tribunals, by default, will resort to the domestic laws of the host state. However, the rules of dispute resolution in tribunals can also be overruled by claims of violations of domestic law, especially since the text of the ICSID Convention articulates that

[1] Convention on the Settlement of Investment Disputes between States and Nationals of Other States (International Centre for Settlement of Investment Disputes [ICSID]) (established in 1966)

the arbitral tribunals under the Convention can only be used for bona fide legal investments. Breaches of domestic law can make an investment illegal, which denies an investor international protection under the ICSID Convention.

An objection to the illegality of investor-state arbitration can arise due to an investor's illegal conduct. The objection to the illegality the host state raises is often based on the law that the decree should not protect an investor since their investment is marked with illegality. The law of investment tribunals determines that decisions and outcomes have played a critical role in evaluating the illegal conduct of investment.[1] When the host state successfully raises an illegality objection, it can avert an arbitral tribunal from hearing the allegations of the investor. In some pacts, the investor's claims often need to be legal to be entitled to protection. The degree of the investor's unlawful conduct is vital in determining the tribunal panel and the foundation upon which the host state will build a strong case. Severe violations of the

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[1] Rabenschlag F.D, 'The Illegality Objection in International Investment Arbitration: a Proportionality-based Approach to Determining the Legality of Investments' (2020), see at: https://ssc-rechtswissenschaften.univie.ac.at/fileadmin/user_upload/s_rechtswissenschaft/Doktoratsstudium_PhD/Expose1/Voelkerrecht/The_Illegality_Objection_in_International_Investment_Arbitration.pdf, 20 may 2024.

jurisdiction's laws, such as fraud or money laundering, would be enough to prevent the investor's claims.

In some instances, a minor violation of the state's treatment may not be sufficient to provide the state with the grounds for rejecting the investor's claims. In the case of Philip Morris v. Uruguay, the defendant's violation of the host nation's treaties was considered minor since the complainant argued that 80% of the health warning left inadequate space on packs for it to use its trademark and branding as was initially planned; therefore, the demand as stated in the Single Presentation Requirement (SPR) implied that it could not promote or market some of its products and brands, including Marlboro Gold.[1] The complainant presented the allegations that Philip had violated the 80/80 Regulation, which demanded that health warnings cover 80% of the packaging instead of 50%. Therefore, this implied that the defendant was only left with 20% of the packaging to market its other brands; hence, the tribunal considered the defendant's claims, ruling in their respondent's favour. In the illegal objection case, the host

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[1] Philip Morris SARL, Philip Morris Products S.A. and Abal Hermanos S.A. v. Oriental Republic of Uruguay, ICSID Case No. ARB/10/7, Award July 8, 2016.

state bears the burden of proof. The state must prove to the tribunal that the investor has engaged in unlawful conduct by demonstrating that the violation of the investor's conduct is linked to the investment.[1]

The litigation based on the investor's engagement in unlawful conduct often involves the defence of the investor as the respondent. The investor may defend their involvement in illegal conduct due to a lack of knowledge. The investor can present the claim of the lack of awareness of the illegality of their conduct, mainly if the host state acts are vague or not enforced strictly. The investor's actions, correcting wrongdoing, might weaken the objection in the case presented by the host stat. Any form of contribution to illegality by the host state may undermine the case, for instance, if the state officials were bribed to allow for the continuation of the illegality.

Failure to conduct comprehensive due diligence may result in the illegality of an objection being raised by the host state. The host state expects investors to conduct a reasonable inquiry on the

[1] Janeba E 'Regulatory Chill and the Effect of Investor-State Dispute Settlements' (2019) 27(4) Review of International Economics 1172-1198.

illegality or legality of their conduct and actions before undertaking it. The court or tribunal regularly expects an investor to conduct reasonable due diligence before executing the investment. Due diligence entails involvement in legal inquiries and the regulatory procedures that guide the operations and conduct of the investor. In addition, due diligence gives the investors knowledge concerning the potential risks and business practices that may result in illegality and possible lawsuits. In the case of Tecnic Gas Services Inc. v. Argentina, which involved a project in Argentina as the host state, the investor Tecnic Gas encountered litigation on an illegality objection due to being accused of violating environmental permit regulations while implementing its gas project in the country.[1] Even though the outcome from the tribunal gave the defendant, Technic Gas, the opportunity to present its claims, it concluded that the company should have conducted comprehensive due diligence concerning the environmental permit requirements for the host state.

The failure of the investor to conduct comprehensive due diligence often results in the investment being jeopardized by

[1] JacobsGibb Limited v. Hashemite Kingdom of Jordan (ICSID Case No. ARB/02/12).

potential lawsuits. The entanglement in the illegal conduct can strengthen the case presented by the host state concerning the illegality objection. The court or tribunal may consider the investor's lack of due diligence as a contributor or a critical omission that might result in aiding illegal activities. For instance, in Eastern Europe Metals Ltd. v. Kazakhstan, the defendant encountered an illegality objection grounded on the accusations of involvement in corruption in acquiring the mining licensees.[1] The tribunal's findings, in this case, exposed the presence of corruption as indecisive. However, they did not complain about the investor's failure to conduct due diligence to identify possible red flags about the licensing process in the host state. In this state, the illegality objection was weakened by the explanation given by the respondent concerning the steps they undertook to obtain investment licenses.

The defendant proved to the tribunal that the company took necessary measures to review the relevant requirements concerning the legality involved in the acquisition of licenses for

[1] Metal-Tech Ltd. v. Republic of Uzbekistan, ICSID Case No. ARB/10/3, Award dated 4 October 2013.

the mining company in the host nation through consultation with the legal advisors and conducting a background check through comprehensive due diligence. Sometimes, the investor faces the risks of hidden illegalities that due diligence cannot expose. Therefore, if the host state presents a case of illegality objection, the investor can argue that the stated illegality was unforeseeable, even after thorough due diligence. When the defendant issues such comments, the host state's case of illegality objection might weaken; thus, the tribunal will likely give a verdict that favours the respondent.

2-3- Breach of Legal Principles

After evaluating the legal basis on which states can object to arbitral tribunals' jurisdiction in investor-state arbitration, it is vital to highlight the legal/judicial principles that tribunals apply when giving their awards. Essentially, international legal principles are often cited when defining investments. This means returning to the legality requirements, the basis for many illegality objections. A key observation from a textual analysis of various cases and literature is that tribunals rely on express legality requirements if they exist, and if such requirements do not exist,

the tribunals imply them[1]. Tribunals tend to evoke various international legal principles, for example, international public policy in Liman Caspian Oil v. Kazakhstan[2], good faith in Phoenix v. Czech Republic, or even unclean hands.

2-3-1- International Public Policy

The principle of international public policy is one of the most-cited principles in arbitral tribunal awards, despite the lack of a mechanism that defines the principle or breaks down its legal aspect. As outlined earlier, the application of the principle of international public policy is made with the guidance of the ICC ruling by Judge Lagergren, who expressed that investors who violate the international public policy forfeit the right to ask for the assistance of the machinery of justice[3]. Deriving from the landmark ICC ruling, many tribunals use international public policy as a yardstick to determine the legality of investors' actions. In other words, the language of the ruling expresses that corruption (and related activities such as bribery) is contrary to good morals and the international public policy common in many

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[1] Mouawad and others, P.R. 58.

[2] Liman Caspian Oil BV and NCL Dutch investment BV v Republic of Kazakhstan, ICSID Case No ARB/07/ 14.

[3] Anh D., P.R. 21.

states. This language implies that corruption and bribery are universally morally wrong, and no country condones such behaviour. Therefore, an agreement between an investor and a host nation is governed by this legality requirement even when the condition is not expressly outlined in the agreement.

An exciting aspect of applying this legal principle is the nature of the evidence that tribunals consider to nullify investors' claims against host countries. In some ICC cases, 'red flags' have played a vital role as evidence or sources of evidence regarding the illegal nature of an investment. For example, in ICC Case No. 3916[1], the Tribunal ruled that the actions of the Iranian party amounted to nothing but the exercise of influence over those deciding with whom the Iranian state would go into contract. Therefore, the agreement was considered null and void and violated international public policy. Similarly, the 1994 ICC Case No. 6497[2] resulted in a ruling that the claimant's extraordinary commission of 33.33%, coupled with the fact that the contract terms did not describe services rendered, indicated a high degree

[1] French purchaser v Dutch Seller, ICC Case No 3916, Final Award (1982) in (1984) 111 JDI 926, 929–30

[2] Consultant v Contractor, ICC Case No 6497, Final Award (1994), para 30 in (1999) 24 YB Comm Arb 71.

that the real object of the agreement was to channel bribes to officials. As such, the contract was null and void[1]. Therefore, all actions that imply that the nature and purpose of a contract are more likely than not to constitute violations of moral codes and international public policy force tribunals to rule the contracts as null and void. The ICC cases are better examples because they are more numerous than those under ICSID that apply the principle of international public policy.

Violation of public policy is a compelling claim for illegality objection of the investor-state arbitration. The general rules in this regard date several in one of the most cited cases of the International Chamber of Commerce (ICC), where the ruling of Judge Lagergren[2] established that even though there was no objection to jurisdiction, the contract was created for corrupt purposes. The judge noted that corruption is an international evil and that gross violation of good morals and international public policy causes investors to forfeit the international protection of

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[1] Emmanuel Gaillard, 'The Emergence of Transnational Responses to Corruption in International Arbitration' (2019) 35(1) Arbitration International, 1.

[2] ICC Award No. 1110 of 1963 by Gunnar Lagergren, YCA 1996, at 47 et seq. (also published in: Arb. Int'l 1994, at 282 et seq.)

justice machinery, in this case, the courts or the arbitral tribunals[1]. Even customs form part of public policy. Indeed, under international law, custom and treaty have equal weight, meaning three core principles regulate inconsistencies: respect for parties' intentions, lex posterior derogat legi priori, and lex specialis derogat legi generali[2]. Therefore, violating the host state's national law is a reasonable cause for illegality objection.

The text of Judge Lagergren's ruling makes several legal issues very clear. First, arbitral tribunals can refuse to resolve an investment dispute if they establish that the claimants grossly violated public policy, even when an objection to jurisdiction is not raised. Second, an arbitral tribunal would find no problems accepting the illegality objection based on a violation of public policy. Very few cases are available on the illegality objection based on violation of public policy under the ICSID Convention. However, there could be further examples from ICC awards where violations of international public policy have helped defeat investors' claims.

[1] Anh D., P.R. 21.
[2] Ivan Puskar, 'Customary Rules as Applicable Law and Their Importance in Investor-State arbitration' in Klara Drličková and Tereza Kyselovska (eds), Coforal International 2017: Resolution of International Disputes (Masaryk University 2017) 13-25.

2-3-2- Principle of Good Faith

The principle of good faith is more prevalent in ICSID cases and has become a pivotal defence for host states against claims made by foreign investors. The customary law of treaty interpretation often relies on Article 31(1) of the Vienna Convention on the Law of Treaties (VCLT), which provides that treaties "shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and the light of its object and purpose[1]." Tribunals interpreting investment contracts operate under the same principle. Similarly, good faith in establishing and performing a contract should always be upheld since it is universally accepted that parties to a contract should act in good faith.

An important aspect of the principle of good faith is that it applies to all actors in investment arbitration: states, investors, and tribunals. The main reason why this is the case is that investment arbitration is based on arbitration agreement rules by the principles of pacta sunt servanda and good faith[2]. As such, the

[1] Vienna Convention on the Law of Treaties art. 31(1), opened for signature May 23, 1969, 1155 UNTS 331.

[2] Sanja Djajic, 'Good Faith in International Investment Law and Policy' 2

principle of good faith is prevalent across all aspects of international law and international treaties, including the VCLT, the UN Charter, the UN Declaration on Principles of International Law Concerning Friendly Relations and Cooperation among States, and The International Law Commission Draft Declaration on Rights and Duties of States[1]. Many of these laws and treaties are essential legal documents based upon which many investment treaties are written. However, some observers highlight that IIAs rarely refer directly to the principle of good faith, even though the trend is now changing. For example, the language of Article 8.18(3) of the Comprehensive Economic and Trade Agreement between Canada and the European Union expressly states that the agreement protects only those investments done legally and in good faith.

2-3-3- Principle of Unclean Hands

The unclean hand doctrine is traditionally rooted in common law defence and provides that a court would not lend its aid to a claimant if the claimant's cause of action is based on an unlawful act. In investor-state arbitration, the principle of unclean

[1] Ibid 3.

hand implies that if an investor engages in activities shrouded in corruption, states could invoke the doctrine of unclean hands, and the investor's claims would be barred[1]. Interestingly, few tribunals accept this principle because a few actors have attempted to evoke this doctrine without success. Examples include Yukos Universal v. Russia; Russia tried to evoke the doctrine of unclean hand, but the Tribunal denied Russia's position because the Energy Charter Treaty could not be read to include the unclean hand doctrine. In a similar case involving Niko v. Bangladesh, the Tribunal did not completely discard the applicability of the unclean hand doctrine, but endorsed the three criteria test provided of an arbitral tribunal involving Guyana v. Suriname[2]. However, tribunals have, in some cases, reduced the damages due to investors' unclean hands[3]. Still, unclean hands can be perceived from the point of view of a violation of domestic laws, and an illegality objection would be evoked based on the implied rule that arbitral tribunals only handle bona fide legal investments.

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[1] Anh D., P. R. 25.
[2] Ibid 26.
[3] Jarrett M., Puig S., and Ratner S., P.R. 266.

3- Case Law of Illegality Objections

The jurisprudence of illegality objections in investor-state arbitration poses serious problems, most of which have already been explored in the previous sections of this paper. Case law development remains the best approach to the jurisprudence of illegality objections. The paper explores jurisprudence issues from the perspective of a textual analysis of treaties, conventions, and arbitral tribunal awards. In this section, an attempt is made to dig deeper and analyse some specific jurisprudential issues.

3-1- Case: Phoenix Action, Ltd. v. The Czech Republic

The case of Phoenix Action, Ltd. v. The Czech Republic (henceforth, Phoenix v. Czech Republic) is considered a landmark case in investor-state arbitration and has been a building block for many legal arguments surrounding ICSID and IIAs, especially as a foundation for judicial principles. The case also illustrates the demarcation of judicial jurisprudence between the state and arbitral tribunals, where domestic laws seem superior to international law and the legal obligations in BITs and IIAs. Essentially, the mere fact that Phoenix was found to be in the breach of local laws was enough for the Tribunal to rule that the

investor was not qualified for international protection under the Czech-Israel BITs[1]. This makes the illegality objection a potent tool for states to use against investors in the case of investor-state arbitration.

The facts of the case include that a three-member tribunal rejected, on April 15, 2009, Phoenix Action, Ltd.'s ("Phoenix") claims against the Czech Republic. Phoenix is a firm that purchased two Czech companies, Benet Group and Benet Praha, in 2002. The two firms were involved in ongoing legal battles: Benet Group with a private party and Benet Praha with the Czech fiscal authorities. The Czech Republic challenged the jurisdiction of the Tribunal based on the claim that Phoenix was an ex post facto sham entity created by a Czech national to create a diversity of nationality. The state specifically requested the Tribunal to decide whether a foreign entity could be formed for the sole purpose of creating a diversity of nationality, which would trigger the ICSID jurisdiction[2]. The Tribunal agreed with the Czech Republic's claims regarding jurisdiction because the investment

[1] Sanja Djajic, 'Good Faith in International Investment Law and Policy' in Julien Chaisse, Leila Choukroune, and Sufian Juso, Handbook of International Investment Law and Policy (Springer 2020) 1-34.
[2] Phoenix v. Czech Republic

Phoenix made was not in good faith, and it constituted an abuse of the ICSID system[1]. Additionally, the Tribunal held that considering the circumstances of the case, Phoenix should bear all the costs of the ICSID proceedings and the Czech Republic's legal fees and expenses.

The Tribunal's award can be used to assess the criteria required for investments to qualify for international protection under the ICSID Convention. The decision also helps to understand the jurisdiction issues in investor-state arbitration. Most importantly, it offers a legal understanding of the concept of 'investment' as it applies to investor-state arbitration and the ICSID Convention. A textual analysis of these elements is essential in understanding the illegality objection, approaches to jurisprudence, and judicial principles.

On whether Phoenix's investment was an 'investment' under the ICSID Convention, the Tribunal clarified two critical conditions an investment must meet. First, the investment must be made in accordance with the laws and regulations of the host state.

[1] Mahza Malik, Phoenix v. Czech Republic (Investment Treaty News, October 18, 2018) <https://www.iisd.org/itn/en/2018/10/18/phoenix-v-czech-republic/>

Second, the investment must be made in good faith. In both conditions, the Tribunal found Phoenix's claim invalid, meaning its investment did not meet the investment criteria and was not made in good faith. The Tribunal denied jurisdiction because Phoenix abused the ICSID investment arbitration system. The violation occurred through a rearrangement of assets within a family, including transferring ownership over two Czech companies to a new company, Phoenix, established in Israel, only after two Czech firms got embroiled in domestic legal battles[1]. In other words, the Tribunal could establish that Phoenix was established merely to gain access to international protection under the Czech-Israel BIT. As such, the investment did not qualify for international protection.

To most scholars, the issue of good faith is the most crucial aspect because it was applied in this case as an autonomous standard and an independent condition for jurisdiction. However, this research considers the issue of illegality as the most important takeaway from the case. The rationale is that the case established that the international protection mechanism cannot be used to

[1] Sanja Djajic, 'Good Faith in International Investment Law and Policy' 17

protect investments that violate the laws of the host state or are involved in other illegalities, for example, concealment, corruption, or misrepresentation, which amounts to an abuse of the international arbitration system[1]. As such, the ICSID protects legal and bona fide investments.

The criteria for the legality of investments is set out in the ICSID Convention and was evoked by the Tribunal in deciding the Phoenix v. Czech Republic case. Paragraph 83 of the Convention establishes the criteria for investment. It relies on the four criteria of the "Salini" test: money and other assets of economic value, an element of risk, a specified duration, and contributing to the host country's development. Even so, the Tribunal noted that there were divergent views regarding the fourth criterion, leading it to propose its own rendition of the protectable elements of an investment. In addition to the four criteria, the Tribunal added two more in the form of investments done in accordance with the laws of the host state and assets invested bonafide[2]. Therefore, the

[1] Mahza Malik, Phoenix v. Czech Republic
[2] Ibid.

breach of any of these criteria can be a ground for illegality claims against a foreign investor.

The Phoenix v. Czech Republic case sets the stage for analysing the illegality objection. Based on the above analysis, a few things have been clarified. First, investor-state arbitration is built around the IIA and enforced through the ICSID Convention. Second, investor-state arbitration requires the parties to consent to an arbitration procedure through a tribunal. Lastly, the ICSID only applies to investments that are legal by the host country's standards and done in good faith. With this in mind, it is possible to outline the conditions under which a state may make claims of illegality in investor-state arbitration and how such claims affect the jurisdiction and jurisprudence in investor-state arbitration. In this section, the analysis will dive deeper into all aspects of illegality, including what actions are considered illegal.

3-2- Case Law Development

The jurisprudence of legality objections was more challenging before landmark cases such as Phoenix V. Czech Republic and Inceysa v. El Salvador. The rationale is that before these cases, arbitral tribunals grappled with various issues,

including how to interpret the ‘in accordance with law' requirements of many BITs. The gravity of violation (whether only serious violations vitiate the Tribunal's jurisdiction), whether objections to jurisdictions based on host state's laws should be bifurcated or handled as part of the case's merits, and the role of estoppel and acquiescence principles[1]. However, tribunal awards have a clearer idea of handling these issues after these landmark cases. Even so, the jurisprudence of the legality objections was weakened by the lack of a functional test for determining whether the violations of domestic laws of the host state vitiate jurisdiction.

Today, many cases have upheld that investment treaties between a foreign investor and a host country should abide by the host state's laws. In other words, arbitral tribunals no longer struggle with the question of whether violations of host states' laws vitiate the jurisdiction of the tribunals. This is because as long as countries can prove local laws were violated, tribunals rule in favour of the illegality objections by the state. In 2018, the Tribunal in Cortec v. Kenya established that even without express

[1] Sam Luttrell, ‘Fall of the Phoenix’ 121

provisions under the BIT, investments must comply with the local laws of the host state otherwise, the investors forfeit the treaty protection[1]. Similarly, the Tribunal in Anderson v. Costa Rica[2] ruled that the investment resulted from a Ponzi scheme, which violated the local law and, thus, was not protected by the IIA due to the conformity clause. In this case, the Tribunal relied on Inceysa v. El Salvador in finding that violations of a host state's laws mean forfeiting the protection under the treaty.

Since the landmark cases (Inceysa and Phoenix), an interesting observation is that tribunals no longer rely on the conformity clause. An example is the case of Churchill Mining v. Indonesia, where the Tribunal ruled that the investor should have been able to identify fraud by conducting due diligence. The absence of a conformity clause does not prevent tribunals from ruling in favour of states where investors are found to violate the state's laws. Similarly, parties making illegality objections focus more on jurisprudence instead of the text of applicable treaties,

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[1] Cortec Mining Kenya Limited, Cortec (Pty) Limited and Stirling Capital Limited v. Republic of Kenya, ICSID Case No. ARB/15/29; Worley International Services Inc. v. Republic of Ecuador, PCA Case No. 2019-15. Final Award - 22 Dec 2023.

[2] Alasdair Ross Anderson and others v Republic of Costa Rica, ICSID Case No ARB (AF)/07/3.

especially in cases where the BITs do not contain express legality requirements[1]. This is made possible by the awards of landmark cases and the growing trend among tribunals in implying compliance with host states' laws.

However, experts and tribunals also note that if the legality requirement is applied too broadly, it would be unfair to investors. Such a caution appeared in tribunal arbitrating Mamidoil v. Albania, which gave the warning that “states must not be allowed to abuse the process by scrutinizing investment post festum to root out minor or trivial illegalities as a pretext to free themselves of obligations”[2]. This warning brings to the fore the problem of gravity, where tribunals must decide the seriousness of violations that should warrant successful illegality objection by states. Essentially, the terms "minor" and "trivial," as used in the warning, do not contain adequate tests based on which the gravity of violations should be evaluated. Legally, such terms are very subjective, meaning that the tribunals would judge gravity based on their discretion instead of an established functional framework.

[1] Sam Luttrell, ‘Fall of the Phoenix’ 130

[2] Mamidoil Jetoil Greek Petroleum Products Societe SA v. Republic of Albania (ICSID Case No. ARB/11/24).

Many cases provided as examples in this paper involve corruption and bribery, which, by any legal or national standard, should be among the gravest violations of the principle of international public policy and the host state's laws.

Some scholars believe that through the sequence of cases, a test of seriousness or gravity has emerged[1]. Before the Phoenix case, there was only a glimpse of such a test; for example, the Tribunal in Rumeli Telekom v. Turkey[2] ruled that investments would be excluded from the protection of the treaty if they breached the 'fundamental legal principles' of the host state. Even such a ruling would still raise the question of what is deemed 'fundamental' and trivial.

Fortunately, a new test for gravity was developed by the Tribunal in the case of Kim and Others v. Uzbekistan (hereinafter, the Kim Tribunal)[3]. The test is carried out in three steps. First, the Tribunal must establish the significance of the obligation with

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[1] Sam Luttrell, 'Fall of the Phoenix' 137

[2] Rumeli Telekom A.S. and Telsim Mobil Telekomunikasyon Hizmetleri A.S. v. Republic of Kazakhstan (ICSID Case No. ARB/05/16), Award of July 29 2008.

[3] Vladislav Kim, Pavel Borissov, Aibar Burkitbayev, Almas Chukin, Lyazzat Daurenbekova, Adal Issabekov, Damir Karassayev, Aidan Karibzhanov, Aigul Nurmakhanova, Kairat Omarov, Nikolay Varenko and Gulzhamash Zaitbekova v Republic of Uzbekistan (ICSID Case No. ARB/13/6) Award of March 18 2017.

which the investor is claimed not to comply. Considerations for this step include the level of sanction provided by law, whether there is noncompliance with the obligation. The presence of general non-enforcement of the obligation by the state. Whether the host country has elected not to investigate or prosecute the alleged act of noncompliance. The second step is where the Tribunal must examine the seriousness of the investor's conduct. This means answering various questions: did the investor's conduct violate the obligation as alleged? Is the law unclear, evolving, or incoherent? What is the intent of the investor? Did the state fail to investigate or prosecute the alleged noncompliance? Did the investor undertake due diligence to understand and comply with the host state's law? What was the investor's subsequent conduct? The last step is where the Tribunal must assess whether the combination of the investor's conduct and the law in question constitutes a compromise of a significant interest of the host state to the extent that the investor forfeits the protection of the BIT treaty.

The Kim test can be considered a major development in the jurisprudence of illegality objections and a paradigm shift from

the Phoenix case. The rationale is that the Phoenix case framed the investors' compliance of the broadest terms. In comparison, the Kim test advocates case-specific inquiries into law in question and how the host state administers that law. Additionally, inquiries comprise more objective criteria for the tribunals to assess the importance of the law in question to the host state. Some scholars still perceive the gravity of illegality as a sliding scale granting tribunals the flexibility to examine factual permutations on a case-by-case basis[1]. Some tribunals hold investors to a strict duty of due diligence, while others factor an investor's level of due diligence into other aspects of proportionality analysis.

The estoppel and acquiescence principles are further considerations for the jurisprudence of illegality objections. Estoppel focuses on the conduct of the state as grounds for the admissibility of a state's claims of illegality. In other words, the principle of estoppel requires that if a state paid no heed to an illegality up until it got embroiled in an investor-state dispute or if the state implicitly or explicitly led an investor to believe that an investment is lawful, the state is estopped from invoking an

[1] Mouawad and others, P.R. 59.

illegality objection[1]. The textual meaning of acquiescence as applied in international law is a tacit recognition through unilateral conduct that another party can interpret as conduct and holds that silence may also speak, especially where the conduct of one party requires a response from another party[2]. Therefore, a state remaining silent when an investor is engaging in illegality, especially when the state is aware of such illegality, may prevent the state from successfully evoking the illegality objection.

The Kim tribunal is one of the best examples of estoppel and acquiescence principles. The Kim test does not place the entire compliance burden on the investor. On the contrary, it recognizes the state's obligation to administer its laws, and failing to do so reduces its ability to rely on those laws internationally.

4- Considerations for the Jurisprudence of Illegality Objections

The ability to adjudicate illegality objections gives countries an upper hand in their illegality objections in investor-state arbitration. The rationale is that tribunals have expanded

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[1] Ibid 92

[2] Jorge Vinuales, 'Defense Arguments in Investment Arbitration' (2020) 18 ICSID Reports 9

their jurisdiction beyond the confines of BITs and IIAs, as illustrated in the ruling of the Urbaser v. Argentina. The text of the decision was that: “The Tribunal must certainly be mindful of the BIT’s special purpose as a Treaty promoting foreign investments, but it cannot do so without taking the relevant rules of international law into account. The BIT has to be constructed in harmony with other rules of international law of which it forms part, including those relating to human rights” [1].

The text of this ruling implies that international arbitration is one area for which arbitral tribunals should have jurisdiction. Therefore, any conduct that violates international on the part of the investor qualifies for counterclaim adjudication by a tribunal. The main reason for exploring the ability of arbitral tribunals to adjudicate illegality objections is that only through illegality objections can states successfully object to arbitral tribunal jurisdiction based on illegality. In other words, it is only possible for illegality objections to work if tribunals can rule on states' illegality objections. In this case, some experts emphasize the 'in

[1] Urbaser v. Argentina para. 1200

conformity provisions' as written in the treaties[1]. Tribunals expect that the 'in conformity provisions' are well established in the IIAs, making it easier for them to use such contracts as applicable laws. However, the most crucial point to note is that since their inceptions, IIAs are expected to be made in accordance with the host state's laws. Should a dispute arise, and an investor sues a state to enforce its obligations, a state can successfully counter such claims by proving that the investor failed to perform the investment 'in accordance with' the host state's laws. Since tribunals only work with legal contracts, breaches of such contracts cause investors to forfeit their international protection.

4-1- Procedural and Substantive Requirements for illegality objections

The procedural and substantive requirements for counterclaims in investor-state arbitration raise a few jurisprudential issues given that the very nature of most investment agreements and treaties are designed to protect foreign investors and enforce the obligations of the host states regarding such protection. In this case, the most important issues to address

[1] Jarrett M., Puig S., and Ratner S., P.R. 262.

include whether host states can bring counterclaims against a foreign investor in investor-state arbitration, conditions for agreeing to arbitrations in counterclaims, the requirement for close contact with the original claim, and the possibility of filing a lawsuit directly before arbitration.

On the question of whether states can bring counterclaims against a foreign investor in investor-state arbitration, the answer is affirmative. However, the main problem is whether states can successfully bring such counterclaims. Exploring current literature reveals that there have been few attempts by states to bring counterclaims but hardly any of them has been successful[1]. The main reason for these observations is the nature of treaty arbitration, which creates a system where two states create an IIA and foreign investors benefit from the provisions of such agreements. As such, the system creates an asymmetry of procedural rights where only the investors can sue states but states cannot sue investors. The outcome of such a system is a deprivation of the rights of the states to bring counterclaims

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[1] Majid Ghamami and Amin Arzhangi, 'Counter Claims in Investor-State Treaty-Based Arbitration (2023) 53(2) Private Law Studies Quarterly 253

against states[1]. Therefore, the treaties and agreements became the main hurdles to the ability of states to bring counterclaims.

On the question of the requirement for close contact with the original claim, the text of available literature suggests that close contact with the original claim is a major requirement for a counterclaim. Further evidence of this requirement comes from cases where tribunals ruled in favour of investors due to a lack of close connection between a state's counterclaims and the original claims. Examples include Paushok v. Mongolia, where the tribunal refused to extend jurisdiction to counterclaims because Mongolia's counterclaims were not closely related to the investor's primary claims[2]. In Urbaser v. Argentina, the tribunal found the state's counterclaims to be closely connected to the investor's claims.

The question of the possibility of filing a lawsuit directly before arbitration is not widely addressed. However, it can be argued that if investors violate a host state's laws, the states reserve the right to sue the foreign investor in domestic courts,

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[1] Ibid 253

[2] Sergei Paushok, CJSC Golden East Company and CJSC Vostokneftegaz Company v. The Government of Mongolia, UNCITRAL.

especially where the texts of the BITs and IIAs prevent states from requesting arbitration under the ICSID Convention. Without evidence of such lawsuits, it is difficult to elaborate the mechanisms or even the possibility of such lawsuits directly before an arbitration. If contracting parties give consent to arbitration, it follows that lawsuit directly before an arbitration can be perceived as actions taken in bad faith.

In the past few decades, there has been a significant rise in allegations concerning investor illegality. The notable rise is attributed to numerous aspects, such as investors engaging in competitive practices that may breach federal and host state permissible orders. Therefore, understanding the procedural and substantive requirements for objections to legality in allegations of investor illegality is increasingly becoming imperative. As the international fight against corruption intensifies, the arbitral tribunal is critical in establishing responses to lawsuits raising corruption concerns. The claims concerning investor misconduct are intricately different and may involve wilful dishonouring of local investment laws or management omission of the host

country perceptively voted to enforce[1]. The procedural requirements for objections to legality are grounded in two primary sources, including an express provision of the agreement that demands an investment be executed by the host jurisdiction's laws. The second source of the procedural legality requirements is an implied intrinsic or self-directed necessity originating from general philosophies of international law that govern respect for the basis of such laws.

The procedural requirements for objections of illegality in investor-state arbitration significantly differ depending on the host state, the jurisdictional laws of the country, and the specific act involved. The procedural requirement demands that illegality objections be raised within a given timeline. A tribunal can review performance corruption when examining the conduct of the investor and the host state and establishing whether the host state violated the international treaty.[2] The timeframe is established for objections of illegality in investor-state arbitration since recognizing the accurate matrices involved in the procedure may

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[1] Mouawad and others, P.R. 59.
[2] Reisman D., P. R. 1

require additional time to be established. The set deadline as part of the procedural requirements for the illegality objections may be associated with a particular court filing or phase in the legal procedure. Therefore, when the complaint misses the set deadline, it may weaken the case before the court. The substantive requirements for the illegality objections in investor-state arbitration entail specificity.

The substantive requirements for illegality objections in investor-state arbitration are comprised of limitations to the host fundamental law and the materiality of the illegality. The accusation should be material and connected to the investment or the claims of the investment. As part of the substantive requirement for objections to illegality, the objection should have a distinctive reason, highlighting why the act or evidence presented in court is illegal. The citation of the specific act or laws violated is essential for supporting the illegality of the investor's actions. Standing is one of the fundamental procedural requirements for objections to illegality. Essentially, the litigant needs to have an individual stake in the result of the litigation process to object. Some individuals involved in this litigation may

not be directly affected or have legal grounds for challenging the suspected illegality. The procedural substantial requirements for raising objections differ significantly when the litigation is raised outside or in court. [1]

The objections raised out of court are settled through the administrative hearing. In contrast, when the illegality objection is filed in court, litigation is settled through a court case trial. Allegations of investor illegal conduct differ, ranging from deliberate disregard of the host state laws to unintentional omissions of key investment restrictions in the host state.[2] The variability in the requirements for the illegality objections of investor-state arbitration is because of the difference between state and federal laws. For instance, in jurisdictions like the United States, there are two levels of government: federal and state procedural guidelines and substantive requirements. Given the rising number of objections to illegality, robust establishment jurisprudence has arisen in designing the defences and exceptions of the overall proportion that investments stained by illegality are

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[1] Hershkoff H and Resnik J 'Constraining and Licensing Arbitrariness: The Stakes in Debates about Substantive-Procedural Due Process' (2023) 76 SMU L. Rev. 613

[2] Mouawad and others, P.R. 59.

not eligible for the treaty defence.[1] The basis of the illegality stretches beyond an investor's ongoing misconduct or misinterpretation of the jurisdiction's laws. For instance, in the case of Fraport v. Philippines, the outcome was the annulment of the objection since the committee concluded that the tribunal had extremely departed from a vital rule of procedure by not observing the applicant's right to be heard, resulting in the annulment of the award in its entirety.[2]

The state can argue that an arbitral tribunal does not have jurisdiction of investor-state illegality objections because investors are not covered under the state's jurisdiction. The pact or treaty might only safeguard particular types of investments or specific investors. When the investor's claim does not fall under the scope of what the state covers, then the host state can present an argument to the court that the arbitral tribunal does not have jurisdiction within the state. When the investor does not obtain consent from the host state, the host state can argue that the arbitral tribunal lacks jurisdiction. Lack of consent presents the

[1] Hershkoff H. and Resnik J, P. R. 613.

[2] Fraport AG Frankfurt Airport Services Worldwide v. The Republic of the Philippines, ICSID Case No. ARB/03/25, Award, August 16, 2007.

most fundamental point, especially when the host states did not agree or never entered into a pact with the investor's arbitration claims; therefore, this can present a significant challenge to the tribunal's authority in the case. The state can argue that the arbitral tribunal has no jurisdiction, especially when the investor has not exhausted all the legal avenues in the host state.[1]

In some states, some treaties demand that the investors deplete all the available legal avenues before settling for international arbitration. Therefore, failure to utilize all the local legal systems may result in the state presenting an argument pointing to the lack of jurisdiction by the arbitral tribunal. A patchwork of bilateral and regional treaties currently controls international investments.[2] When presenting a case concerning the arbitral tribunal's lack of jurisdiction, the state should often present agreements beyond being challenged by the investor since failure to present a strong case may overturn the case in the respondent's favour. For instance, in the case of Church World

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[1] Almeida T. F. "The Inconsistencies of the Investor-State Solution in the International Protection of the Foreign Investor: An Analysis of the Main Substantive Clauses from the Perspective of Host States" (2023) 3 Indian Rev. Int'l Arb. 23.

[2] Marisi, F. "Consistency in Investor-State Arbitration" Rethinking Investor-State Arbitration, (Springer International Publishing 2023). 255-313.

Service v. Venezuela, the plaintiff argued that the defendant had violated the treaties of the U.S.-Venezuela Bilateral Investment Pact by revoking its operational license.[1] The defendant argued that the operational license was revoked because the plaintiff, Church World Service, was not a covered investor under the U.S.-Venezuela trade treaty since their operations in the host states were not controlled by American citizens, but rather led by the religious group.

The host country raised an illegality objection, basing its argument on the improper claim that the trade treaty between Venezuela and the United States covers commercial investments. Therefore, the defendant pointed out that Church World Service operations, such as the running of the radio station, were not profitable activities in the host state. In the ruling, the tribunal found jurisdiction, pointing out that the Church World Service was indeed an investor protected by the U.S.-Venezuela trade treaty and that operations such as running the radio station are forms of commercial activity, particularly given the opportunity for the

[1] Impregilo S.p.A. v. Argentine Republic (ICSID Case No. ARB/08/14).

advertisements to generate reasonable profits. Therefore, when the host nation is arguing a case pointing to the arbitral tribunal's lack of jurisdiction based on the improper claim, there should be a reasonable argument that points to the illegality and the violation of the established trade agreement by the investor.

When returning the jurisdiction to the national court presents vast-ranging legal challenges, such as a potential lack of impartiality, limited expertise of the arbitral tribunal, and inconsistencies in the decision, which can significantly affect the outcome of the litigation process. When the investor's claims do not fall within the scope of the arbitral tribunal's mandate, the host state can present an argument pointing to a lack of jurisdiction. The investor's unlawful conduct can be attributed to the host state raising an illegality objection. Therefore, a successful illegality objection can deny the tribunal the chance of hearing the investor's claim because of the illegality of the business, conduct, or investment. In addition, the host state can argue that the arbitral tribunal has no jurisdiction when the investor has violated the

procedural regularities.[1] For instance, a gross violation of the procedural regulations during the litigation process could potentially establish the grounds for the host state to challenge the arbitral tribunal's jurisdiction.

In the case where the state's defence of the arbitration tribunal's lack of jurisdiction is rejected within the framework of objections to illegality, it implies that the arbitral tribunal has determined to consider the hearing of the investor's claim, notwithstanding the stand raising questions concerning the investor's illegal conduct.[2] Illegality objection and lack of jurisdiction are different arguments, although they are interconnected. Arbitral lack of jurisdiction challenges the tribunal's authority to hear and determine the case. On the other hand, the illegality objection argument maintains that the investor need not be protected from their involvement in unlawful conduct.[3] Therefore, when the state's argument concerning the

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[1] Adilbek T., 'Corruption and Fraud in Investment Arbitration' (Springer International Publishing 2022), 22.

[2] Margrit T., 'The Duty of Arbitrators to Raise Suspected Corruption or to Investigate Poorly Particularized Allegations of Corruption' (2024) ICSID Review - Foreign Investment Law Journal, https://doi.org/10.1093/icsidreview/siae009

[3] Ren R. 'THE DICHOTOMY BETWEEN JURISDICTION AND ADMISSIBILITY IN INTERNATIONAL ARBITRATION' 2024; 73(2), International and Comparative Law Quarterly, 417-446. DOI: https://doi.org/10.1017/S0020589324000022

lack of jurisdiction is rejected, it does not imply that the host state has lost the litigation proceedings. The arbitral tribunal will continue considering the investor's claim, and the defence from the host state will be considered.[1]

For instance, in the international case of Prosecutor v. Todorović, the host state lost the argument presented to the tribunal concerning the lack of jurisdiction. The International Tribunal tried the accused for the Former Yugoslavia (ICTY) for unlawful conduct that the defendant was involved in before the separation of Yugoslavia in the 1990s.[2] The trial proceeded with the ICTY tribunal, resulting in the guilty verdict and the consequent improvement of the accused based on the evidence of committing crimes against humanity. Therefore, when the host state loses the argument concerning the arbitral tribunal's lack of jurisdiction, it does not necessarily mean that the investor has won the case since their evidence concerning the illegality objection will be considered by the tribunal. Nonetheless, the rejected illegality objection grounded on the arbitral tribunal's lack of

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[1] Sancin V, Turšič D. 'Min(d)ing corruption in international investment arbitration' In: Illegal Mining: Organized Crime, Corruption, and Ecocide in a Resource-Scarce World. (Palgrave Macmillan 2020) 413-438.
[2] UNITED NATIONS Case No. IT-95-9/1-S: 31 July 2001.

jurisdiction does not vanish. The state can build claims on merit concerning the investor's illegal conduct during the litigation.[1]

The host state may try to prove to the arbitral tribunal that the investor's involvement in the illegal conduct affects the legality of the investment, thus potentially weakening the investor's case. Even if the state presents a claim concerning the illegality objection and the investor's unlawful conduct, the arbitral tribunal may consider the investor's claim in determining the case in favour of the investor.[2] When the tribunal ruling favours the investor, the state's action affected their business or investment, and they may seek compensation for the damages incurred. When the tribunal rules in favour of the state, this implies that it successfully proved to the tribunal that the investor was involved in unlawful conduct directly connected with its investment. If the evidence presented by the state and investors is weak, the arbitral tribunal might dismiss the case entirely.

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[1] Potestà M. 'State-to-state dispute settlement according to bilateral investment treaties: is there potential?' (T.M.C. Asser Press 2013), 753-768.

[2] Yueming Y. 'Corruption and the (Un)Clean Hands Doctrine in Investor-State Arbitration: Definitional and Reciprocity Challenges' (2024) ICSID Review - Foreign Investment Law Journal, siae006, https://doi.org/10.1093/icsidreview/siae006

The defences and exceptions to the general claim that the investment is entangled in illegality are not subjected to the protection of the trade treaty. Many international bilateral investment treaties and pacts contain clauses that mandate that investors comply with the host state's decrees.[1] In most occasions, the most widely accepted defence against violating the host state laws is that the state failed to be liable for its burden of proving to the arbitral tribunal that there was an illegality. Even in the arbitration where the tribunal establishes that there was an illegality, tribunals have designed exceptions permitting the state even purposely to assert jurisdiction or determine that an investor's claim is admissible. The other potential defences that the investor can use in investor-state litigation include curing the illegality, where the investor makes an effort to rectify the illegal conduct before the states can create a dispute against the action.[2]

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[1] Abubakr M., Khalil Kh., Al Maskari B. 'Renegotiation Clause in State-Investor Contracts' (2023) Journal of Legal and Economic Studies. 1291-1359. DOI: https://dx.doi.org/10.21608/jdl.2023.254255.1251; Abdelhadi, M., & Almahjoub, A. 'The Balance between the Public Interest and Investor Protection' (2019)7(4) Kilaw Journal. https://journal.kilaw.edu.kw/wp-content/uploads/2020/06/117-136-Dr.-Abubaker-Dr.-alhabeeb.pdf, 2 April 2024.

[2] Janeba E. 'Regulatory chill and the effect of investor-state dispute settlements' (2019) 27(4) Review of International Economics, 1172-1198.

Limited materiality can also form the basis under which the investor defends itself against the case claim concerning violating the host state laws.[1] The investor can present the claim that illegality was not associated with material, which is the business's investment. In such an instance, the investor would take individual liability for the illegality without entangling the company in the arbitration.[2] The investors can use the provisions in treaty to defend their illegality, pointing to the argument that the treaty wording restricts the areas of the objections or creates a higher chance for the arbitration process's success.[3] The treaty with the provision allowing the investors to reject the potential lawsuit around illegality objection can be applied in the investor-state litigation to allow the investor to benefit from the treaty's protection during the arbitration process and beyond.

4-2- Legal Consequences of Accepting illegality objections

If a tribunal accepts a state's illegality objections, two immediate possible legal consequences emerge: the tribunal gives

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[1] Khayat D. and Ahern W., 'Allegations of Illegality in Investor-State Arbitration and the Presumption of Innocence' (2017) 6 Indian Journal of Arbitration Law 43

[2] Rachel L. Wellhausen 'Recent Trends in Investor–State Dispute Settlement' (2016) 1 (7) Journal of International Dispute Settlement, 117–135, https://doi.org/10.1093/jnlids/idv038

[3] Protopsaltis P., P.R., 2.

up the jurisdiction to arbitrate between the parties or the tribunal rules in favour of the state. An illustration of these consequences is the Paushok v. Mongolia case, where the tribunal ruled that the illegality objections of Mongolia squarely fell within the exclusive jurisdiction of the country's domestic courts. The primary implication of such a ruling is that the tribunal was not in a position to accept the illegality objections because they would be better handled by local courts. Therefore, the tribunal retained the jurisdiction to arbitrate. The opposite outcome regarding the counterclaim would result in a similarly opposite outcome regarding the jurisdiction. In other words, if the tribunal accepted the illegality objections, it would have given up the jurisdiction to arbitrate under the same conditions that Mongolian courts retained the jurisdiction to handle the issue. Under such conditions, the tribunal would have dismissed the claimant's case and Mongolia would have been at liberty to sue the foreign investor in its domestic courts.

A further assessment of the legal consequences of accepting illegality objections reveals that the outcomes of arbitration regarding the award, damages and remedies, enforceability of the

awards, set-off, and legal precedent are possible consequences. Again, there are not many examples that illustrate these legal consequences, mainly because there are hardly any success stories involving a state's illegality objections[1]. Therefore, these issues can only be discussed based on potential implications awaiting further case law development to guide scholars and practitioners in investor-state arbitration. However, it remains possible that if a tribunal accepts a state's illegality objections, it considered them as valid arguments and, should the illegality objections provide proof that a foreign investor's conduct violated core principles, the award can be given in favour of the state or damages calibrated such that both parties are treated fairly. Additionally, a foreign investor may lose the international protection and states would be at liberty to take further legal action against a foreign investor using domestic courts.

Accepting the illegality objections has consequences for the state and the investor. For inventors, the consequences may be significant and severe compared to the state. The potential

[1] Majid Ghamami and Amin Arzhangi, 'Counter Claims in Investor-State Treaty-Based Arbitration' 253.

implications for investors who accept the illegality objections include the likelihood of losing the protection of the trade pact or treaty.[1] When the tribunal considers the argument presented by the host states in determining the case concerning the illegality objection, the investor automatically loses protection from the treaty and the trade pact relevant to the investment.[2] The implication implies that the investor cannot depend on the trade pact or treaty to challenge the action undertaken by the state or take actions against the state, such as seeking compensation for the losses incurred in the litigation process.[3] The instant consequence of accepting the illegality objections for the investor is that the claim is dismissed. When the investor agrees with the objections as illegal, the tribunal may consider the investor unqualified for protection because of the unlawfulness, essentially throwing the investor out.[4]

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[1] Pelc, K. J. 'What explains the low success rate of investor-state disputes?' (2017). 71(3), International Organization, 559-583.

[2] Samples, T. R. 'Winning and losing in investor-state dispute settlement' (2019). 56(1), American Business Law Journal, 115-175.

[3] Bronckers M. 'Is investor-state dispute settlement (ISDS) superior to litigation before domestic courts? An EU view on bilateral trade agreements' (2015). 18(3), Journal of International Economic Law, 655-677.

[4] Dumberry P., 'New developments in the interpretation and application of the clean hands doctrine by investment tribunals' (2023) 14 (4), Journal of International Dispute Settlement, 504–516, https://doi.org/10.1093/jnlids/idad027

In the case of Micula v. Romania, which involved a businessperson from Romania, the findings reveal that the investor, Franck Micula, outrightly accepted an illegality objection.[1] Accepting the objection of illegality among investors is uncommon; therefore, Micula v. Romania is unique. Before accepting the objection to illegality, the investor challenged the host state, Romania, against expropriating numerous of his businesses. The complainant argued that the state of Romania's expropriation of his several companies is against the treaty and the business pact Romania-Netherlands Bilateral Investment Treaty (BIT). The state argued that the businessperson Micula established several of his companies through fraudulent procedures and has been involved in illegal activities such as bribery and tax evasion, thus affecting the legality of his investments. The defendant pointed out the argument, stating that the businessperson had been involved in illegal conduct, thus entangling his investment.

The tribunal found that the businessperson has been involved in several unlawful acts, with evidence pointing out that

[1] Noble Energy, Inc. and Machalapower Cia. Ltda. v. The Republic of Ecuador and Consejo Nacional de Electricidad, ICSID Case No. ARB/05/12, Decision on Jurisdiction march 5, 2008.

Micula was engaged in illegal dealings amounting to fraudulent conduct and tax evasion; thus, his claim was substantially weakened by the case presented by the host state.[1] The tribunal pointed out that the state's actions in expropriating several of Macula's businesses were appropriate and did not violate the trade treaty between Romania and the Netherlands. The businessperson accepted the illegality objection and was forced to address the accusations of illegal conduct, eventually weakening his case since the evidence presented by the host state was intense. The case highlights the possible consequences of accepting the illegality objections by the investor, including a damaging reputation for the investment.[2]

The litigation process that links an investor with illegality can cause significant damage to the reputation of the business. When in a host country as an investor, being associated with unlawful conduct may result in substantial damage to the reputation, making it challenging to secure future business

[1] Judgement of the Court of Justice of the EU, Case C-516/22, March 14, 2024; Ioan Micula, Viorel Micula, S.C. European Food S.A, S.C. Starmill S.R.L. and S.C. Multipack S.R.L. v. Romania [I], ICSID Case No. ARB/05/20.

[2] Weghmann V. and Hall D. 'The unsustainable political economy of investor-state dispute settlement mechanisms1' (2021) 87(3), International Review of Administrative Sciences, 480-496.

cooperation with other partners.[1] Investments entangled in the legal battle with the state often find it difficult to maintain a positive brand reputation because of wrongful actions.[2] Besides, the investors accepting the illegality objections can significantly affect the host. Acceptance of the illegality objections may result in the reduction of the country's investment flow. When investors repeatedly win a tribunal case against the objection illegality raised by the host state, it might reduce the confidence of foreign investors, thus stifling the inflow of foreign direct investment of the country. The current investor-state arbitration practice permits indirect approaches to hold the foreign investor accountable for specific illegality or breach of host state regulations.[3]Foreign investors will be worried about putting their money in a host state with a harsh approach to illegality concerning investor-state arbitration. The other consequence of the state accepting the illegality objections is possibly prolonging the litigation.

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[1] Horn, H. and Tangerås, T., 'Investor-State vs. State-State Dispute Settlement' (2020). CEPR Discussion Paper No. DP14480, Available at SSRN: https://ssrn.com/abstract=3560287

[2] Thomé H. 'Holding Transnational Corporations Accountable for Environmental Harm Through Counterclaims in Investor-State Dispute Settlement: Myth or Reality?' (2021) 22(5-6), the Journal of World Investment & Trade, 651-686. https://doi.org/10.1163/22119000-12340224

[3] Jarrett M., Puig S., and Ratner S., P.R. 259.

Upon accepting the objections to illegality, the presented claims by the investor may demand that the tribunal review the argument's merits, thus prolonging the litigation process. The state always desires that its corruption claims against the investor succeed in the jurisdiction stage.[1] Accepting the objections of the legality may result in counterclaims by the investor, therefore presenting a detrimental consequence to the host state.[2] The counterclaims in the investor-state arbitration may entail the allegations that the arbitration has caused reputation damage to the investor; thus, investor demands compensation. The investor may open a lawsuit against the host with the claim for the reputational damage caused by the false association of the investor's business with unsubstantiated illegal conduct.[3] In addition, the investor may present a claim with an argument that the state is involved in illegality, such as using the investor to pursue illegal activity. Therefore, in investor-state arbitration, the tribunal plays a fundamental role in balancing the arguments and claims presented

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[1] Anh D., P. R. 25.

[2] Gleason T. 'Examining host-State counterclaims for environmental damage in investor-State dispute settlement from human rights and transnational public policy perspectives' (2021) 21(3) Int Environ Agreem, 427-444. doi:10.1007/s10784-020-09519-y

[3] Matveev A. 'Investor-state dispute settlement: The evolving balance between investor protection and state sovereignty' (2015) 40, UW Austl. L. Rev., 348.

by the state and the host states concerning the objection to illegality. The tribunal's role in the investor-state litigation stretches beyond balancing the claim presented by the litigants to identifying the severity of the investor's involvement in unlawful activities and establishing reasonable connections between the investor's illegal conduct and the investment of business.[1]

At the end of this section, it should be noted that the state could use the mechanism of objecting to illegality before the national judiciary, in order to achieve the opposite issue, which is to adhere to the jurisdiction of the national judiciary to hear these disputes, and thus deprive the investor of protection.[2] This can be demonstrated by many rulings issued by the courts of the Egyptian State Council regarding the consideration of causes related to privatization. Which began in 1991 with the state’s sale of many public sector companies, and the corruption that marred the sale contracts in which the state investor participated, and had a serious impact on investment, unemployment, waste of public money and widespread corruption.

[1] Tienhaara K. ‘Investor-state dispute settlement’ In Peter Drahos, editor, Regulatory Theory: Foundations and Applications. Canberra, Australia: (ANU ePress. 2017). 675-691.
[2] See by example Egyptian State Council: case No. 34517 of the Judicial Year 65 and in Case No. 40848 of the Judicial Year 65, 9/21/2011; Case No. 11492 of Judicial Year 65, 5/7/2011.

The privatization policy affected investment by blocking the implementation of new investments, as investments turned into financing the circulation of existing assets, which pushed the economy to stagnation and stagnation. The state also, did not use the proceeds of privatization to build new productive projects, as the privatization program was the closest thing to it is to consume the stock of assets built by previous generations in order to cover its inability to provide the necessary funding, especially due to tax evasion by businesspersons and their lack of social responsibility. The pre-contracting procedures were marred by corruption and invalidity in a way that reveals that the contracts were concluded tainted by corruption, waste of public money, and harm and damage to the national economy, according to economic policies upon which a large number of officials. They wreaked havoc on the ground and subjected to grave accusations of wasting public money, profiteering, and sabotaging the Egyptian economy. Investors participated in this corruption, whose goal was not to invest properly, but rather to increase their profits at the expense of their contractual obligations, at the expense of workers' rights, and wasting public money.

Consequently, this makes this contract invalid as it was obtained through corruption, which makes it and the disputes of the investor not worthy of the international protection prescribed for foreign investments whose disputes are covered and heard by that centre, as this is a violation of international and internal public order.

In order to the above, the administrative judiciary concluded in its rulings that the Egyptian judiciary has the jurisdiction, so the claim that there is any way to resort to local arbitration is dropped for the invalidity of the arbitration clause. In accordance with article (1/2) of Law No 27 of 1994 regarding arbitration added to the law No 9 of 1997. Also, any claim to any jurisdiction for international arbitration is dropped in accordance with the Convention on the settlement of investment disputes between states and nationals of other states, and in accordance with the arbitration precedents before The International Centre for Settlement of Investment Disputes (ICSID), which makes disputes of investment contracts based Corruption is not worthy of international protection.

The administrative judiciary based its ruling on the dismissal of any claim of jurisdiction for international arbitration in these disputes on the fact that the investor in contracts tainted by corruption is not able to resort to international arbitration in accordance with the Convention on the settlement of investment disputes between States and nationals of other States, for two reasons:

The first matter is that the jurisdiction of the International Centre for the Settlement of Disputes Arising from Investment stipulated in Article (1) of the aforementioned agreement is to consider any requests for international arbitration regarding any legal disputes arising directly from an investment between a contracting state and a citizen of another contracting state in accordance with Article (25).) of the agreement can only be achieved if both parties to the dispute agree “in writing” to submit it to the Centre. If both parties give their approval, neither of them has the right to withdraw that approval without acceptance from the other party. What is established is that neither party to the contract regarding the sale and purchase of public sector companies gave their consent “in writing” to submit their disputes

regarding this contract to the centre stipulated in Article (1) of the agreement. On the contrary, the two parties agreed to resort to local arbitration in the event of a dispute. In addition, according to the provisions of Article (26) of the same agreement, the parties' agreement to arbitration under this agreement is considered an agreement to exclude any other remedy unless otherwise stipulated, therefore, the two contracting parties chose local arbitration, excluding international arbitration stipulated in the agreement.

The second matter is that what has been established in arbitration disputes before The International Centre for Settlement of Investment Disputes (ICSID) is that the contract obtained through corruption is not worthy of the international protection stipulated for foreign investments whose disputes are covered and heard by the Centre, because it violates the international and internal public order.

At the same time, the administrative judiciary responded to the claim that the national judiciary's adherence to its jurisdiction to invalidate these contracts will affect the investment climate: erring investor whose contracts are riddled with suspicions of

corruption cannot be considered a bona fide investor. When the contracting process is tainted by gross corruption, the silence of the judiciary regarding these crimes under the pretext of preserving the investment climate is nothing but a denial of justice. Therefore, the judiciary with truth and justice is nothing but protection for the serious investor, encouragement of investment, and purification of the investment climate from climbers and those seeking to destroy the economies of the country hosting the investment.

The court adds it is the responsibility of the state, before the dispute reaches the court, to choose the serious investor and give him the maximum guarantees. In the other hand, it not to allow those affiliated with it to profit at the expense of the state and invest any contribution in choosing a non-serious investor, and take the necessary decisions to purify the investment atmosphere. All of this leads to the serious investor being reassured that in the protection of the host country and legal justice. Therefore, he will not lose his right or be deprived of an incentive, advantage or guarantee as long as he adheres to the law and respects labour and host country rights.

Most recently, on September 20, 2023,[1] the UK Supreme Court ruled that a $2 billion corruption case involving Mozambique, known as the "tuna bonds" case, could be heard in England, rather than by arbitration in Switzerland. Mozambique demanded compensation from Privinvest worth $2 billion, alleging that the latter had paid bribes to facilitate Mozambique's entry into bank financing guarantees for supply contracts to develop its tuna fishing industry and gas resources, stressing that it had not received the value of the commitments it pledged. To consider Mozambique's allegations of bribery and fraud, it would not be necessary to examine the validity of the supply contracts. The defence of contract validity will not affect the defendants' liability for the Mozambique claims.

The defendants, who are a number of companies owned by Privinvest, argued that the case could not be heard by the English judiciary, due to the existence of an arbitration agreement under the contracts concluded between the two parties. However, the UK High Court decided that none of Mozambique's claims was

[1] Republic of Mozambique v Credit Suisse International & Ors [2021] EWCA Civ 329 (11 March 2021) URL: http://www.bailii.org/ew/cases/EWCA/Civ/2021/329.html

“matters” within the scope of the said arbitration agreements pursuant to section 9 of the English Arbitration Act 1996. The parties may therefore not plead the existence of the arbitration agreements to prevent courts from hearing bribery claims until If these claims are related to basic supply contracts that include arbitration clauses. This is because bribery and fraud are serious allegations that go to the heart of the contractual relationship between the two parties. The arbitration agreement concluded between the parties does not include consideration of the issue of the defendants' liability for Mozambique's claims. This agreement only covers disputes arising from the supply contracts themselves. Therefore, it would be incorrect to leave the issue of estimating compensation solely to arbitration, as this entails separating the issue of liability from the merits of the case. A substantive question under section 9 of the Arbitration Act 1996 is a fundamental question that is legally relevant to a claim or defence, or a defence contemplated within the proceedings.

Conclusion and Recommendations

Illegality objection case based on the investor's unlawful conduct often presents intricate issues concerning investment treaty arbitration. Particular situations and the phrasing of the relevant pact play a vital role in determining how the court or tribunal weighs the objections presented by the litigants. Therefore, the recommendation is that the host state should often be ready to counter the investor's defence by presenting a solid case that connects the illegality of the investor's conduct to the investment.[1] Even though a total absence of the due can be costly to the investor when the host state brings forward an illegality objection case, the tribunal often focuses on the critical elements, such as whether the company missed the relevant information that can result in the illegality of the issue presented. Therefore, the recommendation is that the litigants should have a detailed understanding of specific situations, and the applicable regulations of due diligence will be crucial for the tribunal when considering the illegality objection to give a ruling that favours the plaintiff.

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[1] Newcombe A. 'Investor misconduct. In Improving International Investment Agreements' (Routledge 2013), 195-211.

A host state can benefit from an illegal objection of investor-state litigation, defeating the claims and thus preventing the state from counterclaims and compensating the investor. The burden of proof concerning the arbitral tribunal-lacking jurisdiction lies with the host state to demonstrate a lack of jurisdiction. Therefore, the recommendation is that the host state present the case with specific wording pointing out the severe violation of the relevant trade pacts or treaties, which is critical for helping the court, determine the legality of the arguments presented by the host state.[1] When the arbitral tribunal rejects the lack of jurisdiction argument, the burden of proof essentially shifts to the investor to defend their lack of knowledge concerning the unlawful act and demonstrate to the tribunal that their action was in good faith. Nonetheless, rejecting a claim of lack of jurisdiction due to illegality presents several complications for the state.[2] Therefore, it is recommended that the state consider a deeper dive into the investor's unlawful conduct during the merits stage of the litigation process. Therefore, arbitral tribunal will consider the

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[1] Chen R. C. 'A contractual approach to investor-state regulatory disputes' (2015) 40, Yale J. Int'l L., 295.

[2] Viñuales J. E. 'Investor diligence in investment arbitration: sources and arguments' (2017) 32(2), ICSID Review-Foreign Investment Law Journal, 346-370.

evidence of unlawfulness against a particular claim presented by the investor.

The other benefit of an illegality objection in investor-state litigation is deterring future investor illegal conduct and fostering legal investments. In investor-state arbitration, a trivial regulatory breach may not possibly prevent the claim entirely. The severity of the investor's illegality, such as corruption, tax evasion, and bribery, would potentially result in the disqualification of the protection accorded to the investor as afforded by the relevant trade treaty.[1] Therefore, an in-depth understanding of these potential outcomes would support the investor in establishing a solid defence against the argument presented by the state. The recommendation for effective defence in investor-state litigation would depend on the specific claim presented by the state to the tribunal. The nature of the investor's illegal conduct, along with due diligence efforts and protection afforded by the relevant international investment treaties, will play a crucial role in determining the investor-state litigation by the tribunal.

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[1] Fahner J. H. 'Assessing investor misconduct in mining disputes–legality requirements, clean hands, and contributory fault' In Social License and Dispute Resolution in the Extractive Industries (Brill 2021), 50-81.

Illegality objection of investor-state arbitration remains a challenging issue for arbitral tribunals due to many unanswered questions in jurisprudence. A textual analysis of the legislation, conventions, treaties, and investment contracts does not offer conclusive and universal solutions. However, case law development and arbitral tribunals' willingness to rely on previous awards by other tribunals has helped ease the problem. The evidence of this observation, as outlined in this research, emanates from examining tribunal cases before and after the Phoenix and other landmark cases. Before the Phoenix case, tribunals struggled to address questions such as how serious an investor's violations of local laws warrant an illegality objection or what role the principles of estoppel and acquiescence play. After the Phoenix case, many tribunals answer these questions more easily, for instance, by following the Kim test on the gravity of violations and holding states to a higher degree of obligation in administering their local laws. Considering this new scenario, tribunals can easily rule that a state failed or elected not to investigate or prosecute an investor's alleged violations until the

state was caught up in an investment dispute. In this case, the state cannot evoke the illegality objection.

However, most cases when states evoke the illegality objection are straightforward and do not require deeper examination into the host states' neglect of their administrative duties. The primary guiding principles in such cases are international public policy and good faith, or even the text of the BIT, investment contract, or the ICSID Convention. For example, the ICSID Convention protects only those bona fide legal investments, meaning that a tribunal grants a state's illegality objection if it finds illegalities in an investment or its performance. As outlined in this research, there are various typologies of illegalities, including corruption, bribery, fraud, and violation of the host states' laws. Awards involving corruption, bribery, and fraud are straightforward because the text of the ICSID Convention governs them. In such cases, these illegalities are not compulsory legality requirements in BITs and IIAs, and many tribunals are willing to rule that the requirements are implied even when they are not expressly stated. However, violating the host state's laws poses a significant problem because

tribunals must consider the principles of estoppel and acquiescence and the gravity of the violations.

Due to the challenges regarding the jurisprudence of illegality objections, case law development offers a better view of the issue, especially since many texts of legislation, treaties, conventions, and agreements are subject to interpretation by individual tribunals. This research has established that rulings of past tribunals are not legally binding in new cases, but tribunals are allowed to refer to them. As a result, this research established a common practice where many tribunals borrow heavily from past landmark cases, such as the Salini test, the Kim test, and the Phoenix case. Other common legal references include several ICC cases that are also considered landmarks due to their influence on investment arbitration.

As things currently stand, states are disadvantaged in investor-state arbitration because of the requirements outlined in the treaties and agreements between themselves and other states and foreign investors. Few defences exist that states can use due to the asymmetrical nature of the agreements and the fact that they are meant to protect the investors while, at the same time, denying

states the same rights. Therefore, the main question is what states can do to protect themselves in investor-state arbitration. First, the states should always require foreign investors to abide by domestic laws and include clauses in BITs and IIAs that expressly state the same. Such clauses would prove vital in making illegality objections and illegality objections if investors sue the stake. The analysis conducted in this research regarding the jurisprudence of illegality objections reveals that violations of the host state's laws can lead investors to forfeit their rights to international protection under the ICSID Convention. Additionally, case law development illustrates that tribunals can and often do evoke legality requirements of contracts when awarding cases or determining their jurisdiction. Therefore, expressing that the investors must follow domestic laws of host states makes them more accountable and provided states with an effective defence.

Another recommendation is that states can include clauses that allow them to bring illegality objections to investor-state arbitration. This research has established that many tribunals remain reluctant to accept states' illegality objections due to the texts of the BITs and IIAs that prevent states from bringing

illegality objections. Since arbitration requires the consent of both parties, host states should improve their chances by ensuring that the other parties agree to counterclaims. In such cases, counterclaims become a viable option for host states in IIA since tribunals relying on the text of the treaties and agreements will be bound by such clauses. The main reason for these recommendations is that treaties and agreements are asymmetrical in protecting foreign investors and leave host states at disadvantage. Therefore, these recommendations are designed to give countries a fighting chance against foreign investors.

It should be noted that the host countries should make some reforms in investment agreements by containing clauses that explicitly state that courts for settling disputes between investors and states lack jurisdiction when the investor violates the laws of the host country or international legal principles or corruption in concluding contracts.

The last recommendation is also precautionary and sets up states such that they can rely more on the more favourable domestic judicial system – it involves actively administering its domestic laws. As illustrated earlier, the principles of estoppel and

acquiescence may work against a state that stayed silent when a foreign investor violated its laws. Such a state can be estopped from invoking an illegality objection. Administering domestic laws and enforcing compliance serves more than one purpose. First, it gives states the ability to evoke illegality objection based on domestic laws since they can prove that they were not silent when the investor violated the laws. Second, successfully enforcing domestic laws may prevent the need for arbitration as all parties would be upholding and fulfilling their obligations under the signed treaties. Most importantly, the process of enforcing domestic laws may lead to the domestic courts having more jurisdiction than tribunals. Illegality objectives successfully evoked reverts the cases to domestic courts, where states can have a better chance. Alternatively, arbitral tribunal awards can rule in favour of the states.

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