FALL OF THE PHOENIX: A NEW APPROACH TO ILLEGALITY OBJECTIONS IN INVESTMENT TREATY ARBITRATION

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Abstract: Objections to jurisdiction are standard practice in investment treaty arbitration. One of the types of objection that respondent States often make is that the tribunal lacks jurisdiction because the claimant's investments violated the State's law. This is what is known as an '*illegality objection*'. This paper provides an overview of the law and practice of illegality objections. After making nine general observations on illegality objections, the author considers the influence of the 2009 award in *Phoenix Action v Czech Republic*, where, for the first time, an ICSID tribunal expressed the view that every treaty that offers international arbitration to foreign investors is subject to an '*implicit*' condition that the establishment of the investment conforms with the law of the host State. The author then discusses the 2017 decision in *Vladislav Kim & Ors v Republic of Uzbekistan*, where the tribunal introduced a three-step test for determining whether a given violation of host State law vitiates jurisdiction. The author provides an example matrix to aid in the application of the *Kim* test in future cases.

Keywords: arbitration, International Centre for Settlement of Investment Disputes (ICSID), Bilateral Investment Treaty (BIT), Free Trade Agreement (FTA), jurisdiction, admissibility, illegality, proportionality

I INTRODUCTION

A State has a right to object to jurisdiction when it is sued under a bilateral investment treaty (**BIT**) or other investment protection agreement. It is standard practice for States to exercise this right. As States have become more familiar with the BIT system, they have become more sophisticated in their approach to all aspects of investor-State arbitration procedure, including the grounds upon which the jurisdiction of a tribunal may be challenged in a BIT case. Since the 2006 decision in *Inceysa Vallisoletana, S.L. v Republic of El Salvador*,[1] there has been a noticeable trend of States objecting to

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The impact of the *Inceysa* and *Phoenix Action* awards is clear from the cases that followed. Particularly since the *Phoenix Action* award, the published decisions and awards show investment tribunals grappling with a complex array of issues, namely the interpretation of the '*in accordance with law*' requirements found in many BITs, the gravity of the violation and the extent to which it is relevant to the analysis (i.e. whether only '*serious*' violations will vitiate the tribunal's jurisdiction), the role played by principles of estoppel and acquiescence (i.e. whether they may operate to bar the State to raising the violation as a jurisdictional impediment), and whether jurisdictional objections based on host State law should be bifurcated or dealt with as part of the merits of the case. In the years post *Phoenix Action*, parties and arbitrators were able to find some guidance on these issues in the published decisions and awards, but the jurisprudence of legality objections was weakened by the absence of a functional test for determining whether a proven violation of host State law vitiates jurisdiction. However, in March 2017, a major step forward was taken by the tribunal in *Vladislav Kim & Ors v Republic of Uzbekistan*.[4] The *Kim* tribunal sought to restore discipline and balance to the debate on illegality objections by introducing a test based on proportionality, under which proper account is taken of the conduct of both investor and State and the question is posed whether, in the circumstances of the particular case, it would be just to decline jurisdiction.

The purpose of this paper is to provide an overview of the development of the law and practice of illegality objections in investment

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[1] *Inceysa Vallisoletana S.L. v Republic of El Salvador* (ICSID Case No. ARB/03/26), Award, 2 August 2006.

[2] *Phoenix Action, Ltd v The Czech Republic* (ICSID Case No. ARB/06/5), Award, 15 April 2009.

[3] See above n 2, [101].

[4] *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) Decision on Jurisdiction, 8 March 2017.

treaty arbitration. The focus is on BITs but what follows applies equally to multilateral investment treaties and Free Trade Agreements (**FTAs**) with investment protection chapters. The discussion begins with a series of general observations on illegality objections: their legal foundations, the law that governs them, who has the burden of proof, the relevance of State responsibility, and the procedural considerations they give rise to. The focus then shifts to the jurisprudence and the efforts that tribunals have made to bring clarity to the debate on illegality objections. We will then turn to the recent decision in *Kim*, where the test for illegality as an objection to jurisdiction *ratione materiae* was set out.

II ILLEGALITY OBJECTIONS GENERALLY

As a frame to the discussion of specific cases, it is apt to make some general observations regarding the law and practice of illegality objections. Based on the case law, scholarly commentary and the writer's own experience, nine general observations may be made.

The first observation is that, in an investment treaty case, the extent to which an illegality objection will be tenable depends principally upon the text of the treaty under which the investor's claim is brought. This is because it is that treaty that records the parties' agreement to arbitrate and its conditions. It is only where the treaty contains language that clearly links host State law to the conditions of jurisdiction that an objection to jurisdiction based on illegality will be available to the respondent State (if the treaty contains no such requirement, it will be for the respondent State to persuade the tribunal that the words of the treaty can nonetheless be interpreted as including such a requirement, or that a condition of legality is implied in the treaty; failing such interpretive arguments, the respondent State's only remaining route will be to argue the alleged illegality as a matter of admissibility). The most common location in which legality requirements are found is in the treaty's definition of '*investment*', which controls jurisdiction *ratione materiae*. Many BITs contain express requirements for conformity with host State law, or at least references to host State law, in their definitions of '*investment*'. To take the example of the treaty at issue in *Phoenix Action*, the Israel-Czech Republic BIT defines '*investment*' as '*any kind of assets invested in connection with economic activities by an investor of one Contracting Party in the territory of the other Contracting Party in accordance with the laws and regulations of the latter* [...]'. The meaning and effect of this type of language is discussed below, suffice to say here that where a treaty defines '*investment*' in this way, the lawfulness of the investment under host State law will be relevant to the tribunal's jurisdiction. Other treaties contain dedicated scoping provisions which specify that the treaty only applies to investments made '*in accordance with*' host State law or, more commonly, investments '*admitted*' by the host State. The latter variety of scoping clause may refer to host State law generally or to specific laws or regulations that control foreign investment in its territory. As an example of the latter, many of Indonesia's BITs contain provisions stipulating that they only apply to investments '*which have been granted admission in accordance with the Law*

No. 1 of 1967 concerning Foreign Investment or with any law amending or replacing it.'[5] Whether these scoping provisions go to jurisdiction or admissibility is debatable and will depend on the treaty. In any case, to determine the meaning and effect of such a provision, the provision must first be interpreted in accordance with the Vienna Convention on the Law of Treaties 1969 (**Vienna Convention**). Of course, the results of a Vienna Convention interpretation will be different in each case, depending on the specific text of the provision, its context and the objects and purposes of the treaty in which it is contained (and potentially other considerations). But, as a general observation, it may be said that admission requirements usually have limited temporal scope. This is evident from the plain meaning of the noun '*admission*', which is '[t]*he process or fact of entering or being allowed to enter a place*'.[6] Thus, treaty provisions that refer solely to '*admission*' are concerned with the point in time at which the investment *enters* the host State. We see this reading in *Churchill Mining v Indonesia*, where the tribunal ruled that the admission requirement in the UK-Indonesia BIT was '*a one-time occurrence*' that applied '*at the time of entry into the country and not during the entire operation of the project*'.[7] It will ordinarily be difficult, therefore, for a State to argue that an admission clause of this kind expresses or implies a broader requirement of continuous conformity with host State law. The same is true even where the admission requirement is expressed as applying when the investment is '*established, acquired or expanded*' – the temporal focus is still on discrete events in the life-cycle of the investment, rather than the investment's daily conformity with host State law. Further, and whatever the scope of the '*admission*' provision, it must be interpreted with due regard to the treaty's definition of '*investment*', which will often be broad and cover assets and interests for which individual acts of admission would be neither legally necessary nor commercially practical. For example, where (as is often the case) the BIT includes intellectual property (**IP**) rights in its list of example '*investments*', it is difficult to see how that class of investments could be subject to an admission requirement given that many businesses generate IP on continuous basis (meaning a formal admission process would not be *practical*) and certain classes of IP rights – such as copyright – may be acquired under municipal law without the need for registration by the local authorities (meaning a formal process of admission would not be *necessary*).

The second observation concerns interpretation. In circumstances where the treaty *does* contain an express legality requirement (such as a definition of '*investment*' that includes '*in accordance with* [host State law]' wording), the meaning and effect of the words that the treaty drafters used to express that legality requirement will need to be established before the requirement itself is able to be applied to the facts. To do this, the candidate provision must be interpreted in accordance with the Vienna Convention. In

[5] See, for example, Article 2(1) of the United Kingdom-Indonesia BIT; see also Article 3(1)(a) of the Australia-Indonesia BIT.
[6] *Oxford English Dictionary*, admission, (2018).
[7] *Churchill Mining v. Republic of Indonesia* (ICSID Case Nos. ARB/12/14 and 12/40), Decision on Jurisdiction, 24 February 2014, [289] – [290].

matters of treaty interpretation, the master provision of the Vienna Convention is Article 31 (General Rule of Interpretation). Article 31(1) requires that: '[a] *treaty 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 in the light of its object and purpose*.' Fidelity to the text of the treaty is required: in its commentary on a draft version of Article 31 of Vienna Convention, the International Law Commission considered that '*the text* [of the treaty] *must be presumed to be the authentic expression of the intentions of the parties; and that in consequence, the starting point of interpretation is the elucidation of the meaning of the text* [of the treaty], *not an investigation ab initio into the intentions of the parties*';[8] as the International Court of Justice noted in the *Case Concerning the Territorial Dispute between Libya and Chad*, '[i]*nterpretation must be based above all upon the text of the treaty*'.[9] Given the established principle of textual priority, it is concerning that, in practice, the essential step of interpreting the underlying treaty provision is often not undertaken by the party invoking the provision (the State) but instead by the party responding to the objection (the investor); consequently, the threshold question of interpretation is commonly addressed at the reply stage of the written pleadings on jurisdiction. This is because, as a matter of strategy, the objecting party (the State) will normally prefer to focus on the facts of the alleged illegality rather than the legal framework for its objection. While this may be understandable from a tactical perspective, it is unsatisfactory from a legal perspective, not least because it results in a debate that should be precise instead being conducted in the abstract. It is incumbent upon tribunals to apply the law, and the law that applies to the interpretation of the treaty is the Vienna Convention and the customary international law that it reflects. If a tribunal does not apply the law, its award may be set aside (in an ICSID case, the award may be exposed to annulment on the basis that the tribunal has manifestly exceeded its powers[10]). In circumstances where an objection to jurisdiction is made on the basis of an express legality clause in a BIT, the burden of interpreting that clause must be on the party who advances the objection (the State). It is not enough for the objecting party merely to identify the clause on which it relies in its illegality objection: the objecting party must take a position on what the clause means, and that position must have a legal foundation.

Similarly, if the treaty does *not* contain an express legality requirement, the burden is on the objecting party to establish that, when interpreted in accordance with the applicable law, the treaty is nonetheless subject to a legality requirement. As Professor Douglas put it:

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[8] Report of the International Law Commission on the second part of its seventeenth session and on its eighteenth session (UN Doc. A/6309/Rev.l), Yearbook of the International Law Commission 1966, (1967) New York: UN, vol. II, [11].

[9] *Case Concerning the Territorial Dispute between Libya and Chad*, Judgment of 3 February 1994 [1994] ICJ Reports, [41].

[10] As observed by Professor Schreuer, '[t]*here is widespread agreement that a failure to apply the proper law may amount to an excess of powers by the tribunal*'. See C. H. Schreuer, The ICSID Convention: A Commentary (Cambridge University Press, 2013), 955.

> [i]f [a party argues that] international law, independent of any policies underlying national laws, nonetheless compels an international tribunal to decline its jurisdiction in the face of a successful plea of illegality, then the burden of persuasion lies upon those advocating this position to demonstrate why that is the case and how it is consistent with the principles of interpretation in Article 31 and 32 of the Vienna Convention.[11]

In practice, '*implied legality*' arguments are often made more based on case law (*Phoenix Action* and its successors) than treaty interpretation. This can lead to a situation where the parties end up debating the relevance of previous decisions (whether they are distinguishable), instead of focusing on how the treaty that governs *their dispute* should be construed. In circumstances where the text of a treaty is at issue, submissions based on case law are no substitute for a Vienna Convention analysis (especially in a legal system where there is no doctrine of precedent). Not only must the objecting party conduct the proper interpretive analysis to support its implied term, but it must also clearly articulate the substantive and temporal scope of the legality requirement that it seeks to imply. To be clear: the *substantive* dimension is about what rules and laws of the host State are covered by the implied requirement; the *temporal* dimension is about the point in time at which compliance with these rules and laws is relevant to jurisdiction (i.e. when the investor makes its investment or during the entire life-span of the investment?[12]). Where it is argued that the legality requirement is implicit, it is critical that the objecting State clearly articulate its position on these two dimensions because there is a risk that, in alleging the existence of an implied legality requirement without taking a position on its substantive and temporal scope, the objecting State may put the claimant investor at a procedural disadvantage, in that the claimant may not know the case it has to meet.

The third observation concerns the doctrine of separability. Just as in an arbitration under a contract, an arbitration under an investment treaty is based on an arbitration agreement – the difference is that, in an investment treaty arbitration, the offer and the acceptance are conveyed through separate instruments (normally the BIT and the investor's Request for Arbitration respectively). But the end result – the formation of an arbitration agreement – is the same. It is a general principle that all international arbitration agreements are separable from the legal instrument in which they are contained.[13] As illustrated in the case of *Plama v Bulgaria* (discussed below), if the allegation of illegality goes to an instrument that is extraneous

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[11] Z. Douglas, 'The Pleas of Illegality in Investment Treaty Arbitration, ICSID Review (2014) 29:1, 171.
[12] For an illustration of the temporal dimension of a legality requirement in a BIT, see *Kardassopoulos v Georgia* (ICSID Case No. ARB/05/18) Decision on Jurisdiction of 6 July 2007. In this case, the tribunal held (at paragraph 182) that, while a State retains a degree of control over foreign investments by denying BIT protection to those investments that do not comply with its laws, this control '*relates to the investor's actions in making the investment. It does not allow a State to preclude an investor from seeking protection under the BIT on the ground that its own actions are illegal under its own laws. In other words, a host State cannot avoid jurisdiction under the BIT by invoking its own failure to comply with its domestic law*'.
[13] See above n 11, 170.

to the investor-State arbitration agreement, the alleged illegality will not raise an issue of jurisdiction (though it may raise an issue for the merits).[14]

This leads to the fourth observation, which is that objections to jurisdiction can only be based on the legal instruments that the investor relies on to establish jurisdiction and the law that governs those instruments.[15] The law that governs jurisdiction in an investment treaty case may be (and often is) different to the law that governs the merits. Many BITs contain governing law clauses, which sometimes provide for the application of host State law (usually subject to the provisions of the BIT and applicable rules of international law). Governing law clauses are also standard inclusions in the new generation of FTAs. But it must be understood that such clauses are normally not relevant to the legal question of jurisdiction. As Professor Schreuer has observed, '[t]*ribunals have held consistently that questions of jurisdiction are not subject to the law applicable to the merits of the case. Questions of jurisdiction are governed by their own system which is defined by the instruments containing the parties' consent to arbitration*.'[16] Where an arbitration agreement is formed through an investor's acceptance of an offer of arbitration made by a State in a treaty, the agreement is formed on the international plane and can only be governed by the law of that plane, international law. Thus, there should ordinarily be very limited scope for host State law to play a role in the determination of jurisdiction in a BIT case. To be sure, where the treaty contains an express legality requirement in its definition of '*investment*', host State law may be relevant in the analysis of subject-matter jurisdiction, but the wider arbitration agreement remains under the control of international law. Similarly, even where the applicable treaty contains no express legality requirement, there are some aspects of jurisdiction in which host State law necessarily plays a role. The best example is the existence of property rights: international law cannot create property rights and so the question of whether the investor has property rights must be answered by reference to the law of the State in which the investor alleges it has or had such rights (i.e. the host State). As the existence of property rights bears on the question of whether or not there is an '*investment*' for the purposes of the BIT, host State law necessarily informs jurisdiction *ratione materiae* in this context. But that does not mean host State law controls the issue. It means, simply, that in the analysis of whether or not there is an '*investment*', a limited question of host State law must be asked, i.e. were property rights created in the first place? For jurisdiction, the question is not whether those property rights, once created, were lawfully exercised by the party that held them. If that question arises at all, it arises in the merits of the dispute – at which point, subject to the law

[14] *Plama Consortium Limited v Republic of Bulgaria* (ICSID Case No. ARB/03/24), Decision on Jurisdiction of 8 February 2005, [130].

[15] In a BIT case before an ICSID tribunal, there are two treaties: the BIT (which records the State's offer of arbitration and the conditions on which it is made) and the ICSID Convention (Article 25 of which establishes certain additional jurisdictional conditions). In a non-ICSID case, such as a BIT dispute referred to UNCITRAL Rules arbitration, there will be only one treaty implicated in the analysis of jurisdiction (the BIT).

[16] C. Schreuer, 'Jurisdiction and Applicable Law in Investment Treaty Arbitration', McGill Journal of Dispute Resolution (2014) 1:1, 3.

that governs the dispute (which may or may not be stipulated in an express clause of the BIT), host State law may play a role.

Fifth, objections to jurisdiction must be based on law. This may sound trite, but it is not unusual to see States argue that non-compliance with host State law deprives the tribunal of jurisdiction as a matter of '*international public policy*'. Such arguments proceed from a flawed premise. A truly gross violation of host State law may raise an issue of international public policy, but that is a matter of admissibility, not jurisdiction (except perhaps in the extreme case where the violation is so offensive to international public policy that it can credibly be said to negate the investor's property rights *ab initio*, such that jurisdiction *ratione materiae* is impacted). Clearly, some forms of illegal conduct are offensive to international public policy, such as bribery – the pernicious effects of which are well understood. However, that does not mean that international public policy views all forms of non-compliance with host State law in the same light. It is facile to assert that there is an international public policy in favour of the rule of law, such that any non-compliance with host State law bars the investor's claim. If that was right, ever BIT would be subject to a '*hair trigger*' test for illegality completely at odds with the object of promoting investment. Rather, at the threshold, the burden is on the State to establish that the law in question is of a kind that is so important, and that investor's breach of that law is so serious, that the international community would be shocked if the investor was still able to have its claims under the BIT decided by an international tribunal. In the writer's experience, such particularisation is rare – violations of international public policy are more often simply asserted, without any attempt to place the law and the breach in the international moral compass. States that invoke public policy in this way are, in the words of Professor Douglas, using it a '*blunt instrument*'.[17]

The sixth observation is that legal relations between investor and host State are subject to an overarching, reciprocal duty of good faith. This duty applies independent of the express protections and standards of the BIT. It is the State's burden as sovereign to administer the laws it makes. If the host State makes but does not enforce a law, good faith dictates that the State cannot be heard to argue that non-compliance with that law vitiates the jurisdiction of an international tribunal. If the State does normally enforce the relevant law but was subjectively aware that the investor in question was not complying with that law and took no action, the State should ordinarily be estopped or precluded from raising that non-compliance in any context (jurisdiction, admissibility, liability or quantum) in a subsequent dispute with that same investor. If the State is not barred then, at the very least, its failure to enforce the relevant law should weigh against any submission by the State to the effect that the relevant law protects an essential State interest and is therefore sufficiently '*serious*' to justify the investor being denied the protection of the BIT. Finally, if there is no evidence of the State raising the alleged illegality prior to the disputed measures, that will further embarrass

[17] See above n 11, 181.

the objection – especially if the alleged violation is raised for the first time after the investor has commenced arbitration under the treaty (an unfortunate but not uncommon sequence). Of course, in the analysis of these issues of fact, due regard must be had to the investor's *bona fides*. If, for example, there is clear evidence that the investor consciously took advantage of the host State's lack of resources to police compliance with an important law, that will warrant consideration by the tribunal and may impact on the investor's access to equitable principles such as estoppel. As we shall see, one of the most appealing features of the *Kim* test is the balanced way in which it evaluates the conduct of the both parties in this area.

The seventh observation concerns State responsibility. It is sad but true that, in many countries, government officials break the law. It is not enough for the State to simply disown the acts of those officials. Article 7 of the International Law Commission Articles on State Responsibility provides that '[t]*he conduct of an organ of a State or of a person or entity empowered to exercise elements of the governmental authority shall be considered an act of the State under International law if the organ, person or entity acts in that capacity, even if it exceeds its authority or contravenes instructions*'. It is a general principle of international law that no one can be allowed to take advantage of his or her own wrong. As noted above, it is also a general principle that States are bound to act in good faith *vis-à-vis* foreign investors. Thus, if the State is responsible for the illegal acts of its own officials, the State has breached good faith and it cannot take advantage of that breach to challenge the jurisdiction of an international tribunal. The recent case of *Georg Gavrilovic & Gavrilovic d.o.o. v Republic of Croatia* illustrates the confluence of these principles. In that case, Croatia objected to jurisdiction, alleging (*inter alia*) that the claimants acquired their investments in an irregular bankruptcy proceeding. The tribunal (Dr Michael Pryles, Dr Stanimir Alexandrov and Christopher Thomas QC) found that the bankruptcy proceedings were irregular in certain respects but that they were part of a scheme in which State organs were involved. In dismissing Croatia's illegality objection, the tribunal ruled:

> it is not open to the State to plead the patent irregularities of a bankruptcy proceeding overseen and authorised at critical junctures by its own court or the making of an extraordinary loan approved by a senior government minister, which might or might not have been unlawful under Croatian law, in opposition to the BIT claim. Put another way, if this investment was not made in conformity with the legislation of Croatia, on the evidence before this Tribunal, this is due to the acts of organs of the State. In this regard, the Tribunal recalls that under Article 7 of the ILC Articles, the conduct of an organ of a State shall be considered an act of the State under international law if the organ exceeds its authority or contravenes instructions.[18]

Thus, in circumstances where a State challenges jurisdiction relying on illegal acts by its own officials, principles of good faith and State responsibility may bar the State's objection. Of course, the availability and

[18] *Georg Gavrilovic & Gavrilovic d.o.o. v Republic of Croatia* (ICSID Case No. ARB/12/39), Award, 26 July 2018, [384].

strength of such an argument will depend on the facts – including the extent to which the investor was complicit in the wrongdoing. But the operation of these principles should not be overlooked.

The eighth observation concerns the burden of proof. In circumstances where a jurisdictional objection is made, the burden of proof is naturally on the party that advances the objection, not the party against whom the objection is directed. This rule is reflected in the maxim that the burden of proof is upon he or she who affirms, not he or she who denies (*affirmati non neganti incumbit probatio*). This general rule applies to illegality objections as it does to any other form of jurisdictional objection. However, in the illegality context, the allocation of the burden of proof may be complicated by the fact that both parties – investor and State – invoke the clause that contains the legality requirement. This situation of dual invocation arises most often where the BIT's definition of '*investment*' contains '*in accordance with law*' language: the investor invokes this clause as part of establishing the tribunal's jurisdiction and the State invokes it as part of contesting it. The fact that the investor has invoked the clause first does not mean the investor carries all burdens under that clause. Rather, what should be determinative in the allocation of the burden of proof is the way the clause is invoked: positive or negative. The investor has the burden of proving that the basic conditions of the tribunal's jurisdiction are satisfied, and this includes proving that the investor had an '*investment*' as defined in the applicable treaty. Where the treaty's definition of '*investment*' contains '*in accordance with law*' language, the investor will need to show that it has (or had) assets and interests recognised under host State law. But this positive invocation cannot result in the investor having to prove that its investments were *not* illegal under host State law – that would entail proving a negative and, as observed by the International Court of Justice in the *Diallo* case, '*it cannot as a general rule be demanded of the Applicant that it prove the negative fact which it is asserting*'.[19] The burden of proving the negative must be on the party that invokes the legality clause in the negative fashion: the State. One of the many decisions and awards that support this allocation is *Gavrilovic*, where the respondent State's illegality objections were underpinned by allegations of investor misconduct reaching back over 25 years. The tribunal ruled that the burden of proof was on the State:

> Since the Respondent has alleged that the Claimants' investment was not made in accordance with host State law, the Respondent bears the burden of proving that allegation. Given the passage of time since the events at issue, it would be unreasonable in the present case to expect the Claimants to prove that they have not violated any of the multitude of laws of Croatia since 1992. Rather, the onus must be on the Respondent State to identify which laws it alleges the Claimants have violated and to prove that violations did occur.[20]

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[19] *Ahmadou Sadio Diallo* (Republic of Guinea v Democratic Republic of the Congo), Merits, Judgment, ICJ Reports 2010, 639, [55].
[20] See above n 18, [231].

Of course, as the *Gavrilovic* tribunal noted, the burden may subsequently shift to the investor – but only if sufficient evidence is supplied to support its allegations. It bears noting too that the jurisprudence displays a general recognition that the standard of proof must be sensitive to the nature of the illegal conduct alleged. The usual standard ('*balance of probabilities*', or the like) should apply unless the investor misconduct alleged is of a serious nature and could attract criminal sanctions, such as imprisonment or large fines. In cases where the alleged illegality is serious in nature – such as fraud or corruption – the tribunal should require that the accusing party (the State) meet a higher standard of proof. At the very least, where the usual standard of proof is applied to allegations of this nature, higher quality evidence should be required from the accusing party (an approach that has been adopted by several tribunals in recent years). Those investment treaty tribunals that have applied a higher standard of proof have generally described it in terms of '*clear and convincing evidence*', '*comfortable satisfaction*' or '*reasonable certainty*'. Whichever approach is taken – higher standard of proof or higher quality evidence – it is right and proper that a rigorous approach be taken to allegations that, if proven, may have serious consequences for the investor (just as it is right and proper for a rigorous approach to be taken where an investor alleges serious misconduct against State officials, such as corruption).

The ninth and final observation is procedural in nature. When an illegality objection is made, there are good reasons to start from a presumption against bifurcation (and in favour of dealing with the matter in the merits of the case). This is because illegality objections will normally (though not always) require a broader inquiry than that which can efficiently be conducted on a preliminary basis. As Professor Douglas explains, '[a] *plea that the Claimant has violated the law of the host State in the procurement of an investment invariably necessitates an analysis of the conduct of both the claimant and the respondent host State*'.[21] The presumption against bifurcation should be strongest where the alleged illegality is of a serious nature (such as fraud or corruption) and requires a full trial of fact to be fairly determined. Of course, the presumption should be rebuttable and there will be situations where the allegation of illegality is sufficiently narrow to justify bifurcation, such as where (in the Indonesian style) the BIT requires a specific approval under a specific statute and the contention is that the required approval was lacking. But experience shows that narrow objections of this kind are the exception, not the rule.

III Rise Of The Phoenix

In the development of the branch of international investment law that concerns illegality objections, case law has played a dominant role. As noted above, parties making illegality objections tend to focus more on the jurisprudence rather than the text of the applicable treaty – especially where the BIT contains no express legality requirement. In the practice of illegality

[21] See above n 11, 183.

objections, there are many authorities to choose from. However, practice reveals that States making illegality objections place greatest emphasis on four cases: *Plama* (2005),[22] *Inceysa* (2006),[23] *Fraport AG Frankfurt Airport Services Worldwide v Philippines* (2007)[24] and *Phoenix Action* (2009).[25] Of these four cases*, Phoenix Action* is the most interesting because it is relied upon as authority for the proposition that all BITs are subject to an '*implicit*' condition of conformity with host State law. And, because of the *Phoenix Action* tribunal's broad statement that *'States cannot be deemed to offer access to the ICSID dispute settlement mechanism to investments made in violation of their laws*', the case is also relied upon in proceedings under BITs that do contain express legality clauses (as authority for the expansive application of those provisions). It is because of the extensive reliance that States have placed on *Phoenix Action* that, so to speak, we have seen the Phoenix rise.

We turn now to discuss each of these cases in chronological order. Readers should note that this is not intended to be a comprehensive analysis of each case but rather only a summary of the legal and factual bases of the illegality objection that was made and the way it was dealt with by the arbitrators in each matter. It should also be emphasised that the cases discussed below do not represent the full constellation of authorities in this area – there are many other decisions and awards not mentioned below which deal with illegality objections.

A *Plama v Bulgaria*

In *Plama*, the claim was brought under the Energy Charter Treaty (**ECT**). The tribunal comprised Carl Salans (as President), Professor Albert Jan van den Berg and V. V. Veeder QC. The arbitrators were confronted with an allegation that the investor secured the consent of the Bulgarian privatisation authorities by fraudulent misrepresentation. Despite the fact that the ECT does not contain a legality requirement, Bulgaria argued this point as a matter of jurisdiction. The tribunal disagreed, deciding that the issue should instead be addressed in the merits, principally because the arbitration agreement was formed under the ECT, rather than the document to which the allegation of fraudulent misrepresentation related.[26] Subsequently, in the

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[22] See above n 14, [130].
[23] See above, n 1.
[24] *Fraport AG Frankfurt Airport Services Worldwide v. Republic of the Philippines* (ICSID Case No. ARB/03/25), Award, 16 August 2007.
[25] See above, n 2.
[26] See above n 14, [130]. The tribunal held: '[t]*he Respondent's charges of misrepresentation are not directed specifically at the parties' agreement to arbitrate found in Article 26 ECT. The alleged misrepresentation relates to the transaction involving the sale of the shares of Nova Plama by EEH to PCL and the approval thereof given by Bulgaria in the Privatization Agreement and elsewhere. It is not in these documents that the agreement to arbitrate is found. Bulgaria's agreement to arbitrate is found in the ECT, a multilateral treaty, a completely separate document. The Respondent has not alleged that the Claimant's purported misrepresentation nullified the ECT or its consent to arbitrate contained in the ECT. Thus not only are the dispute settlement provisions of the ECT, including Article 26, autonomous and separable from Part III of that Treaty but they are independent of the entire Nova Plama transaction;*

merits, however, the tribunal found for Bulgaria, finding that the substantive protections of the ECT cannot apply to investments that are made contrary to law.[27] The *Plama* case therefore provides a compelling illustration of the fourth point made above: how the application of the doctrine of separability will normally militate against treating illegality as a matter of jurisdiction.

B *Inceysa v El Salvador*

The *Inceysa* case is often identified as the first case in which an ICSID tribunal declined jurisdiction on the basis of an '*in accordance with law*' requirement in a BIT. The dispute arose out of a concession contract that the El Salvador Ministry for the Environment and Natural Resources signed with the investor (Inceysa) to provide vehicle inspection services. The concession was awarded following a public tender process. When the Ministry decided not to proceed with the concession, Inceysa brought a claim under the El Salvador–Spain BIT. El Salvador objected to jurisdiction on the basis that Inceysa's investment was not '*in accordance with*' El Salvador's law because Inceysa had misrepresented its financial condition and experience in its bid and had presented fraudulent and forged supporting documents to the authorities. While the El Salvador– Spain BIT did not contain a legality requirement in the definition of '*investment*', other provisions of the treaty contained language indicating that only investments made in accordance with host State law were protected under the BIT. Article 3 of the El Salvador–Spain BIT provides that '[e]*ach Contracting Party shall protect in its territory the investments made, in accordance with its legislation*'. Article 2 also provides that the El Salvador–Spain BIT applies to pre-existing investments made '*in accordance with the laws of the other Contracting Party*'. Further, the *travaux préparatoires* of the El Salvador–Spain BIT revealed that the contracting parties had intended for the BIT to apply only to investments which were made in accordance with the laws of the host State.[28] Specifically, the *travaux préparatoires* revealed that the contracting parties understood that the legality requirements in other provisions of the BIT were sufficient to ensure that only lawful investments would be protected and that a legality requirement in the definition of '*investment*' would be superfluous.[29] Accordingly, the existence of the abovementioned legality requirements in the El Salvador–Spain BIT, combined with the *travaux préparatoires*, gave the *Inceysa* tribunal a basis for holding that the claimant's violation of the principle of good faith deprived the tribunal of jurisdiction. The tribunal (Rodrigo Oreamuno Blanco, Burton Landy and Dr Claus von Wobeser) held:

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so even if the parties' agreement regarding the purchase of Nova Plama is arguably invalid because of misrepresentation by the Claimant, the agreement to arbitrate remains effective'.

[27] *Plama Consortium Limited v. Bulgaria* (ICSID Case No. ARB/03/24), Award, 27 August 2008, [138] – [139] ('*Unlike a number of Bilateral Investment Treaties, the ECT does not contain a provision requiring the conformity of the Investment with a particular law. This does not mean, however, that the protections provided for by the ECT cover all kinds of investments, including those contrary to domestic or international law* […] *The Arbitral Tribunal concludes that the substantive protections of the ECT cannot apply to investments that are made contrary to law*').

[28] See above, n 1, [195].

[29] Ibid [194] - [196].

> Inceysa violated the principle of good faith from the time it made its investment and, therefore, it did not make it in accordance with Salvadoran law. Faced with this situation, this Tribunal can only declare its incompetence to hear Inceysa's complaint, since its investment cannot benefit from the protection of the BIT, as established by the parties during the negotiations and the execution of the agreement.[30]

Despite the way States often present *Inceysa* today, when read correctly, the *Inceysa* decision does not stand for the proposition that a legality requirement is to be implied into the definition of '*investment*' in every treaty. *Inceysa* is therefore not the predecessor to *Phoenix Action* that it is sometimes argued to be. It was, instead, a decision based on a rare combination of text and *travaux*, and alarming facts. The reality is that, in most situations, the *Inceysa* decision will be clearly distinguishable as few BITs will be accompanied by the negotiating history that motivated the *Inceysa* tribunal to reach the interpretive conclusions it did.

C *Fraport v Philippines*

In the *Fraport* case, the applicable BIT defined '*investments*' as any asset '*accepted in accordance with the respective laws and regulations of* [the host State]'. The dispute arose out of the annulment of a concession contract concluded between the Philippine Department of Transportation and Communication and Germany investor Fraport for the construction and operation of an international passenger terminal at Ninoy Aquino International Airport in Manila. After Fraport initiated ICSID arbitration under the Germany-Philippines BIT, the Philippines made an illegality objection and ultimately established that Fraport had circumvented Philippine laws concerning foreign ownership restrictions, namely the Anti-Dummy Law. The tribunal comprised Yves Fortier QC, Dr Bernardo Cremades and Professor Michael Reisman. The majority decided that, given the specific definition of '*investments*' in the BIT, this violation of host State law deprived the tribunal of jurisdiction *ratione materiae*. The majority found that '*Fraport was consciously, intentionally and covertly structuring its investment in a way which it knew to be a violation of the* [Anti-Dummy Law]'.[31] Dr Cremades dissented, saying that the majority's interpretation of the BIT '*does violence to the object and purpose of promoting and protecting investment in the Philippines*'. The *Fraport* award was later annulled by an *ad hoc* committee at ICSID (comprising Judge Peter Tomka, Judge Dominique Hascher and Professor Campbell McLachlan QC)[32] and, in the resubmitted proceeding, the second tribunal found against Fraport.

D *Phoenix Action v Czech Republic*

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[30] See above n 1, [239].
[31] See above, n 24, [306].
[32] *Fraport AG Frankfurt Airport Services Worldwide v The Republic of the Philippines* (ICSID Case No. ARB/03/25), Decision on the Application for Annulment of Fraport AG Frankfurt Airport Services Worldwide, 23 December 2010.

The claim in *Phoenix Action* arose out of an Israeli company's acquisition of two metal Czech companies, Benet Praha (**BP**) and Benet Group (**BG**). BG and BP were controlled by the same person, a Czech citizen named Vladimir Beno. BP and BG became involved in proceedings before Czech courts – BG in relation to the ownership of three other Czech companies (one of which was insolvent); BP in a public prosecution for tax and custom duty evasions in which assets of BP had been frozen and seized. Mr Beno sold BP and BG to Phoenix Action Ltd, a company incorporated under the laws of Israel and controlled by other members of his family. Two months later, Phoenix gave the Czech Republic notice of the existence of an investment dispute. Eleven months after giving notice of dispute, in February 2004, Phoenix commenced arbitration against the Czech Republic under the Israel-Czech Republic BIT, alleging unlawful expropriation and other violations of the BIT. A three-member Tribunal was formed, comprising Andreas Bucher, Professor Juan Fernandez-Armesto and Professor Brigitte Stern (as President of the Tribunal).

The Czech Republic objected to jurisdiction – principally on the basis that the tribunal lacked jurisdiction because the claimant company was '*nothing more than an ex post facto creation of a sham Israeli entity created by a Czech fugitive from justice, Vladimir Beno, to create diversity of nationality*'.[33] The State described the claim as '*one of the most egregious cases of treaty shopping that the investment arbitration community has seen*'.[34] The State argued that the tribunal lacked jurisdiction *ratione temporis* because the acts said to constitute a violation of the BIT took place before Phoenix acquired BP and BG and made its investment in the host State. The Czech Republic put it that, in light of this chronology, the action could be characterised as an abuse of the process of ICSID Convention. The Czech Republic also objected to jurisdiction *ratione materiae*, on the basis that Phoenix's acquisition of BP and BG was not an '*investment*' within the meaning of Article 25 of the ICSID Convention and Articles 1 and 7 of the Israel-Czech Republic BIT.[35] However, this objection was premised on the allegation that Phoenix was merely '*a passive investor in two inactive companies*'[36] and that its investments could not '*pass any of the four criteria of the so-called 'Salini test*'.[37]

The tribunal declined jurisdiction on the basis that the claimant investor had '*made an 'investment' not for the purpose of engaging in economic activity, but for the sole purpose of bringing international litigation against the Czech Republic*.'[38] The tribunal found that '[t]*his kind of transaction is not a bona fide transaction and cannot be a protected investment under the ICSID system*'.[39] On this basis, the tribunal held that it

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[33] See above n 2, [34].
[34] See above n 2, [34].
[35] See above n 2, [38].
[36] Ibid [38].
[37] Ibid [39].
[38] Ibid [142].
[39] Ibid [142].

lacked jurisdiction under the ICSID Convention and the Israel-Czech Republic BIT.[40] However, before it reached this conclusion, the tribunal conducted its own analysis of what was required in order for an '*investment*' to be '*in accordance with the laws of the host State*'. As noted above, the Israel-Czech Republic BIT contains '*in accordance with law*' wording in its definition of '*investment*', and so from a textual perspective it is understandable why the tribunal did this. But, based on the summary of the parties' pleaded cases in the Award, it appears the Czech Republic did not present a case that the investor had violated its laws. Further, the Tribunal expressly stated that it did not find that a violation of host State law had occurred.[41] So it is hard to read what the *Phoenix Action* tribunal said about the requirement for conformity with host State law as anything other than *obiter dicta*. Nonetheless, what the tribunal said at paragraphs 100 to 105 of the Award has had a significant influence on the practice of illegality objections in BIT cases. The critical paragraph of the award is 101, where the tribunal offered the following opinion:

> In the Tribunal's view, States cannot be deemed to offer access to the ICSID dispute settlement mechanism to investments made in violation of their laws. If a State, for example, restricts foreign investment in a sector of its economy and a foreign investor disregards such restriction, the investment concerned cannot be protected under the ICSID/BIT system. These are illegal investments according to the national law of the host State and cannot be protected through an ICSID arbitral process. And it is the Tribunal's view that this condition – the conformity of the establishment of the investment with the national laws – is implicit even when not expressly stated in the relevant BIT.[42]

As noted above, this part of the *Phoenix Action* award is often cited by States in cases where the applicable BIT lacks an express legality requirement. The last sentence of paragraph 101 is often quoted in isolation – a practice that distorts the true rationale of the award. The *Phoenix Action* tribunal was not saying that *any* violation or non-conformity with host State law will deprive the tribunal of jurisdiction. A wider review of the *Phoenix Action* award reveals that the arbitrators were focused on breaches of host State laws as they specifically regulate the establishment of investments in the economic sector in question – in other words, laws that control the extent to which a foreigner can make and own the investment that is the subject of the dispute.[43] Nor was the *Phoenix Action* tribunal suggesting that the investor must conform to host State law throughout the life of its investment: the temporal scope of the '*implicit*' requirement identified by the *Phoenix Action* tribunal is very narrow, with focus being on conformity with host State law at the point of '*establishment*'[44] of the investment.

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[40] Ibid [145].

[41] Ibid [134] ('*In the present case, there is no violation of a rule of the Czech Republic legal order, and not even of the principle of good faith as embodied in the national legal order, as it has not been contended that the acquisition was against Czech laws, or was performed with dissimulation or otherwise contestable methods.*').

[42] Ibid [101].

[43] Ibid [101].

[44] Ibid [101].

IV EMERGENCE OF THE 'SERIOUS VIOLATION' TEST

After *Phoenix Action*, many investment tribunals were confronted with broad-scope illegality objections – often made in reliance of paragraph 101 of the *Phoenix Action* award, extracted above. Several such tribunals attempted to bring clarity to the issue and articulate proper boundaries for illegality objections. For example, in *Alpha Projektholding v Ukraine* (2010) the tribunal said the illegality must be '*serious*' to justify a denial of jurisdiction;[45] in *Quiborax v Bolivia* (2012) the tribunal considered the published authorities and found that the legality requirement is limited to non-trivial violations, violations of the host State's investment regimes and fraud;[46] in *SAUR v Argentina* (2012), the tribunal took a very narrow view of the scope of the '*tacit condition*' of legality, finding that such a condition is only engaged where the investor has committed '*serious violation*[s] *of the legal order* [of the host State]';[47] and in *Flughafen Zürich AG v Venezuela* (2012), the tribunal held that the implied condition of legality amounted to a requirement that the investor has '*not committed a serious violation of the law of the receiving State*'.[48]

These decisions show the gradual emergence of a concern that the opinion expressed by the *Phoenix Action* panel had the potential to undermine the intended operation of BITs and that, if BITs are to work as their drafters intended, a narrower view would need to be taken where illegality is raised as an impediment to jurisdiction. One of the strongest expressions of these concerns is found in the 2015 award in *Mamidoil v Albania*.[49] In *Mamidoil*, the applicable BIT contained a legality requirement, and the ICSID tribunal found that the claimant investor had not built and had not started to operate its investment, a tank farm, in accordance with Albanian legislation.[50] But the tribunal (Professor Dr Rolf Knieper, Dr Yas Banifatemi and Steven Hammond) refused to accept that this was enough to deprive it of jurisdiction:

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[45] *Alpha Projektholding GmbH v. Ukraine* (ICSID Case No. ARB/07/16), Award, 8 November 2010, [294].

[46] *Quiborax S.A., Non Metallic Minerals S.A. and Allan Fosk Kaplún v. Plurinational State of Bolivia* (ICSID Case No. ARB/06/2), Decision on Jurisdiction, 27 September 2012, [266] ('*The Tribunal considers that the BIT's legality requirement has both subject-matter and temporal limitations. The subject-matter scope of the legality requirement is limited to (i) non-trivial violations of the host State's legal order (Tokios Tokelés, LESI and Desert Line), (ii) violations of the host State's foreign investment regime (Saba Fakes), and (iii) fraud – for instance, to secure the investment (Inceysa, Plama, Hamester) or profits (Fraport). Additionally, under this BIT, the temporal scope of the legality requirement is limited to the establishment of the investment; it does not extend to the subsequent performance. Indeed, the Treaty refers to the legality requirement in the past tense by using the words investments 'made' in accordance with the laws and regulations of the host State and, in Spanish, 'haya efectuado' (Fraport, Hamester, Saba Fakes)*', internal citations omitted.

[47] *SAUR International SA v. Republic of Argentina* (ICSID Case No. ARB/04/4), Decision on Jurisdiction and Liability, 6 June 2012, [358].

[48] *Flughafen Zürich A.G. and Gestión e Ingenería IDC S.A. v. Bolivarian Republic of Venezuela* (ICSID Case No. ARB/10/19), Award, 18 November 2012, [132].

[49] *Mamidoil Jetoil Greek Petroleum Products Societe S.A. v. Republic of Albania* (ICSID Case No. ARB/11/24), Award, 30 March 2015.

[50] Ibid [479].

> [t]he Tribunal finds, however, that this conclusion is not sufficient to bar its jurisdiction to hear and decide the dispute based on the general assumption that States do not consent to the arbitration of disputes relating to illegal investments. The result of such a sweeping and undifferentiated opinion might contradict the purposes of international conventions for the protection of investments.[51]

In its review of the case law, the *Mamidoil* tribunal placed *Phoenix Action* in the group of cases it said have '*circumscribed the concept* [of illegality] *in a teleological intention in order to restrict its application*'.[52] The *Mamidoil* tribunal cautioned that, if the legality requirement was applied too broadly, that would be unfair to investors:

> States must not be allowed to abuse the process by scrutinizing the investment post festum with the intention of rooting out minor or trivial illegalities as a pretext to free themselves of an obligation. A State must act consistently with its obligations and not resist jurisdiction because it wants to escape the consequences of its standing agreement to arbitrate.[53]

Through this sequence of cases (of which there are many others), a test of '*seriousness*' or gravity emerged and, it might be said, the Phoenix began to fall. To be sure, there were glimpses of this test in pre-*Phoenix Action* cases. For example, in *Rumeli Telekom v Turkey* (2008) the tribunal held that '*investments in the host State will only be excluded from the protection of the treaty if they have been made in breach of fundamental legal principles of the host country*',[54] and similar parameters were fixed by the tribunal in the *LESI* case in 2005.[55] However, as noted in the introduction to this paper, what was lacking was a clear articulation of the test that an investment treaty tribunal should apply to determine whether a proven act of violation or non-compliance with host State law will vitiate jurisdiction. Despite the progress made by the tribunals in the post-*Phoenix Action* cases discussed above, it was not until eight years after *Phoenix Action* that this test was finally delivered in the *Kim* case.

V THE NEW TEST IN *KIM*

The dispute in *Kim* arose out of measures taken against certain investments made by a group of Kazakh investors in two cement companies in Uzbekistan. The disputed State acts comprised a series of regulatory and judicial measures – including a criminal investigation – effected by various branches of the Uzbek Government. The investors alleged that the measures resulted in the unlawful nationalisation of the two cement companies in which they had invested. The investors initiated ICSID arbitration under the Uzbekistan-Kazakhstan BIT, which contained an express legality

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[51] Ibid [480].
[52] Ibid [482].
[53] Ibid [483].
[54] *Rumeli Telekom A.S. and Telsim Mobil Telekomunikasyon Hizmetleri A.S. v. Republic of Kazakhstan* (ICSID Case No. ARB/05/16), Award, 29 July 2008, [319].
[55] *Consortium Groupement L.E.S.I.- DIPENTA v. République algérienne démocratique et populaire* (ICSID Case No. ARB/03/08), Award, 10 January 2005, [24(iii)].

requirement. The tribunal that was constituted to hear the case comprised eminent practitioners Professor David Caron, Yves Fortier QC and Toby Landau QC.

In the proceedings, Uzbekistan alleged a range of violations of its laws and, on this basis, objected to the jurisdiction of the ICSID tribunal. Specifically, Uzbekistan alleged that (i) certain of the claimants' Share Purchase Agreements had been registered with a false purchase price; (ii) that certain of the claimants' Share Purchase Agreements were not registered with the Tashkent Stock Exchange as required by law; (iii) that the claimants acquired their investments in the two companies in violation of Uzbek law by purchasing shares from employees at below market prices; and (iv) that the claimants' acquisition was fraudulent and caused harm to the State and minority shareholders in the two companies. The State also alleged that the investors committed further violations of Uzbek law by making corrupt payments in the establishment of their investments. In support of each head of its illegality objection, Uzbekistan alleged violation of various national laws and regulations, including the Uzbek Civil Code, the Criminal Code, the Securities Law and the Rules of the Tashkent Stock Exchange.

The tribunal received extensive submissions from the parties on how the express legality requirement of the applicable BIT should be applied. In its analysis of the scope of the BIT's legality requirement, the *Kim* tribunal began with the following survey of ICSID practice:

> Numerous tribunals have addressed the legality requirement present in other BITs and forged, if not a test of the substantive scope of the legality requirement, a series of statements that have come to be employed by ICSID tribunals. The dominant tendency within these awards is (1) to state that the substantive scope of the legality requirement is limited to violations of fundamental laws of the Host State and (2) to state a variety of rule-like statements whereby the first proposition may be applied.[56]

Importantly, the *Kim* tribunal then went on to say:

> The Tribunal does not find the analysis thus far satisfactory. The rule-like statements in other awards are in several instances constructed without reference either to the text of the treaty in question or to underlying principles. A characteristic of rules is that they may include more situations than appropriate (over-inclusive) and simultaneously not include situations that should be captured (under-inclusive). Previous tribunals through rule-like statements, as a practical matter, have approximated what this Tribunal regards as the core of those acts that trigger a legality requirement, but the lack of underlying principles makes problematic a nuanced articulation of the boundaries of that core. Although all proceedings are contested, unmoored rule-like statements have accentuated the contestation in this proceeding. Moreover, such rule-like statements are not necessarily phrased in ways that can be applied easily to other Host State laws, or adapted to the variety of legal systems encountered by ICSID tribunals.[57]

[56] See above n 4, [384].
[57] Ibid [385].

The tribunal sought to restore discipline and balance to the debate on legality requirements by introducing a test based on proportionality:

> The denial of the protections of the BIT is a harsh consequence that is a proportional response only when its application is triggered by noncompliance with a law that results in a compromise of a correspondingly significant interest of the Host State.[58]

The tribunal explained that it chose this test '*so as to focus more sharply the substantive scope of the legality requirement not on whether the law is fundamental but rather on the significance of the violation*'.[59] The tribunal opined that '*the proper test must be applied on a case-by-case basis taking into account all relevant factors*',[60] which involves three steps:

- '*First the Tribunal must assess the significance of the obligation with which the investor is alleged to not comply*'[61] – the considerations that are relevant in this first step include: (i) the level of sanction provided in the law, including whether the violation is curable;[62] (ii) whether there is general non-enforcement of the obligation by the host State; (iii) whether the host State has specifically decided not to investigate or prosecute the particular alleged act of noncompliance; and (iv) whether there is widespread noncompliance with the obligation;

- '*Second, the Tribunal must assess the seriousness of the investor's conduct*'[63] – the relevant considerations in this step include: (i) whether the investor's conduct violates the obligation as alleged; (ii) the investor's intent; (iii) whether the law is unclear, evolving or incoherent; (iv) the investor's due diligence and efforts to understand and comply with the law; (v) whether the State has failed to investigate or prosecute the alleged particular act of noncompliance; and (vi) the investor's subsequent conduct; and

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[58] Ibid [400].
[59] Ibid [398]. The tribunal explained that '*the gravity of the law itself is a central part of the examination but not the sole focal point. It is not only the law, but the act of noncompliance (or in some wordings, the violation) that is key. The seriousness of the act is a combination of both the importance of the requirements in the law and the flagrancy of the investor's noncompliance. The text or standing of the law – although central – does not in and of itself determine whether the legality requirement is triggered. Rather, the law must be considered in concert with the particulars of the investor's violation. An investor may violate a law of some import egregiously or it may violate a law of fundamental importance in only a trivial or accidental way. Seriousness to the Host State is to be determined by the overall outcome, which will depend on the seriousness of the law viewed in concert with the seriousness of the violation.*'
[60] Ibid [396].
[61] Ibid [406].
[62] Ibid [406]. The tribunal illustrated the issue of sanction as follows: '[a] *low level fine, for example, suggests an obligation that is less significant than obligations that involve forfeiture of assets or that are within the criminal code and provide for possible imprisonment. Similarly, a law which provides that a transaction is void (ab initio) suggests that the obligation is significant. A law that provides that the transaction is voidable, suggests – but does not necessarily indicate – less significance than a provision that declares the transaction void. Likewise, a law that allows for the State to waive the legal consequences of the wrong-doing suggests that the obligation – at least in some cases – is less significant. Finally, the possibility that the law provides that the illegal act may be cured through specified acts by the noncompliant party suggests an obligation of lesser significance*' ([406], bullet 1).
[63] Ibid [407].

- '*Third, the Tribunal must evaluate whether the combination of the investor's conduct and the law involved results in a compromise of a significant interest of the Host State to such an extent that the harshness of the sanction of placing the investment outside of the protections of the BIT is a proportionate consequence for the violation examined*'.[64]

In the writer's view, this three-step test represents a major contribution to the jurisprudence in this field. First, it takes proper account of the realities of foreign investment in the market concerned. Unlike paragraph 101 of *Phoenix Action* – in which the investor's obligation of compliance is framed in the broadest terms ('*the conformity of the establishment of the investment with the national laws*') – the first limb of the *Kim* test calls for a case-specific inquiry into the law concerned and the way it is administered by the authorities of the host State. Significantly, the inquiry includes a set of objective criteria to guide the tribunal's assessment of how important the law in question is to the host State (which avoids an outcome whereby undue weight is given to the host State's assertion that the law violated is '*fundamental*' – acceptance of which could put the State in a position where it is able to effectively self-judge an element of the test). Second, the *Kim* test allows for the proper, reciprocal operation of the duty of good faith: if the host State does not enforce the law in question, it may be estopped from raising a violation of that law before the tribunal; equally, if the investor has knowingly or intentionally breached that law, the investor will lack good faith and the jurisdictional relevance of their violation of the relevant law may be increased. In contrast to other authorities, *Kim* does not place all the burden of compliance on the foreign investor: it recognises that the host State has an obligation to administer the laws it creates and, if it does not do so, its ability to rely on those laws to its advantage in an international context may be reduced. Third, the *Kim* test incorporates the essential element of fairness. It does this through use of an established device of international law: proportionality. Through the weighing of the factors identified in the *Kim* tribunal, an appropriate balance may be struck between a range of competing interests, namely the State's natural (and entirely reasonable) interest in ensuring adherence to its laws and the investor's (usually critical) interest in recourse to an independent tribunal for the adjudication of its claims.

One of the appeals of the *Kim* test is that the analytical framework it posits has a quantitative character. It is broken up into three steps: the first two steps are party specific (step one focuses on the significance of the relevant legal obligation to the State; step two focuses on seriousness of the investor's conduct with respect to that obligation); the third step is unitary (being a proportionality analysis that draws together the results of the first and second steps). It is possible, therefore, to display the *Kim* test in the form of a table or matrix which identifies the relevant considerations and summarises the evidence for each. An example '*Kim* matrix' is attached to

[64] Ibid [408].

this paper. It was developed by the writer and his team for an ongoing BIT case in Africa, in which context it was provided to the tribunal as an annex to the investors' written reply to the State's illegality objection and as a demonstrative with the investors' opening submissions at the hearing on jurisdiction. The *Kim* matrix is not intended to be a substitute for the other essential steps identified above – especially the Vienna Convention analysis of the specific treaty provision on which the illegality objection is founded. Nor is the matrix intended to be a comprehensive representation of the *Kim* test. It is simply intended to be a tool for summarising the evidence as it pertains to the first two steps of the *Kim* test. The third step (proportionality analysis) is obviously less suited to representation in table form, but the matrix at least allows the submitting party to summarise its position on results of the first and second steps.

VI CONCLUSION

Every State has a right to make laws and enforce them and every State has a right to challenge the jurisdiction of an international tribunal. But when States sign BITs and FTAs that include offers to arbitrate disputes with foreign investors, they are bound by the terms of the offer they make. That is not a controversial proposition (or at least it should not be).

If the terms of the State's offer to arbitrate do not include any express requirement that foreign investments comply with its law, the State will not normally have a legal basis on which to contend that a violation of its law deprives the tribunal of jurisdiction. Absent an express legality requirement, the only way the respondent State will be able to mount an objection to jurisdiction *ratione materiae* under the applicable treaty will be if the State can establish that, applying the Vienna Convention, the treaty should be read as containing an *implicit* requirement of local law compliance. It is the burden of the objecting State to articulate both the legal basis for the implication of such a term and the scope of the term to be implied. This burden cannot be discharged by reliance on case law. To the extent the objecting party relies on paragraph 101 of the *Phoenix Action* award, the true context and limitations of that *obiter dicta* should be acknowledged. It should also be understood that, if such a term can be implied into the treaty in question, cases such as *Flughafen Zürich* and *SAUR* indicate that the term will be of very narrow scope indeed. If the treaty contains no express legality requirement, and the State is unable to convince the tribunal that such a term is implicit, the alleged violations will not be relevant to the assessment of jurisdiction. Unless they amount to serious criminal misconduct, it is unlikely the violations will go to the admissibility of the investor's claims either. Of course, it will remain open to the State to raise the violations in the merits – for example, as a justification for the disputed measures or as matters that bear on the assessment of damages. But they will not be relevant *in limine* as matters of jurisdiction or admissibility.

Conversely, if – as is increasingly the case in the new generation of BITs and FTAs – the State's offer to arbitrate is expressly as covering only investments made '*in accordance with*' the State's law, the alleged violation may be raised as an impediment to jurisdiction. But the temporal and substantive scope of the legality requirement will need to be determined by application of the Vienna Convention to the specific language of the treaty. This is critical because without interpretive discipline, there is a risk that the provision may be applied in an '*over-inclusive*' manner that conflicts with the object and purpose of the treaty. Further, once the meaning and operation of the provision has been determined by the tribunal, the State's objection should be subject to a case-specific analysis, in which proportionality is the ultimate control. This is where the *Kim* test comes into play.

This paper has endeavoured to show how the law and practice of illegality objections has evolved in the eight years since the *Phoenix Action* award. During this time, there was a significant increase in the volume of investment treaty cases and much ink was spilled by scholars and practitioners alike in the debate on illegality objections. While in this period there developed a general consensus that host State law is relevant to jurisdiction where the BIT's definition of '*investment*' includes *'in accordance with* [law]' language, it is only since the *Kim* decision in 2017 that users of the investment arbitration system have had clear analytical framework for the application of such provisions to the facts. When the reasoning in *Kim* is taken alongside the various decisions in which the requirement of '*serious violation*' was identified, we can see that what has now emerged is essentially the recognition that fairness is a critical element of the relationship between host State law and jurisdiction in investment treaty arbitration.

Kim matrix

		Significance of the obligation to the State					Seriousness of the Claimant's conduct							Proportionality analysis
No.	Alleged non-compliance with Ruritanian law	Level of sanction under Ruritanian law	General enforcement / non-enforcement of the obligation by Ruritanian authorities	General prosecution / non-prosecution of the particular act by Ruritania	Widespread non-compliance by investors	Conclusion	Compliance / non-compliance by the Claimant	Intent of the Claimant	Clarity of the law	Due diligence / efforts to comply	Prosecution / non-prosecution of the Claimant by Ruritania	Subsequent conduct by the Claimant	Conclusion	(Assumes violation has been established)
1.														
2.														