

GLOBAL CONSTRUCTION

LET THE CHIPS FALL WHERE THEY MAY OR WHERE THE ARBITRAL TRIBUNAL ARRANGES THEM

Considerations of the Illegality Defense for Construction Disputes in International Arbitrations

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Statistics from the Organization for Economic Cooperation and Development (OECD) suggest that anti-corruption provisions often contained in construction contracts are frequently ignored: Two-thirds of cases involving bribery in 2014-15 arose from construction, extraction, transportation and storage, and information and communication contracts.¹ Importantly, many of these construction contracts are subject to the long reach of anti-corruption legislation, such as the United States' Foreign Corrupt Practices Act (FCPA), the United Kingdom's Bribery Act, and Canada's Corruption of Foreign Public Officials Act. Most recently, these companies and projects have also become subject to anti-corruption regulations implemented by countries in developing regions, like Latin America and Africa.²

Although corruption practices are widespread globally, construction companies and projects in developing regions have become a major focus of corruption and bribery investigations at a local and international level.³ Construction projects in developing countries are subject to a significant number of international players, complex and multitiered engagements, and underdeveloped local compliance and anti-corruption measures, leading to increased risks of corrupt practices and heightened attention from governmental anti-corruption bodies.⁴ Such risks are not to be taken lightly: Anti-corruption legislation under the FCPA imposes hefty criminal and civil charges against U.S. individuals and companies doing business in the U.S. and abroad, as well as companies that register securities or are required to file reports with the U.S. Securities and Exchange Commission. Further, countries like Argentina, Chile, and

1. Marc D. Veit, "Proving Legality Instead of Corruption," *The Powers and Duties of an Arbitrator: Liber Amicorum*, 373, Patricia Shaughnessy et al., eds., (Wolters Kluwer, 2017). http://www.lalive.ch/data/publications/Shaugnessy_Tung_9789041184139_Flyer.pdf

2. See OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, Oct. 17, 1997, 37 I.L.M. 1, (signatories include Argentina, Brazil, Colombia, Costa Rica, and South Africa, among others). <http://www.oecd.org/corruption/oecdantibriberyconvention.htm>

3. "Corruption is 'Public Enemy Number One' in Developing Countries, says World Bank Group President Kim," World Bank press release, Dec. 19, 2013. <http://www.worldbank.org/en/news/press-release/2013/12/19/corruption-developing-countries-world-bank-group-president-kim>

4. Joseph J. Mamounas and Marcelo Ovejero, "Emerging Anticorruption Trends in Latin America," 33 *International Law Quarterly* 18, 2017. <http://www.mondaq.com/unitedstates/x/564844/Emerging+Anticorruption+Trends+in+Latin+America>



Brazil, among others, have implemented local anti-corruption and transparency regulations by imposing criminal and civil sanctions for bribery and failures to disclose conflicts of interest in the procurement and execution of contracts.⁵

In light of these recent trends, Latin American companies engage in projects that are governed by local and extraterritorial anti-bribery and anti-corruption regulations, and increasingly incorporate anti-corruption clauses into their contracts. Importantly, for the construction sector — one of the industries suffering the most from pervasive corruption — many of these contracts are enforced through international arbitration.⁶ Indeed, anecdotal evidence suggests that a potentially large number of disputes resolved through international arbitration in the construction sector, involving state companies and officials in particular, involve illegality.⁷ Consequently, arbitral tribunals are constantly faced with the challenge of making decisions regarding the so-called illegality defense, “an affirmative defense resembling the common-law defense of unclean hands, which bars a claimant from recovery if he is guilty of some injustice concerning the very matter for which he seeks relief.”⁸ The arbitral tribunal’s challenge is multifaceted: First, it must decide whether to retain jurisdiction of the case despite the corruption allegations; second, it is tasked with determining the appropriate award once illegality is established; finally, it must ensure that the parties “do not use the arbitral process as a shelter to give effect to agreements tainted with corruption or obtained by bribery.”⁹

EMERGING TRENDS TO ILLEGALITY CLAIMS AND DEFENSES IN INTERNATIONAL ARBITRATION

An allegation of corruption in a construction dispute triggers arguments regarding the arbitral tribunal’s jurisdiction and admissibility of the claims on the basis that a contract is void, or

at least unenforceable.¹⁰ “[A] finding of inadmissibility is different from a finding of voidness of the commercial contract. Whereas contracts procured by corruption, depending on the applicable law, may or may not be voidable by the innocent party, contracts providing for corruption are null and void *ab initio* under most national laws.”¹¹ As such, in cases where contracts are void *ab initio*, arbitral tribunals have typically denied exercising jurisdiction. For example, in a 1963 ICC decision, Judge Gunnar Lagergren declined enforcement of a contract as it was an agreement to facilitate bribes.¹²

Moreover, arbitral tribunals have denied exercising jurisdiction over disputes in which a party claims corruption in the procurement of the contract, citing to public policy arguments, among others.¹³ This denial is based on the arbitral tribunal’s stance that its duty to render enforceable awards is hindered when ruling on corruption allegations, as such awards may be nullified on grounds of domestic public policy violations. In other words, arbitral tribunals have denied jurisdiction over contracts procured through illegality, which should not be a source of rights for the corrupt party.¹⁴

An alternate tendency in handling corruption claims, however, has emerged: Arbitrators are addressing corruption concerns together with the merits of the case, and not just as a jurisdictional or admissibility question.¹⁵ This trend is consistent with Article 16(1) of the United Nations Commission on International Trade Law (UNCITRAL) Model Law on International Commercial Arbitration, which provides that the arbitral tribunal may rule on its own jurisdiction, including making determinations on objections to the existence or validity of the arbitration agreement.¹⁶ Thus, if a tribunal finds that a contract is illegal or tainted by corruption, it can still make a determination as to the voidability of the contract because the arbitration agreement, as a severable provision, is still in force. In the U.S. and the U.K., for

5. See, e.g., Poder Ejecutivo Nacional, Mensaje No. 127, Argentina’s Bill on Corporate Criminal Liability for Cases of Corruption and Guidelines for Compliance Programs, Oct. 20, 2016 (Arg.); Lei No. 12.846, Clean Companies Act of Brazil (Lei da Empresa Limpa), Aug. 1, 2013 (Braz.); Law No. 19829, Oct. 8, 2002, Diario Oficial (Chile); Law No. 20393 art. 4, 25, Dec. 2, 2009, Diario Oficial (Chile).

6. Romy Descours-Karmitz, “The Role of ICSID Tribunals in the Combat Against Corruption,” 11:1 *World Arbitration and Mediation Review*, 1, 5, 5 (2017) (citing Peter Muchlinski, Federico Ortino and Christoph Schreuer, *The Oxford Handbook of International Investment Law*, 592 (Oxford University Press, 2008)).

7. *Ibid.*, note 1.

8. Claus von Wobeser, “The Corruption Defense and Preserving the Rule of Law,” *International Arbitration and the Rule of Law: Contribution and Conformity* 203, 205, Andrea Menaker, ed., (Wolters Kluwer, 2017).

9. *Ibid.*, note 6, 6 (citing Mathew L. Rea, “Curbing Bribery and Corruption in International Arbitration,” Law360, Oct. 3, 2016, <http://www.law360.com/articles/839534/curbing-bribery-and-corruption-in-international-arbitration>).

10. *Ibid.*, note 8, 222–23; See also Dolores Bentolila, *Arbitrators as Lawmakers*, 210 (2017).

11. *Ibid.*, 213.

12. ICC Case No. 1110 of 1963, Award of 1963, 10:3 Arbitration International, 282, 291 (1994). https://www.trans-lex.org/201110/_/icc-award-no-1110-of-1963-by-gunnar-lagergren-yca-1996-at-47-et-seq/

13. Carlos F. Concepción, “Combating Corruption and Fraud from an International Arbitration Perspective,” 9:2 *Arbitraje: Revista de Arbitraje Comercial y De Inversiones*, 369, 385 (2016). <https://www.ibanet.org/Article/NewDetail.aspx?ArticleUid=10dc0d5d-1c13-45e3-959e-030449be81f8>.

14. *Ibid.*, note 8, 213.

15. *Ibid.*, note 6, 6 (citing Cameron A. Miles, “Corruption, Jurisdiction and Admissibility in International Investment Claims,” 3(2), *Journal of International Dispute Settlement*, 329, 334 (2012)).

16. UNCITRAL MODEL LAW, G.A. Res. 40/72, 40 U.N. G.A.O.R. Supp. (No. 17), U.N. Doc. A/40/17 (June 21, 1985), revised in 2006, G.A. Res. 61/33, U.N. Doc. A/61/33 (Dec. 4, 2006), http://www.uncitral.org/pdf/english/texts/arbitration/ml-arb/07-86998_Ebook.pdf.

example, courts have become increasingly reluctant to do away with contracts and contract claims upon a finding of illegality.¹⁷ As such, arbitral tribunals can retain jurisdiction over the matter despite a finding of illegality. Many have: The number of awards in both commercial and investor-state arbitrations dealing with corruption allegations has continuously increased.¹⁸

Once the arbitral tribunal has decided to address the corruption allegations as part of the merits of the case, it must navigate jurisprudential uncertainty. While arbitrators have become adept at handling arguments raised under anti-corruption provisions and regulations governing construction contracts, the principles and analyses applied by arbitrators vary because of the lack of jurisprudence on the standard of proof applied to corruption claims and defenses in international arbitrations.

Further, once the arbitral tribunal has made a determination regarding illegality, it must face the additional hurdle of determining the appropriate damages to be awarded. There is a current trend in common-law jurisdictions to address the windfalls that can result from rendering contracts unenforceable because of illegality. Arbitral tribunals are more often considering alternative consequences to findings of corruption so as not to undermine the ability of a party to obtain compensation for work actually performed.

This article sets out to examine and inform of relevant trends in international arbitrations regarding claims and defenses to illegality, specifically the standard of proof arbitral tribunals apply in determining illegality and the results of proving such illegality. While this article focuses on construction matters in the context of commercial arbitration, the standards and principles addressed have been informed by cases in both the commercial and investment arena.

STANDARD OF PROOF OF CORRUPTION ALLEGATIONS: A CHALLENGING TASK FOR ARBITRATORS

If an illegality defense is raised, the arbitral tribunal must determine the standard of proof it will adopt. The standard

of proof refers to the threshold of evidence required to prove a fact, a claim, and ultimately a party's case.¹⁹ International arbitration proceedings do not provide for a "one-size-fits-all" approach; instead, standards of proof vary across the legal systems and the rules of evidence at play in the jurisdiction in which the dispute is being resolved.²⁰

Common and civil law jurisdictions adopt different standards of proof. While arbitral tribunals applying common law principles frequently use the "preponderance of evidence" and the "balance of probability" standards, arbitral tribunals applying civil law principles base their decisions on whether the arbitrators are "convinced."²¹ For instance, in *Patel v. Mirza* (2016) UKSC 42, the U.K. Supreme Court, applying common law principles, denied the illegality defense to bar claims under the contract procured through corruption, and instead applied a balancing test to consider whether denial of the claim would be disproportionate to the claimant's illegality.

It is important to consider that arbitral tribunals also have the discretion to heighten the standard of proof required to prove illegality. A finding of corruption has serious implications and, as such, allegations of serious wrongdoing, such as corruption and criminal activities, should require more convincing evidence than other facts in dispute. Arbitral tribunals in support of this position have applied higher standards of proof to claims of illegality, such as "clear and convincing evidence," "more likely than not," or "beyond reasonable doubt"²² to discourage groundless allegations.

Others, however, apply the same standard of proof to all claims, including illegality, believing it would be problematic to require proof beyond the "balance of probabilities where an allegation of gross misconduct is made against a highly placed person."²³ Those in support of the same standard believe that heightened standards are reserved for criminal matters, in which the final outcome might be sending individuals to prison, which is not a possible result of international arbitration.²⁴ As a result, arbitral tribunals of this opinion have rejected the application of higher standards of proof to corruption claims and illegality defenses.²⁵

17. *Ibid.*, note 13, 386, n. 104 (citing *Scherk v. Alberto-Culver Co.*, 417 U.S. 506, 519, n. 14 (1974) (finding that the fraud exception to an arbitration clause "means that an arbitration or forum-selection clause in a contract is not enforceable if the inclusion of that clause in the contract was the product of fraud or coercion"); see also *Buckeye Check Cashing, Inc. v. Cardegna*, 546 U.S. 440, 449 (2006); *Westacre Investments, Inc. v. Jugoinport-SPDR Holding Co. Ltd.*, 1998 2 Lloyd's Rep 111, 114 (QB).

18. Dolores Bentolila, *Arbitrators as Lawmakers*, 210-11; *Ibid.*, note 8, 205-13.

19. *Ibid.*, note 8, 216.

20. Richard H. Kreindler, "Practice and Procedure Regarding Proof: The Need for More Precision," *Legitimacy: Myths, Realities, Challenges*, 156, 157, Albert Jan van den Berg, ed., (Kluwer Law International, 2015).

21. *Ibid.*, note 1, 375.

22. *Ibid.*, note 8, 217, 218; see also *Himpurna California Energy Ltd. v. PT (Persero) Perusahaan Listrik Negara*, UNCITRAL, award dated May 4, 1999, *Mealey's International Arbitration Report*, 14:12 (1999) 54, para. 169; *EDF (Services) Ltd. v. Romania*, ICSID Case No. ARB/05/13, award dated Oct. 8, 2009, para. 221; *Waguih Elie George Siag and Clorinda Vecchi v. Arab Republic of Egypt*, ICSID Case No. ARB/05/15, award dated June 1, 2009, paras. 325-326; ICC Case No. 5622, award of 1988, *Yearbook XIX (1994)* 105 at 112, para. 23; ICC Case No. 13384, award of December 2005, 24 ICC Bulletin (Supplement 2013), 62, 64.

23. *Ibid.*, 216-17 (citing *Tokios Tokelés v. Ukraine*, ICSID Case No. ARB/02/18, award dated July 26, 2007, para. 124).

24. *Ibid.*, 218.

25. *Ibid.*, 219; see also *Libananco Holdings Co. Ltd. v. Republic of Turkey*, ICSID Case No. ARB/06/8, award dated Sept. 2, 2011, para. 125; *Fraport AG Frankfurt Airport Services Worldwide v. Republic of the Philippines*, ICSID Case No. ARB/03/25, award dated Aug. 16, 2007, para. 399.

Absent direct evidence of corruption, arbitral tribunals may rely on circumstantial evidence, “red flags,”²⁶ or use adverse inferences in assessing illegality defenses. Several tribunals have resorted to these practices because definitive proof of corruption is extremely rare and arbitrators have limited power to compel production of evidence, unlike domestic courts.²⁷ None of the standards of proof has emerged as dominant.²⁸

THE RESULTS OF PROVING ILLEGALITY: HARSHLY SANCTIONED OR HIGHLY COMPENSATED

After the standard of proof has been established by the arbitral tribunal, and the party raising the illegality defense has successfully met the standard, the arbitral tribunal still must determine the appropriate damages to be awarded.²⁹ There is currently no consensus as to the appropriate damages to be awarded when illegality has been proved.

Traditionally, arbitral tribunals have applied the illegality doctrine in determining that no award is appropriate once corruption has been proved. The illegality doctrine, applied to construction contracts governed by New York law, for example, holds that “[a] contract procured through fraudulent and collusive bidding is void as against public policy and recovery cannot be had upon any theory.”³⁰ When applied to performance of a contract, the illegality doctrine requires that a party “be denied recovery ... if it appears that he has resorted to gravely immoral and illegal conduct in accomplishing its performance.”³¹ In other words, the doctrine bars a party from enforcing a contract that it procured or performed illegally.

A blanket application of the illegality doctrine may prove problematic. As noted by practitioners and scholars, the illegality defense may promote “tactical claims of corruption made on spurious grounds to discredit the other party or to

26. *Ibid.*, 219; see also *The ICC Guidelines on Agents, Intermediaries and Other Third Parties* (2010) (providing a nonexhaustive list of 14 types of situations identified as “red flags”).

27. *Ibid.*, note 8, 218, 219; see also *Europe Cement Investment & Trade S.A. v. Republic of Turkey*, ICSID Case No. ARB(AF)/07/2, award dated Aug. 13, 2009, paras. 150-164; ICC Case No. 13515, award of April 2006, 24 ICC Bulletin (Supplement 2013) 66 at 71; ICC Case No. 12990, award of December 2005, 24 ICC Bulletin (Supplement 2013), 52 at 53; *Jan Oostergetel and Theodora Laurentius v. The Slovak Republic*, UNCITRAL, award (redacted) of April 23, 2012, para. 303.

28. *Ibid.*, note 6, 17 (citing Florian Haugeneder and Christoph Liebscher, “Investment Arbitration—Corruption and Investment Arbitration: Substantive Standards of Proof,” in *Austrian Yearbook on International Arbitration*, 547 Gerold Zeiler et al. eds., (Manz’sche Verlags und Universitätsbuchhandlung 2009).

29. Nigel Blackaby et al., *Redfern and Hunter on International Arbitration*, 120, 6th ed., (Tribunals have been increasingly turning to the substantive issue of illegality and the consequences of such impropriety.) (Oxford University Press, 2015). <https://global.oup.com/academic/product/redfern-and-hunter-on-international-arbitration-hardcover-and-ebook-9780198744870?cc=us&lang=en&>

30. *Jered Contracting Corp. v. New York City Transit Authority*, 239 N.E.2d 197, 200 (N.Y. 1968).

31. *McConnell v. Commonwealth Pictures Corp.*, 7 N.Y.2d 465, 471, 166 N.E.2d 494 (N.Y. 1960).





attempt to escape from a bad transaction or investment” where a finding of illegality leads to the dismissal of a claim or case in its entirety.³² For example, the victim of a corrupt act may also become a victim to the illegality doctrine when it seeks to enforce its contract because the illegality defense can result in zero recovery for both parties if corruption is proved no matter the balance of the facts. In an effort to combat this risk, arbitral tribunals are increasingly conducting a case-by-case assessment to determine the results of illegality findings.

In certain cases, arbitral tribunals have accounted for the potential benefit provided by the party engaged in the corrupt acts in assessing appropriate damages. For example, certain tribunals have permitted parties engaged in corrupt practices in the procurement or enforcement of the contract to still obtain an award for direct costs and expenses, excluding awards for profits and expected damages.³³

Importantly, taking a more flexible approach, the arbitral tribunal also considers the extent of both parties’ corrupt practices in the procurement and execution of the contract. Where both parties are corrupt, arbitral tribunals may consider the possibility of granting certain protections to provide restitution to the contractor who delivered a benefit to the contracting party, although both engaged in corrupt practices.³⁴ This would prevent parties who attempt to shield themselves with the illegality defense from avoiding their obligations under the contract.³⁵ Still, arbitral tribunals may deem it appropriate to award no damages to either party “where most, if not all, actors are tainted by corruption.”³⁶

CONCLUSIONS

In the international legal arena, findings of illegality can have severe consequences both inside and outside of the arbitration hearing. Such findings can result in a dismissal of the claims,³⁷ subsequent criminal investigations, and sanctions against the corrupt party. Therefore, one should raise and approach the defense cautiously, taking into consideration the ultimate goals of the business or project, the public policy in the jurisdiction for enforcement, and the significant discretion an arbitral tribunal has in determining the applicable standard of proof and awarding damages when corruption claims have been raised.

32. Ibid., note 6, 10 (citing Mathew L. Rea, “Curbing Bribery and Corruption in International Arbitration,” *Law360* (Oct. 3, 2016), <http://www.law360.com/articles/839534/curbing-bribery-and-corruption-in-international-arbitration>).

33. Domitille Baizeau and Tessa Hayes, “The Arbitral Tribunal’s Duty and Power to Address Corruption Sua Sponte,” Andrea Menaker (ed.), *International Arbitration and the Rule of Law: Contribution and Conformity*, ICCA Congress Series, Volume 19 (Kluwer International, 2017) 244.

34. Ibid., note 8, 211.

35. Ibid., note 6, 23.

36. Ibid., note 33, 232 (citing Aloysius P. Llamzon, *Corruption in International Investment Arbitration*, 1.02 (Oxford University Press, 2014)).

37. Ibid., note 33, Baizeau et al., 226.

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As such, it is important for a party addressing illegality to keep the applicable, alternative standards of proof required to prove illegality in mind when considering presenting such claims. Parties raising or defending against claims of corruption are in a unique position to argue the appropriate standard upon which illegality should be weighed, in light of particular facts and circumstances surrounding their case. Given the lack of jurisprudence on the matter, parties may consider including the standard of proof of their choice in their anti-corruption and arbitration clauses to provide guidance to the arbitral tribunal as to the parties' expectations.

As detailed above, the possible results of raising and proving illegality in the context of international arbitration can prove futile: An award may be set aside during enforcement proceedings in a jurisdiction where enforcement of a void contract is against public policy, or damages for costs will be awarded to the party against whom the defense was raised for the benefit the delivered.³⁸ Importantly, these risks exist regardless of the arbitral tribunal's findings on illegality.

The increase of construction contracts and enforcement of anti-corruption measures in developing regions like Latin America, among others, forces the international arbitration community to continue to face and address concerns surrounding corruption and illegality. As such, practitioners and parties alike must be apprised of the discourse and developments of international jurisprudence related to illegality in this context, especially given the discrepancy in results that a finding, or even claim, of illegality can have on a case and ultimate award.

38. "Convention on the Recognition and Enforcement of Foreign Arbitral Awards," article V(2)(b), June 10, 1958, 21 U.S.T. 2517, T.I.A.S. No. 6997, 330 U.N.T.S. 38, available at <http://www.uncitral.org/pdf/english/texts/arbitration/NY-convention/New-York-Convention-E.pdf>

Ibid., note 29, 623, 624, 634.