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**TITLE**

# Defenses of States in Investment Arbitration:

## *Theoretical Case Study of Lydian International Ltd v. the Republic of Armenia*

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# LIST OF ABBREVIATIONS

| | |
|---|---|
| BIT | Bilateral Investment Treaty |
| FET | Fair and Equitable Treatment |
| FPT | Full Protection and Security |
| ICSID | International Centre for Settlement of Investment Disputes |
| ILC | International Law Commission |
| PCA | Permanent Court of Arbitration |
| PP | Police Powers |



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***"In preparing for battle I have always found that***

***plans are useless,***

***but planning is indispensable."***

– Dwight D. Eisenhower

## INTRODUCTION

Gold extraction projects are considered the most dangerous ones in the world. Amulsar mine is one of the largest mining projects in the world today and is the largest international investment in Armenia[1] by Lydian Armenia OJSC (hereinafter the "Company" and/or "Investor"), the Amulsar mine (hereinafter the "Mine") explosion company.[2]

Amulsar is on the border of Vayots Dzor and Syunik regions. The rivers Vorotan, Araqs, Arpa passed through this area from the eastern and western slopes, and the mineral waters of Jermuk, Armenia's national treasure, forum in this area. From Amulsar to Jermuk it is 10 kilometers in a straight line. In the next 10 years gold and silver are planned to be extracted with the help of cyanide solution.[3] Based on the data of Amulsar Gold project by the Company, solid cyanide will be mixed with water to form dilute solution (approx. 100ppm). Further, that cyanide solution will be used to irrigate heap leach facility, as solution has the chemical ability to leach (dissolve) gold and silver from ore.[4]

Moreover, Amulsar is the first mining project to be implemented by the International

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[1] https://armenpress.am/arm/news/925283/ (last visited Feb. 11, 2019).
[2] https://www.azatutyun.am/a/27934977.html (last visited Feb. 11, 2019).
[3] https://www.lydianarmenia.am/resources/mainFiles/pdf/052ee4cdda4b9480af76ad44a8c60ab5.pdf/ (last visited Feb. 11, 2019). For further information, the toxic sodium cyanide has been used in gold mining since 1887, and it remains the primary reagent in use for gold processing today because it allows for efficient extraction of gold from low-grade ore, that is why the use of cyanide has been closely regulated in most countries and banned in others:
<https://www.mining-technology.com/features/featureshould-cyanide-still-be-used-in-modern-day-mining-4809245/> (last visited May 2, 2019)
[4] https://www.lydianarmenia.am/images/new_website/Cyanide_eng.pdf (last visited May 2, 2019)



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Finance Corporation and the Reconstruction and Development and the European Bank standards for environmental and social impact assessment and monitoring. More than $ 400 million has been invested in the project. More than 1,300 people will be involved in the construction and 700 permanent jobs will be created during the next 10 years.[5] Lydian Armenia is the ninth largest taxpayer in Armenia, yet it is still under construction.[6]

In spite of this, the Company has repeatedly been subjected to harsh criticism for its activities. Particularly, during the construction of the Mine the Company has damaged the drinking water pipes of nearby settlements (Jermuk, Gndevaz), drinking water was polluted, irrigation reservoirs were damaged. Dust from the Mine was spread thoughout the fields, and the waste water was dumped nearby and the rivers (Arpa). As a result of the preparations for the Amulsar mine exploitation carried out the Company, it has been claimed that health, social and economic damage was caused to the population of Jermuk, Gndevaz, Saravan, Kechut communities.[7]

Furthermore, the experts and environmentalists envisage potential risks of the Mine explosion: contamination of rivers and Lake Sevan, environmental pollution, clouds of dust, large portions of cyanide, harm to the health status of the population.[8]

The former Armenian authorities have allegedly supported the Company by altering and adjusting the Armenian legislation to the interests of the Company. In 2012, the Company already had all the necessary licenses and permits to start the exploitation of the Mine.[9]However, there are lots of legal, financial and economic issues related to the implementation of the project.

From May to June 2018, the environmentalists and the citizens of Amulsar have been closing the roads leading to Amulsar and were demanding to stop the exploitation of the Mine for it was causing large environmental and health problems.[10]

Media reports of 2018 alleged earlier that Lydian Armenia is planning to file a lawsuit against the Republic of Armenia, demanding $2 billion (approximately 70% of the state budget) from the Armenian authorities for the failure to provide conditions for the

[5] https://www.lydianarmenia.am/index.php?m=pages&lang=eng&p=94
[6] http://www.harkatu.am/companies/hy;jsessionid=B707245C49DDB10EA4E67C2B6C4779AA?0 (last visited Feb. 11, 2019)
[7] https://www.youtube.com/watch?v=LWhbwVIvhq8 (last visited Feb. 11, 2019).
[8] https://hetq.am/hy/article/68681 (last visited Feb. 11, 2019).
[9] https://www.youtube.com/watch?v=LWhbwVIvhq8 (last visited Feb. 11, 2019).
[10] https://hetq.am/hy/article/90775 (last visited Feb. 11, 2019).



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Company's normal operation. It is assumed that the Company will demand a compensation for the damages caused, its lost profit, for the suspension of its activities and /or indirect expropriation.[11]

The problem question or **subject matter** of the present thesis paper is the examination of the possible defense mechanisms for the States in Investor-State Arbitration in general, and for the Republic of Armenia in Lydian International Ltd vs. Armenia hypothetical case, in particular.

The choice of the subject matter is **justified** by the fact that the Dispute is still unset and in case Investor-State negotiations go wrong, problems will rise both for the State and the Investor itself.

The practical **significance** of the paper lies in the fact that nowadays the number of the disputes between the investors and the state is not less all over the world and in Armenia as well. Moreover, the outcome of the Dispute will be essential for both foreign current and potential investors to consider whether or not to make further investments in Armenia. Hence, the paper will serve as a useful guideline for similar cases and situations for both Armenia and foreign investors.

The paper **aims** to examine the possible mechanisms for the State to be utmost prepared to face the challenges in the investment arbitration, meanwhile saving its face in international investment climate for future and potential investors.

To achieve the aim of the research the following **objectives** have been set forth:

- to envisage the potential claims to be raised by the Investor in Lydian International Ltd vs. Armenia hypothetical case;
- to present and analyse possible defense mechanisms for the States in Investor-State Arbitration in general;
- to examine possible defense mechanisms for the Republic of Armenia in Lydian International Ltd vs. Armenia hypothetical case in particular;
- to offer an insight on international best practices with regard to State defenses in Investor - Host State Arbitration;
- to discuss the strong and weak points and positions of both the State and the Investor;

[11] https://panarmenian.net/eng/news/256626/Lydian_Armenia_refutes_reports_on_suing_Armenia (last visited Feb. 11, 2019).



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- to come up with some general recommendations to manage and prepare for such Disputes in International Investment Arbitration.

The paper **literature** is based on a vast array of research articles, legal journals, scholarly papers, as well as books by reputable authorities and world-acclaimed authors involved in both legal and environmental fields of investment issues. The paper makes references to international and local expert opinions and reports available online on mining and environmental risk assessments. Certain legal instruments in terms of Laws of the Republic of Armenia, Bilateral Investment treaties are also cited in the paper. Namely, the Agreement on Encouragement and Protection of Investments between the Government of the Republic of Armenia and the Government of the United Kingdom of Great Britain and Northern Ireland signed on 27 May, 1993, which is the core document to be analyzed in this paper. Gary Born's "International Arbitration: Law and Practice" proves a valuable contribution to this research by offering an insight into international best practices with regard to State defenses in Investor - Host State Arbitration. The work by co-authors Crawford and Bishop titled "Foreign Investment Disputes" proves to be another useful reference point in coming up with best solutions for foreign investment disputes from the prospective of both the state and the foreign investor.

The following **methods** of analysis have been applied: the cognitive method, the comparative method, the qualitative data collection method, content analysis, interviews with experts in the field.

The scope of research will then be **limited** to studying solely and purely the legal aspect of the Dispute. It is not intended to give consultation or advice to the Parties of the Dispute. As the factual background, confidential and original documents are not available at hand; the Paper is limited to the facts and assumptions available on the Internet. The Paper will also be limited to the theoretical analysis of the case and will not delve into the trustworthiness of the facts and evidences.

This thesis paper shall consist of an introduction, two chapters, a conclusion and a bibliography. The **Introduction** highlights the background information on the dispute between the Republic of Armenia and Lydian International Ltd and its prospectives under the light of investment law, points out the statement of the problem, methodology of the research, justification and significance of the issue raised, underlines its scope and limitations. **Chapter 1** is designed to study the possible claims that could be raised by the Investor. Particularly it



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will touch upon such standards of protection as *fair and equitable treatment*, *full protection and security* and the right to get adequate compensation in case of *expropriation*. **Chapter 2** will be touching upon the possible defense mechanisms inherent in Investment Arbitration for the States and under the light of the theoretical case of Lydian International Ltd v. the Republic of Armenia. It will represent international best practices of the implementation of those techniques and strategies. It will consist of three subchapters. **Subchapter 1** will be devoted to *Police Powers doctrine* or the State's right to regulate in international investment law**.** It will delve into the subtle line of indirect expropriation and valid non-compensatory regulatory actions of a sovereign State. **Subchapter 2** will argue how the *State of Necessity* may be used by the State as an exemption from state responsibility for investments, i.e. presenting the justification of the State's actions by the protection of public interests, such as public health and environmental protection from imminent peril. Finally, **Subchapter 3** will touch upon the doctrine of *Unclean Hands* and the inadmissibility of claims by Investor in that respect, particularly addressing the legality of the Investment and its compliance with the domestic legislation. Followed by a bibliography listing all the sources used for the paper, the **Conclusion** will succinctly outline main findings of the research.

## CHAPTER 1

## POSSIBLE CLAIMS TO BE RAISED BY THE INVESTOR

It is assumed that the Dispute will be based on the Agreement on the Promotion and Protection of Investments between the Government of the Republic of Armenia and the Government of the United Kingdom of Great Britain and Northern Ireland signed on 27 May, 1993 (hereinafter referred to as the "Agreement")[12].

According to the Article 8 (1) and (3) of the Agreement, the Parties undertake to resolve any dispute in the International Center for Settlement of Investment Disputes (ICSID), and in case an agreement is not reached between the parties within three months through pursuit of local remedies or otherwise, then, if the national or company affected also consents in writing to submit the dispute to the Centre for settlement by conciliation or arbitration under the Convention, either party may institute proceedings by addressing a request to that effect to the Secretary-General of the Centre as provided in Articles 28 and 36 of the ICSID Convention.

[12] https://investmentpolicyhub.unctad.org/Download/TreatyFile/143 (last visited March 12, 2019)



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It is stated in Lydian International Limited Management's discussion and analysis on November 14, 2018, that the Government inaction to remove the illegal blockades and ongoing government audits and inspections have resulted in construction schedule slippages that impact the Company's ability to achieve its 2018 milestones, including:

• Completing construction of Amulsar;

• Commissioning of the processing facilities, including material handling systems and gold recovery facilities;

• Achieving first gold production; and

• Advancing safety, health, environmental initiatives commensurate with the Company's transition to production. Achieving these milestones is subject to the removal of the blockades, access to site, resumption of construction activities and the necessary funding to complete such activities.[13]

The Analysis goes on claiming that as a result of the illegal blockades and the actions or inactions of government officials in Armenia, the ability of the Company to raise additional capital at reasonable costs, or at all, may be extremely limited. Any additional sources of capital may be limited and may not be sufficient to allow the Company to complete or even continue construction once the illegal blockades are removed. To secure additional financing, a restructuring or refinancing of existing obligations will be required. This will require issuance of substantial additional equity or conversion of debt-to-equity, which may result in current equity holders losing all or some of their investment.

Hence, based on the above, the possible claims of the Lydian to the Arbitration Tribunal are assumed to be the following:

- The Republic of Armenia has violated Article 2 § 2 of the Treaty, i.e. investment of citizens or companies of each Contracting Party shall be accorded *fair and equitable treatment* in the territory of the other Contracting Party and shall ensure *full protection and security*:
- The Republic of Armenia has violated Article 5 § 1 of the Agreement, the investments of citizens or companies of one Contracting Party are not subject to nationalization, *expropriation* or other equivalent (indirect expropriation) in the territory of the other Contracting Party.

[13]https://www.lydianinternational.co.uk/images/Financial%20Reports/2018/Q3_2018_MDA_FINAL_NO_LINKS_VERSION_-_PDF.pdf (last visited March 12, 2019)



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### 1.1 Breach of the Fair and Equitable Treatment Standard by the State

The FET standard is increasingly becoming "the most invoked treaty standard in investor-state arbitration".[14] Article 2 of the Agreement, titled *"Promotion and Protection of Investment"*, contains some of the Treaty's most important and broad-reaching investment protections. That Article provides that each contracting party shall encourage and create favorable conditions for investors of other contracting parties to make investments. It goes further stating that such conditions shall include a commitment to accord at all times to investments of investors of other contracting parties fair and equitable treatment. If police systematically fail to protect foreign-owned facilities, such inaction might indicate a policy of discrimination against foreign investors.[15]

There are cases, in which the arbitral tribunals have found a breach of the FET standard, even though the expectations were not grounded on a vested right, a unilateral representation or even the general regulatory framework of the State, but on the subjective business plans and expectations of the investor.

In *MTD* v. *Chile*[16], the investor wished to make an investment in a land close to Santiago, where development was not allowed, in accordance with municipal laws. In order to import the necessary funds in Chile, the investor asked for permission from the Foreign Investment Commission, which required the investor to specify the location and nature of the project. The FIC approved the transfer of funds (not the project) with an explicit mention that the project must comply with all applicable national laws. Consequently, the municipal authority refused MTD's request for a land redevelopment in that zone. The claimant invoked the FET standard, claiming that the inconsistencies between the two arms of the same Government vis-à-vis the same investor had given rise to a breach of the FET standard. The Tribunal upheld the claim: even though it could not identify any unilateral statement addressed to the investor that its investment would proceed, nor was that permissible under domestic law, the Tribunal found a breach of legitimate expectations relying on the investor's plans.

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[14] August Reinisch, *Standards of Investment Protection* (OUP, 2008), 111

[15] Molly Zohn, *Filling the Void: International Legal Structures and Political Risk in Investment*, 2007 by the authors. Fordham International Law Journal is produced by The Berkeley Electronic Press (bepress). http://ir.lawnet.fordham.edu/ilj

[16] *MTD Chile* S.A. *v*. Republic of *Chile*, ICSID Case No. ARB/01/7 (May 25, 2004)



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On the other hand, acknowledging legitimate expectations in the compensable nature of regulation is a matter of basic *fairness*. If the investor has been dragged into making an investment relying on the government's representations, assurances, promises and impressions, it would be unfair to stripe the investor off the economic value of its investment thus frustrating its legitimate and reasonable expectations. For example, an implicit cause in *Metalclad*[17] is the fact that the company heavily relied on Mexico's reassurances that all regulatory conditions in terms of environmental policy had been met.

Nearly the same scenario is with Lydian. It is claimed by the Company that it possesses all necessary licenses and permits to start the works in the Mine. They are all given by the previous Government creating a platform of legitimate expectations, hence was the milestone of the Company's 2018 business plan. Thus, the Company's legitimate expectations were frustrated. Therefore, there is a high probability that the first claim the Company will bring against Armenia will be the breach of fair and equitable standard.

### 1.2 Breach of the Full Security and Protection Standard by the State

In the second paragraph of Article 2, the Agreement contains a provision granting "Full" security and protection for investments. The wording of this clause suggests that Armenia is under an obligation to take active measures to protect the Lydian's investments from adverse effects.

Arbitral practice is generally agreed that the standard of full protection and security relates to the physical protection of the investor and its assets. Traditionally, the primary purpose of this standard was to protect the investor against the physical violence, including the invasion of the premises of the investment. In fact, in a number of cases arbitral tribunals seem to have assumed that this standard applies exclusively or preponderantly to physical security and to the host state's duty to protect the investor against violence directed at persons and property stemming from state organs or private parties.[18]

Case law also supports the view that the formula 'full protection and security' covers not only protection against violence but also provides protection against infringements of the

[17] *Metalclad Corp. v The United Mexican States*, ICSID Case No. ARB(AF)/97/1 (Aug. 30, 2000)
[18] Schreuer, Ch. *Full Protection and Security, Journal of International Dispute Settlement*, (2010), pp. 1–17



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investor's rights.[19] The standard may be violated by a change of the legal framework that renders the investor vulnerable to the adverse action by private persons.[20]

In the first scenario of the present Dispute between the Company and the State if the Arbitral Tribunal finds out that the State has violated treaty standards of FET and FPS, the State's argument of PP doctrine will not be justifiable. For example, in *Suez v. Argentina*[21] case, the Tribunal has held that, "the application of the police powers doctrine as an explicit, affirmative defense to treaty claims other than for expropriation is inappropriate, because … if a Tribunal finds that a State has violated treaty standards of fair and equitable treatment and full protection and security, it must of necessity have determined that such State has exceeded its reasonable right to regulate. Consequently, a decision on the application of the police powers doctrine in such circumstance would be duplicative and therefore inappropriate."

The second scenario of the present Dispute between the Company and the State refers to State's inaction and failure to protect Company's investments from third party blockades and physical attacks. In this scenario, if the Arbitral Tribunal finds out that there is a violation of the FET and FPS standards, the State may be held liable. Such as in *Wena Hotels* case[22], the Tribunal concluded that "Egypt breached its obligations under Article 2(2) of the IPPA by failing to accord Wena's investments in Egypt "fair and equitable treatment" and "full protection and security." Even if the Egyptian Government did not authorize or participate in the attacks, its failure to prevent the seizures and subsequent failure to protect Wena's investments give rise to liability. The Tribunal also finds that "Egypt's actions amounted to an expropriation – transferring control of the hotels from Wena to EHC without "prompt, adequate and effective compensation" in violation of Article 5 of the IPPA."[23]

Hence, the Company may claim that Government's and/or police's failure to prevent blockades or unauthorized people to enter their workplace and protect their investment, gives rise to the breach of the full security and protection standard, if he Company proves that it was done with intentional negligence.

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[19] *Azurix Corp v. Argentine Republic,* ICSID Case No. ARB/01/12 (July 14, 2006)
[20] *CME Czech Republic B.V. (the Netherlands) v. Czech Republic,* 9 ICSID Reports 121 (Sep. 13, 2001)
[21] *Suez*, *S.A. v*. *Argentine Republic*, ICSID Case No. ARB/03/17 (July 30, 2010)
[22] *Wena Hotels LTD. v. Arab Republic of Egypt,* ICSID Case No. ARB/98/4 (Dec. 8, 2000)
[23] Crawford, J., *ICSID Reports: Volume 8*, Cambridge University Press (2005), p. 15



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### 1.3 Indirect Expropriation of the Investment

Lydian may claim that the Government's "non-actions" gave rise to indirect expropriation of its investment as the failure or neglect to remove the illegal blockades, ongoing government audits and inspections have resulted in construction schedule slippages that impacted the Company's ability to achieve its 2018 milestones. The blockades hindered the employers and employees of the Company to manage their business, which caused loss of the control over their investment and deprivation of property rights.[24] These failures to act, insufficient actions, and delayed actions would all have been cognizable as failing to fulfill a favorable condition for investment, which should all be deemed as *"non-actions"*, and these non-actions are equal to *"acts tantamount to expropriation."*

The first paragraph of Article 5 of the Agreement contains protections against unlawful expropriations or nationalizations. By referring to *"measures having effect equivalent to nationalisation or expropriation"* - it protects against *"indirect"* or *"regulatory"* expropriations, or interferences by the State that have the effect of gradually eroding the investor's property interests.

In three cases (*Pope & Talbot* v. *Canada*[25], *SD Myers* v. *Canada*[26], *Marvin Roy Feldman Karpa* v. *Mexico*[27]) it was settled that 'tantamount to expropriation' is functionally equivalent to indirect expropriation.

As a general rule, indirect (covert, incidental, creeping, *de facto*) expropriation supervenes when the State interferes with the use of property without taking the formal title thereof and has an *effect* equivalent to direct expropriation, because it deprives the owner, in whole or in *significant part* of the use or reasonably to be expected benefit of property, even if this is not necessarily to the obvious benefit of the State.[28]

When the indirect expropriation arises from non-action, the foreign investors can start an action stating that the host State failed to offer favorable conditions for investment under the BIT. If the foreign investor's claim is based on an obligation under the BIT (*e.g.*, fair and equitable treatment), the Tribunals should hold that the presence of damages presumptively

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[24]https://www.lydianinternational.co.uk/images/financial%20reports/2018/q3_2018_mda_final_no_links_version_-_pdf.pdf (last visited 22 March, 2019)
[25] *Pope & Talbot Incorporated v Canada*, Interim award, IIC 192 (2000) (June 26, 2000)
[26] *S.D. Myers, Inc. v Canada*, Award, IIC 252 (2004) (Jan. 13, 2004)
[27] *Marvin Roy Feldman Karpa v. United Mexican States*, ICSID Case No. ARB(AF)/99/1 (Jan 1, 2003)
[28] See footnote 17.



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arose from the host State's failure to satisfy its BIT duties, requiring the host State to prove it was not negligent with regards to its obligations.[29]

Resolution No. 86 of the MIGA Convention Establishing the Multilateral Investment Guarantee Agency of 1985 contains the following provision in its Article 11 (ii) (Expropriation and Similar Measures) on Covered Risks:[30]

*"Any legislative action or administrative action or omission attributable to the host government which has the effect of depriving the holder of a guarantee of his ownership or control of, or a substantial benefit from, his investment, with the exception of non-discriminatory measures of general application which governments normally take for the purpose of regulating economic activity in their territories."*

In *Phillips Petroleum Co. v. Iran* case, the panel pointed out that *"a series of concrete actions"* can form a deprivation of property, and refrained from excluding the possibility that non-action could form a type of indirect expropriation.[31]

Commentators generally agree that the closest case to true creeping expropriation is the Somalia government's assorted actions or non-actions, including occasional arrests of key employees and blocking access to the physical plant, against a foreign-owned shellfish processing facility, ultimately compelling the plant manager to terminate operations.[32]

Regarding the action and non-action of the Government and/or policy, the special character of creeping expropriation is that it is constituted by a number of inseparate elements which constitute an international wrongful doing or a slow and incremental encroachment on foreign investors' property interests—and a series of actions or non-actions can satisfy these qualification requirements. [33]

Lydian may substantiate its claim by Sole Effect Doctrine, which is generally in contradiction with Police Powers Doctrine. Tribunals have frequently upheld the Sole Effect Doctrine when the *intent* of the Government is less important than the *effects* of the measures on the owner and the *form* of the measures is less important than the *reality of their impact*'.[34]

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[29] Journal of International Law, University of Pennsylvania, 1978, available at http://pennjil.com/non-action-as-an-indirect-expropriation/.
[30] http://www.miga.org/sites/default/files/archive/Documents/MIGA%20Convention%20(April%202018).pdf (last visited 24 March, 2019).
[31] *Phillips Petroleum Co. Iran v. Iran* , 21 Iran-U.S. Cl. Trib. Rep. 79, at 115–16 (1989).
[32] As cited from Vance R. Koven*, Expropriation and the 'Jurisprudence' of OPIC*, (1981), pp. 269, 291; case citation is unavailable
[33] http://pennjil.com/non-action-as-an-indirect-expropriation/(last visited 25 March, 2019)
[34] *Tippetts*, Abbett, McCarthy. Strattm *v. TAMS-AFFA*, Award No. 141-7-2 (29 June 1984)



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In *Santa Elena SA* v. *the Republic of Costa Rica,* the Tribunal noted that the purpose of the expropriation does not affect the obligation to compensate the investors:

*"...Expropriatory environmental measures –no matter how laudable and beneficial to society as a whole – are, in this respect similar to any other expropriatory measure that a State may take in order to implement its policies: where property is expropriated, even for environmental purposes, whether domestic or international, the State 's obligation to pay compensation, remains."*[35]

Article 5 adopts the familiar *"Hull Formula"* for prompt, adequate, and effective compensation, first articulated in 1936 by U.S. Secretary of State Cordell Hull in response to Mexico's nationalization of U.S. petroleum companies. It is to be noted that expropriation is not illegal per se under international law. It has always been beyond doubt that a State has the power and the right to expropriate the property of nationals and of foreigners, in principle. However, a legal expropriation of foreign owned property is subject to certain conditions. These conditions are commonly referred to as a public interest, absence of discrimination, due process of law and compensation that is prompt, adequate and effective. [36]

Hence, the Company may claim prompt, adequate and effective compensation for the indirect (creeping) expropriation of its investment as the measures had an adverse effect on its business, deprived it from the opportunity to manage its business operations and property rights.

[35] *Santa Elena S.A. v. Republic of Costa Rica*. ICSID Case No. ARB/96/1 (31 May, 1995)
[36] Yannaca, Katia, *Arbitration Under International Investment Agreements: A Guide to the Key Issues* (2010), p.49



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## CHAPTER 2

## DEFENSES OF STATES IN INVESTOR-STATE ARBITRATION IN THE CONTEXT OF LYDIAN INTERNATIONAL LTD V. REPUBLIC OF ARMENIA

At the start of a dispute Parties are often best able to find mutually agreeable resolutions. As a result, States should pro-actively assess the cost-benefit of settlement as soon as they receive notice of a dispute. This could include the following:

i. Making a preliminary assessment of potential liability under the claim: this is primarily an assessment of the particular case. However, a State may also consider systemic implications of a settlement;
ii. Considering the mechanisms available to discuss early resolution of the dispute: a State may want to explore settlement informally or through formal negotiation, mediation, early neutral evaluation, or otherwise;
iii. Holding preliminary discussions with the investor: such discussions are useful to learn about the background to the dispute, relevant factual allegations, and legal claims of the investor. This can be done as part of a formal "cooling off" period discussion, or could be done by agreement of the parties without a formal cooling off requirement. Such discussions are usually held on a confidential and "without prejudice" basis, so that parties are not constrained in future proceedings if a resolution is not found;
iv. If a resolution is reached, it should be documented so that the terms are clear to all parties. This may include an appropriate release of liability; nevertheless, the dispute can be resolved at any time before the final award is rendered.[37]

Early preparation is vital to ensuring the Respondent advances its case as effectively as possible. The earlier this is done, the better. Ideally, such preparation should begin when the State is made aware of a dispute. However, preparation should certainly start when a Request for Arbitration is received.

However, once the arbitration has been commenced against the State, it has a relatively short period of time in which to file an Answer to the Request for Arbitration, which is also called a Response to the Notice of Arbitration or the Answer to the Notice of

[37] https://icsid.worldbank.org/en/Pages/resources/Practice-Notes-for-Respondents-in-ICSID-Arbitration.aspx (last visited 25 March 2019)



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Arbitration under certain arbitral rules. Under most arbitration rules, the respondent has 30 days to file an Answer or Response to the Notice of Arbitration the Answer does not have to be in any particular form, and can be a narrative. The Answer however must specify all of the available defenses that the party relies upon, and all facts relative to those defenses. A general denial is not a sufficient answer.[38]

It is to be noted that there are difference defence mechanism for the States to protect itself from the claims of the investor. However, based on the alleged claims of the Investor there are some possible defense mechanisms of the State that may be taken into consideration, especially in our case, which are being presented and discussed below.

### 2.1 Police Powers or the State's Right to Regulate in International Investment Law

Because of the lack of the facts and evidences of the Case, we have to do assumptions and base our assumptions on the information available. In case the Investor raises an argument, that the State has expropriated its investments by its positive actions, i.e. interferences, discriminatory inspections and/or temporary or permanent termination of the its license, the State may bring a preliminary objection claiming that there is no *prima facie* case for expropriation of the Investor's assets. Moreover, even if the Tribunal finds out that there was an expropriation of the investments, the State has to prove the lawfulness of it. If the actions are not qualified as expropriation, they do not incur responsibility for the legitimate and *bona fide* exercise of sovereign police powers.[39]

The doctrine of police powers and State's right to regulate ("police powers") represents an attempt by investment tribunals to reconcile the sovereign right of the State, as the guardian of the general, public interest, to regulate economic activities on its territory with its treaty or contractual obligations. In particular, "the right of entering into international engagements is an attribute of State sovereignty."[40] Moreover, as noted by the *Framatome* tribunal, the same principle applies to contractual commitments as well.[41]

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[38] https://www.international-arbitration-attorney.com/model-answer-to-request-for-arbitration/ (last visited 25 March 2019)

[39] A. Newcombe and L. Paradell, *Law and Practice of Investment Treaties* (Kluwer Law International 2009), p. 358

[40] Permanent Court of International Justice, *S.S. "Wimbledon",* Judgment (17 August 1923), Series A, No. 1, p. 25

[41] *Framatome v. Atomic Energy Organization of Iran (A.E. O.I.),* ICC Case No. 3896, Award (30 April 1982).



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The police powers rule has a customary basis its application does not depend upon a clause incorporating it into the treaty. The customary rule will not apply only if there is *lex specialis* in the treaty clearly excluding the application of the customary rule. In our case, there is no *lex specialis* in the Agreement to exclude the application of PP.

The police powers doctrine accepts that a non-discriminatory taking of property without compensation can be lawful, if decided for a reason of public interest.[42] Its purpose is to preserve the right of the State to regulate in the public interest. As an ICSID tribunal put it:

*"Governments must be free to act in the broader public interest through protection of the environment, new or modified tax regimes, the granting or withdrawal of government subsidies, reductions or increases in tariff levels, imposition of zoning restrictions and the like. Reasonable governmental regulation of this type cannot be achieved if any business that is adversely affected may seek compensation."*[43]

The distinction between expropriation and regulation resulting from the police powers doctrine as applied by US Courts was only fully endorsed in the *Third Restatement* (1987):

*"A state is not responsible for loss of property or for other economic disadvantage resulting from bona fide general taxation, regulation, forfeiture for crime, or other action of the kind that is commonly accepted as within the police power of states, if it is not discriminatory."*[44]

The Harvard Draft Convention on the International Responsibility of States for Injuries to Aliens recognised the following categories of non-compensable takings: *An uncompensated taking of an alien property or a deprivation of the use or enjoyment of property of an alien which results from the execution of tax laws; from a general change in the value of currency; from the action of the competent authorities of the State in the maintenance of public order, health or morality; or from the valid exercise of belligerent rights or otherwise incidental to the normal operation of the laws of the State shall not be considered wrongful.*[45]

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[42] Newcombe, A. *The Boundaries of Regulatory Expropriation in International Law,* 20 ICSID Rev. F.I.L.J. 26 (2005) or Arnaud de Nanteuil, *supra* n.13, at 481.
[43] *Marvin Feldman v. Mexico,* ICSID Case No. ARB(AF)/99/1, Award (16 December 2002)
[44] American Law Institute, *Restatement of the Law, Third, Foreign Relations Law of the United States*, (1987), vol. 2, 201, 712.
[45] Sohn, L., & Baxter, B. *Draft Convention on the International Responsibility of States for Injuries to Aliens. American Journal of International Law*, (1961) 55(3), pp. 548-584



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Academic scholar Brownlie has stated, "*state measures, prima facie a lawful exercise of powers of governments, may affect foreign interests considerably without amounting to expropriation. Thus, foreign assets and their use may be subjected to taxation, trade restrictions involving licenses and quotas, or measures of devaluation. While special facts may alter cases, in principle such measures are not unlawful and do not constitute expropriation*".[46]

In case the Company claims that economic damage was caused to its business, it can be argued that for example, in *Sedco*[47]*; Methanex*[48]; *TECMED*[49] cases the Tribunal held a principle, according to which 'the State's exercise of sovereign powers within the framework of police power may cause economic damage to those subject to its powers as administrator, without entitling them to any compensation whatsoever, is undisputable' (§119).

Arbitral awards have quite often reminded investors that they are supposed to bear the normal risks related to business: in *Starrett Housing v. Iran* [50], the Tribunal held that 'a revolution as such does not entitle investors to compensation under international law'! There was no reason to doubt that the revolution in Iran seriously hampered the investor from proceeding with the project, but "…investors have to assume a risk that the country might experience strikes, lockouts, disturbances, changes in the economic and political system and even revolution. That any of these risks materialized does not necessarily mean that property rights affected by such events can be deemed to have been taken."

In *Generation Ukraine*[51], the tribunal noted, "the investment always entails risk. Nor is it sufficient for the disappointed investor to point to some governmental action or inaction, which might have contributed to his ill fortune. Yet again, it is not enough for an investor to seize upon an act of maladministration, no matter how low the level of the relevant governmental authority; to abandon his investment without any effort at overturning the administrative fault; and thus to claim an international delict on the theory that there had been an uncompensated virtual expropriation."

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[46] Brownlie, I. *Public International Law*, Oxford University Press, 6th Edition, (2003) p. 509
[47] *Sedco v. National Iranian Oil Company*, IUSCTR Case No. 128, Interlocutory Award (17 September 1985)
[48] *Methanex Corporation v United States*, IIC 167, Final Award (19 August 2005)
[49] *Técnicas Medioambientales Tecmed SA v Mexico*, IIC 247, Award (29 May 2003)
[50] *Starrett Housing Corp v Iran*, Interlocutory Award No ITL 32-24-1 (19 December 1983)
[51] *Generation Ukraine*, Inc. v. Ukraine, ICSID Case No. ARB/00/9 (16 September 2003)



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In *Olguín v. Paraguay*[52], the Tribunal has held that "expropriation requires a teleologically driven action for it to occur; omissions, however egregious they may be, are not sufficient for it to take place."

To sum up, it should be noted that the investor cannot reasonably expect the Government to respect any subjective expectation that it retains. As a matter of fact, investment contracts are not insurance policy and do not insulate the investor from any potential future risks. This happens even when the investor wishes to get involved into a sector that is highly regulated or in areas where stringent and evolving local regulation has to be anticipated by the investor. Especially, in the domain of environmental law, where science is constantly progressing, investors cannot expect that the law will freeze at the moment when a large-scale economic project was agreed to.

### 2.2 State of Necessity as an Exemption from State Responsibility for Investments

Using James Crawford's terms,[53] there are six "justifications", "defenses" or "excuses" precluding the wrongfulness of conduct which would otherwise be a breach of an international obligation. These circumstances are consent, countermeasures, force majeure and fortuitous event, distress, state of necessity and self-defense. In our case the State may invoke the state of necessity to justify its conducts.

The early doctrine about necessity was directly related to the notion of "self-preservation". When a danger that threatened the existence of the state arose, the state was authorized to take measures for its own preservation, even if they implied the breach of an international obligation. The notion of necessity was considered as a "right" of the state. This concept developed into the "essential interest doctrine".[54]

The term 'state of necessity' is used by the International Law Commission to denote the situation of a state whose sole means of safeguarding as essential interest against a grave and imminent peril is to adopt conduct not in conformity with what is required of it by an international obligation to another state.[55]

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[52] *Eudoro Armando Olguín v. Republic of Paraguay*, ICSID Case No. ARB/98/5 (26 July 2001)
[53] J. Crawford, *The International Law Commission's Articles on State Responsibility, Intorduction, Text and Commentarie,* (2002), pp. 5-6
[54] See footnote 50.
[55] Crawford, J., *The International Law Commission's Articles on State Responsibility* (2002) p. 96



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The generally accepted requirements in Article 25 of the Draft Articles on Responsibility of States for Internationally Wrongful Acts elaborated by the ILC are the following:

(i) the measures taken are the only way for the state to safeguard an essential interest against a grave and imminent peril;

(ii) the act does not seriously impair an essential interest of the state or states towards which the obligation exists, or of the international community as a whole.[56]

The first condition that must be fulfilled is that necessity may only be invoked if it is the only way for the state to safeguard an essential interest against a grave and imminent peril. [57]

An essential interest of a state does not mean that the very "existence" of the state must be in danger. The next question is, logically, what interests shall be considered "essential". The ILC considered that it was pointless to try to identify or categorize these "essential" interests. They should be judged on a case by case basis.

According to the ILC, the term "imminent" is used in the sense of "proximate".[58] The threat to that essential interest "has to be extremely serious, representing a present danger to the threatened interest."[59]

The ICJ made a pronouncement on this requirement in the Gabčíkovo-Nagymaros case, asserting that the word "peril" evokes the idea of risk and that is what distinguishes "peril" from material damage. According to the ICJ, a state of necessity could not exist without a peril duly established at the relevant point in time; the mere apprehension of a possible peril is not enough. It also pointed out that the peril constituting the state of necessity must at the same time be "grave" and "imminent".[60]

In the present case there are several environmental risks that should be properly assessed by international independent experts. However, some common risks that have been recently argued and should be considered more thoroughly. To understand whether gold extraction from the Mine represents an imminent danger or not first let us try to understand what means of gold extraction are expected to be used by the Company.

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[56] http://legal.un.org/ilc/texts/instruments/english/commentaries/9_6_2001.pdf (last visited 25 March, 2019)
[57] See footnote 52, p. 105
[58] See footnote 52, p. 202.
[59] See footnote 53
[60] Ryan Manton, *Necessity in International Law* (2016), p. 102



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First of all, any mountain is a living organism, which consists of various layers and contains all the elements of mend leaves periodic table. At Amulsar all chemical substances are hardened or, as scientists say, are dormant and safe, as long as there is a natural protective layer of the mountain with its vegetation. From the moment the protective layer of the mountain is disturbed it triggers irreversible chemical processes just like the apple core is subjected to change when its protective layer is removed. The iron in the apple is oxidized and the apple changes its color. Various Amulsar substances allegedly will change their chemical composition from contact with air and water by forming new formations. Prior to removing the protective layer of Amulsar potential chemical formations and the danger they would pose for the environment should be scientifically assessed.[61]

According to the project the top layer of barren rocks weighting approximately 300 million tons will be removed first. The ore is crushed and graded in the crushing plant then transported to the cyanide heap leaching pad where point 7-8 grams of gold are extracted from each ton or 1 million grams of ore after leaching with cyanide solution. While the subsequent ore pile remains on the platform. There are many heavy radioactive and toxic metals in that pile.

Secondly, according to the experts cyanide heap-leaching technology will be used in Armenia for the first time and the seismic resistance of this platform is one of the most important concerns. The region is seismoactive. The upper threshold of the possible earthquake has been estimated as 7.2 magnitude. Increasing or decreasing of one tenth of the magnitude results in a ten-time difference in the construction cost. If the predicted earthquake occurs in the region this dangerous plant with its chemicals will come into contact with Arpa River and will greatly damage the environment. There are many cases of goldmine exploitation and gold extraction through cyanide heap leaching in the world. Among the most important is the case of Costa Rica where eventually the mine was closed and the government had to spend enormous sums to recover these damages.[62]

The approach of the international experts is that the acid drainage should be avoided at mine planning stage rather than following the mine opening and then trying to solve the problem. Otherwise, the government will have to spend tremendous amounts of money for

[61] https://www.youtube.com/watch?v=LWhbwVIvhq8 (last visited Feb. 11, 2019)
[62] https://www.youtube.com/watch?v=LWhbwVIvhq8 (last visited Feb. 11, 2019).



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centuries to get rid of the consequences and there will be several times exceeding the amount earned from the extracted minerals.

Thirdly, experts claim that acid water will actively dissolve heavy metals present in the rock, which are many in the mine, including those of first class of toxicity – mercury, lead, arsenic and so on. As a result, a high density leachate of high acidity, heavy metal ions is formed, which mixing with the water of Vorotan and Arpa rivers, will affect the quality of water.[63]

Moreover, it is assumed by the experts that part of the contaminated groundwater will immediately impact the Spandaryan-Kechut tunnel, destroying the concrete and the metal parts. As a result collapses will occur. Even the damaged tunnel will be a drainage path through which the acidic and toxic waters will penetrate Kechut reservoir (5 million $m^3$ / year and more).

In addition, experts have expressed the view that it will be impossible to transport additional water to Lake Sevan without serious damage to the ecosystem of the lake and the loss of water quality. Contaminated water outflow from the mine site will cause serious problems in the irrigated agricultural fields, particularly the vineyards, in the Vorotan and Arpa rivers.[64]

As a result of mine exploitation, experts claim that mercury and carbon dioxide will be emitted into the environment, which will break Armenia's obligations undertaken by international conventions (Climate Protection, Minamata).[65]

Hence, alternatively, if State's actions were claimed to be qualified as international wrongful acts, the State may invoke the state of necessity as an exemption from State Responsibility for Investments because of the imminent environmental and public health hazards that may be cause by the mine exploitation.

### 2.3 Unclean Hands and the Inadmissibility of Claims by Investors

Many tribunals have concluded that they lacked jurisdiction over a claim (or that it was inadmissible) because an investor had made its investment in violation of the host State's

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[63] http://www.armecofront.net/en/amulsar-2/acid-mine-drainage-in-amulsar-and-its-hazard%E2%80%A4-professor-armen-saghatelyan/ (last visited March 22, 2019)

[64] https://www.lragir.am/en/2017/12/21/37798 (last visited March 25, 2019)

[65] http://www.mercuryconvention.org/Portals/11/documents/conventionText/Minamata%20Convention%20on%20Mercury_e.pdf (last visited March 25, 2019)



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laws. The legality requirement is usually considered to be a manifestation of the clean hands doctrine. A number of investment tribunals have in fact already applied the clean hands doctrine in their awards to bar the admissibility of claims. [66]

The "clean hands" doctrine has been defined as *"an important principle of international law that has to be taken into account whenever there is evidence that an applicant State has not acted in good faith and that it has come to court with unclean hands."* It originated from the general principle of good faith. The application of the "clean hands" doctrine in international law is still controversial. In the context of state responsibility, the ILC Special Rapporteur James Crawford explained that "if it exists at all," the doctrine would operate as a ground of inadmissibility.[67]

The 'clean hands' doctrine originated from the general principle of equity (and good faith)[68] and is found in many civil and common law jurisdictions.[69] It has been expressed in many Latin maxims including *ex delicto non-orituractio* ("an unlawful act cannot serve as the basis of an action at law") and ex turpicausa non-oritur ("an action cannot arise from a dishonourable cause").[70] It means that "if some form of illegal or improper conduct is found on the part of the investor, his or her hands will be "unclean", his claims will be barred and any loss suffered will lie where it falls".[71]

Many tribunals have concluded that they lacked jurisdiction over a claim (or that they have jurisdiction, but that the claim is inadmissible) based on the ground that an investor had failed to make its investments "in accordance with the law" of the host State.

As explained by the *Hamester* tribunal: "An investment will not be protected if it has been created in violation of national or international principles of good faith; by way of corruption, fraud, or deceitful conduct; or if its creation itself constitutes a misuse of the

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[66] Dumberry, P., *State of Confusion: The Doctrine of 'Clean Hands' in Investment Arbitration After the* Yukos *Award, in The Journal of World Investment & Trade* (2016), p. 59

[67]https://www.researchgate.net/publication/327318458_The_Doctrine_of_'Clean_Hands'_and_the_Inadmissibility_of_Claims_by_Investors_Breaching_International_Human_Rights_Law_in_Ursula_Kriebaum_ed_Transnational_Dispute_Management_Special_Issue_Aligning_Huma (last visited March 25, 2019)

[68] Kreindler, R., *Corruption in International Investment Arbitration: Jurisdiction and the Unclean Hands Doctrine* (2010), p. 317.

[69] See footnote 65

[70] Llamzon, A., *Yukos Universal Limited (Isle of Man) v The Russian Federation: The State of the "Unclean Hands" Doctrine in International Investment Law: Yukos as Both Omega and Alpha* (2015), p. 30

[71] See footnote 67, p. 316



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system of international investment protection under the ICSID Convention. It will also not be protected if it is made in violation of the host State's law".[72]

In other words, when these tribunals are deciding whether or not an investment is protected under a BIT containing a legality requirement clause, they are in fact applying the clean hands doctrine.[73]

In the present case, the UK-Armenia BIT does not contain any explicit legality requirement clause. In the *Phoenix v. Czech Republic* case, the Tribunal affirmed that the obligation for investors to make their investments in accordance with the host State's law is implicit even when not expressly stated in the relevant BIT.[74] This is indeed the position which has been adopted by several other tribunals: *Hamester,*[75] *Yaung Chi Oo,*[76] *Fraport II*,[77] and *SAUR*.[78] The same position has also been adopted by many scholars.[79] Several tribunals have concluded that they lacked jurisdiction over a claim (or that it was inadmissible) because an investor had failed to make its investments 'in accordance with the law' of the host State. Tribunals have in fact adopted this position even in the absence of any explicit legality requirement clause in the treaty.

Thus, it may be claimed that the investment has been made in violation of laws of the Republic of Armenia. Particularly, the Article 10 (2) (c) of the Law on Lake Sevan[80] clearly states that ore processing is prohibited if it is organized in the immediate area of impact of the lake basin. However, the Government Decree N 746 of 2013 amended the draft of the territorial plan for the catchment basin of Lake Sevan, which had been operating for ten years. [81]

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[72] *Gustav F W* Hamester *GmbH & Co KG* v. *Republic of* Ghana, ICSID Case No. ARB/07/24 (18 Jun 2010)
[73] Schwebel, S., *Clean Hands, Principle* (2009), p. 32
[74] *Phoenix Action, Ltd. v. The Czech Republic*, ICSID Case No. ARB/06/5 ()
[75] See footnote 69
[76] *Yaung Chi Oo Trading Trading Pte Ltd v Myanmar*, ASEAN Case No ARB/01/01 (31 March 2003)
[77] *Fraport AG Frankfurt Airport Services Worldwide v Philippines*, ICSID No ARB/11/12, Award (10 December 2014)
[78] *SAUR International v Argentina*, ICSID Case No ARB/04/4 (6 June 2012)
[79] Moloo and Khachaturian (n 9) 1475; Bjorklund and Vanhonnaeker (n 9) 370; Llamzon and Sinclair (n 3) 508; Schill (n 11) 313.
[80] Հայաստանի իրավական տեղեկատվական համակարգ, ՀՀ օրենքը «Սևանա լճի մասին», <http://www.arlis.am>
[81] «Հայաստանի Հանրապետության Կառավարության 2003 թվականի դեկտեմբերի 11-Ի N 1787-Ն որոշման մեջ փոփոխություն կատարելու մասին» ՀՀ կառավարության՝ 18 հուլիսի 2013 թվականի որոշում N 746-Ն, <https://www.arlis.am/DocumentView.aspx?docid=84485>



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In 2014, it was discovered that the Potentilla porphyrantha plant listed in Armenia's red book of endangered species grew in the Amulsar mine exploitation zone. In the same year the Government has adopted allegedly an anti-legislative Decree N781 allowing the red book flora species to be uprooted from their native habitat and replanted elsewhere.[82] There are two prohibitions one forbids to reduce the number which they did they planted elsewhere well done, but there is also a second prohibition carrying out activities that lead to habitat degradation. In 2015, Decree N 244 the government decides to alter the permissible limits of surface mines haulage road slope.[83]

The main assumption that can drown is that the mentioned amendments were made in favor of the Investor and for the best interests of it, although initially it may have had confrontations with the local legislation. Hence, the lawfulness of the investment, namely the legality of the license can be questioned.

In *Inceysa v. El Salvador*, the Tribunal held that "because the investor obtained its investment through fraud, the investor could not seek relief for alleged harm to that investment under either the governing IIA or the contract".[84]

In *World Duty Free* case, the Tribunal held "the Claimant had in fact procured the 1989 Agreement through a bribe to the former Kenyan President and that, consequently, the Claimant had no right to pursue or recover under any of its pleaded claims, all of which arose from that 1989 Agreement".[85] *World Duty Free* is further notable in that it signals that foreign investors not only have *rights* in the countries where they invest, but also *obligations*; it similarly illustrates that foreign investors' enjoyment of their rights may be contingent on the investors' compliance with their obligations. Together, *World Duty Free* and *Inceysa* may therefore support a growing recognition and significance of foreign investors' duties to comply with national and/or international law relating to their investments.[86]

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[82] «Հայաստանի Հանրապետության բուսական աշխարհի օբյեկտների պահպանության և բնական պայմաններում վերարտադրության նպատակով դրանց օգտագործման կարգը սահմանելու մասին» ՀՀ կառավարության՝ 31 հուլիսի 2014 թվականի, N 781-Ն որոշում, <https://www.arlis.am/documentview.aspx?docID=91830>

[83] «ՀՀ կառավարության 2010 թվականի հունվարի 21-ի N 51-Ն որոշման մեջ փոփոխություններ կատարելու մասին» ՀՀ կառավարության՝ 10 մարտի 2015 թվականի N 244-Ն որոշում <https://www.arlis.am/DocumentView.aspx?docid=96350>

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

[85] *World Duty Free Co Ltd v. The Republic of Kenya*, ICSID Case No. ARB/00/7 (Sep. 25, 2006)

[86] https://www.iisd.org/itn/2018/10/18/world-duty-free-v-kenya



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It should be noted, however, that recent award of *Yukos*[87] case is important in this context because it is the first one to specifically analyse whether the clean hands doctrine is a general principle of law applicable during this later phase in the life of an investment.

Russia alleged no less than 28 instances of 'illegal and bad faith conduct' by Claimants from the privatization of Yukos in the mid-1990s to its liquidation in November 2007. The Tribunal summarized these allegations as follows: "In sum, Respondent alleges that Yukos neither paid its tax debts in full immediately after these debts were assessed, nor made reasonable settlement offers; dissipated the assets it had on hand; lied to its auditors; obstructed the work of the bailiffs; and sabotaged the YNG auction". Russia took the position that Claimants' 'unclean hands' 'deprive the Tribunal of jurisdiction, render Claimants' claims inadmissible and/or deprive Claimants of the substantive protections of the ECT.'[88]

The first obvious argument raised by the Claimants was that the ECT does not contain a 'in accordance with the law' clause nor any reference to the principle of 'unclean hands'. For Russia, the lack of a specific clause to this effect was not fatal insofar as 'the ECT protects only bona fide and lawful investments and Respondent's consent to arbitrate only extends to such investments'.[89]

The Tribunal therefore explicitly endorsed the proposition that a legality requirement exists even in the absence of a clause to that effect in the treaty. In that sense, the Tribunal recognized the existence of the clean hands doctrine (albeit with a limited scope).[90]

However, the Tribunal's final conclusion was that Respondent's 'unclean hands' argument 'does not operate to deprive the Tribunal of its jurisdiction in this arbitration, render inadmissible any of the Claimants' claims or otherwise bar Claimants' from invoking the substantive protections of the ECT'.[91] It should be added that the Tribunal nevertheless mentioned that the allegation of unclean hands should be treated as contributory fault and/or a failure to mitigate on the part of Claimants and 'could have an impact on the Tribunal's assessment of liability and damages'.[92]

Hence, Armenia should be very careful in arguing that the Company has violated the "clean hands"' doctrine and in putting the legality of investment under question. Unless it can

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[87] *Yukos Universal Limited v Russian Federation*, Final Award, PCA Case No AA 227, IIC 652 (2014)
[88] See footnote 63
[89] *Hulley Enterprises Limited (Cyprus)* v. *The Russian Federation*, UNCITRAL, PCA Case No. AA 226.
[90] Bjorklund, A. and Vanhonnaeker, *Yukos: The Clean Hands Doctrine Revisited* (2015), p. 372.
[91] See footnote 84, para. 1373
[92] See footnote 84, para. 1374



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be proved that the change in legislation was due to an act of corruption in which the Investor was involved (which would be extremely difficult, if not impossible to prove) the Investor cannot be penalized for the "unclean hands" of someone else. However, in case Armenian authorities succeed to bring relevant and sufficient evidences on this occasion, it may have a great impact on the Tribunal's assessment of the State's liability and damages.

## CONCLUSION

Summarizing the claims, findings and observations in this paper, it can be concluded that although the Dispute is still unset many investors are looking at the issues around Lydian, and how the Government is handling those very sensitive and controversial issues. The resolution of the Dispute through Investment Arbitration will probably be the last resort of the Government to which it should be properly prepared even in pre-arbitration phase and "cooling off" period.

In case the State wins the arbitration, there is still a disadvantage on the general investment climate in the country, which will make the investment platform vulnerable and



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undesirable for future potential investors as they will take into consideration the example of the present case.

Losing the case will be a harsh resolution for the State as the monetary claim to be compensated is assumed to be over half of the state budget, which in its turn will cause an environmental and economic crisis for the State itself.

Summing up the possible defense mechanisms for the State, here are some of the Strong arguments of the State:

- There was no prime facie expropriation of the Company's investment as the State neither has terminated nor seized the license of the Company nor has taken any actions to interfere with the ongoing business operations.
- The State's regulatory actions can be justified under the famous police power doctrine as the state has sovereign right to regulate the economic activities in its territory, proceeding from public interest and guided by public purpose.
- Alternatively, relevant actions (if any) may be justified based on the principle of necessity, for public interest, such as public health and protection of environment.

There are some weaknesses as well in the arguments and actions of the State, which are assumed to be the following:

- The State has allegedly violated fair and equitable treatment standard. The obligation to accord fair and equitable treatment appears in the great majority of international investment agreements. Among the protection elements of the international investment agreements, the standard has gained particular prominence, as it has been regularly invoked by claimants in investor-State dispute settlement proceedings, with a considerable rate of success.
- The State has not exercised its positive obligations in order to ensure *full protection and security* of the Company's investments, as the blockades, however continued and physically interfered the employees of the Company to enter their workplace:
- Inaction or implicit neglect of the State may be viewed as act tantamount to *expropriation* or other equivalent (indirect expropriation), which even if considered lawful, must afford just adequate compensation to the Company.
- The argument on "police power" is weak. The "police power" can be invoked only if a positive action (as opposed to inaction) of the government was the cause of action not in our case where we are effectively dealing with a case of "inaction" (rather than



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positive action) of the government which could be held to imply approval. Moreover, compensating a damage on grounds of "police action" is an exception to the general rule and must be interpreted restrictively.

Thus, it is recommendable for the State:

- to make a preliminary assessment of potential liability under the claim: this is primarily an assessment of the particular case. However, a State may also consider systemic implications of a settlement;
- to think through possible terms of a mutually agreeable resolution: this often includes financial terms, but it may also include non-financial terms. Non-financial terms may be especially relevant to keeping the investor operating in the host State;
- to involve international experts and professionals in the field of mining and environment to conduct necessary professional experiments and risk assessment.

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