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COMMERCIAL ARBITRATION

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Impact of Sanctions on International Arbitration Involving Russian Parties

В данной статье автор рассматривает влияние санкций на международный арбитраж, обсуждает практические вопросы, возникающие в связи с арбитражем с участием лиц, в отношении которых введены санкции и актуальную в этой связи рыночную практику в России, а также дает общий обзор и анализирует недавние изменения Арбитражного процессуального кодекса РФ, вступившие в силу 19 июня 2020 года, распространяющие исключительную юрисдикцию российских государственных арбитражных судов на споры с участием лиц, находящихся под санкциями. Статья публикуется на английском языке.

Sanctions imposed by the U.S.A, the EU, and other jurisdictions in relation to certain Russian individuals and legal entities over the past few years since 2014, have had a substantial impact on international arbitration involving Russian parties[1].

There exist serious concerns as to the ability of sanctioned Russian parties and their contractual counterparts to realise their right to defend themselves in the course of international arbitration proceedings. These concerns have led to changes in market practice regarding the choice of the arbitration forum and to some recent legislative changes in Russia that may potentially have a dramatic impact on international arbitration involving Russian parties.

[1] See also: *Kroll K.* "Russia Reacts: Impact of Sanctions on International Arbitration Involving Russian Parties" // CEE Legal Matters Magazine. January 2020. P. 52–53.

Sanctions

Although this article does not aim at providing a comprehensive review of applicable sanctions, let us set a very broad framework of the key sanctions regimes impacting Russian parties – namely, the U.S. and the EU sanctions.

There are several U.S. sanctions programs targeting Russian entities, including:

– The *Specially Designated Nationals and Blocked Persons* (SDN) program, which blocks assets of SDNs within the remit of the U.S. and prohibits any U.S. citizen or resident and any legal entity or organisation registered in the U.S. (*i.e.*, a "U.S. person") from dealing with an SDN, unless authorised by the Office of Foreign Assets Control of the US Treasury Department (OFAC);

- The *Sectoral Sanctions Identifications* (SSI) program, which targets selected industries and applies to certain financing and equity transactions;
- The *Crimea-related sanctions* program, which prohibits with a few exceptions, any dealing involving Crimean assets or counterparties (i.e. individuals residing in Crimea and legal entities either registered in the Crimea or carrying out activities there);
- The *U.S. Countering America's Adversaries Through Sanctions Act of 2017* (CAATSA), which targets, *inter alia,* non-U.S. third parties entering into "significant" transactions with Russian sanctioned entities.

Any U.S. person, whether individual or corporate, is bound by the U.S. sanctions regardless of their location. Importantly, a non-U.S. person may become subject to the *secondary* sanctions if such person is involved in, or facilitates, a "significant" transaction with a sanctioned Russian entity or its affiliate. There is no clear criteria to define a "significant" transaction and any such determination would be made by OFAC in its discretion.

The EU sanctions (or "restrictive measures") can be divided into smart sanctions, which prohibit all transactions with specific entities ("targets" or "EU blocked persons"), and sectoral sanction, which target sectors of the economy and industries. EU sanctions apply (i) to any national of a EU member state irrespective of their location, or to legal entities and organizations registered or carrying out activity in the EU (ii) to any person within the territory of the EU; and (iii) with respect to any business conducted, even in part, in the EU.

The EU sanctions prohibit:

- engaging in nearly all types of commerce with "the EU blocked persons" (designated by Regulation 208 and Regulation 269); and
- engaging in the specifically prohibited transactions with "sanctioned entities" (designated by the so-called "sectoral" sanctions set out in Regulation 833).

EU sanctions also prohibit participation in activities the object or effect of which is to "circumvent" the applicable prohibitions set by the EU sanctions.

The key problem caused by sanctions is not just that they are plentiful, contained in multiple sources of law and often complex. International businesses are known to be able to quickly learn and adjust to new regulatory requirements, as for example they do with constantly evolving compliance regimes generally.

The worst factor from the commercial perspective is, in my view, that it is impossible for a business to predict whether its counterparty, which is not subject to any sanctions at the time of entering into a commercial transaction, may become sanctioned in the future, as new sanctions are regularly introduced against new subjects without any obvious transparent logic behind them. Moreover, the risk of application of "secondary" sanctions is almost impossible to quantify and assess as their application is completely arbitrary. As a result, the most conservative market participants may often find it easier to abstain from entering into any transactions with any Russian counterparties, even non-sanctioned, to minimize even the slightest potential risk[2].

Impact on Arbitration

There can be a view that arbitration is in essence a commercial service provided to the parties of a dispute, yet many scholars would argue that the nature of arbitration is a quasi-judiciary function and hence beyond the scope of sanctions targeting commercial activities. In reality, irrespective of which school of thought on this complex theoretical subject one may find more persuading, there are practical issues that come up in arbitration involving sanctioned entities.

The practical problems may arise at various stages of arbitration, including, for example, the appointment of arbitrators, instructing legal counsel, involving experts, participation of sanctioned persons as witnesses, payment of

[2] See "Great Bear shrugs: Russia feels sanctions pain but business continues" // WorldECR Magazine. May 2020. Issue 89. P. 8. (www.worldecr.com).

arbitration fees, expenses, and costs, and paying legal counsel.

If the arbitral institution, or arbitrators, or legal representatives of the parties are domiciled in a jurisdiction that has imposed sanctions on a party to a dispute, they may be required to obtain an authorisation (often called a "licence") from a competent regulator in the relevant jurisdiction allowing it to perform its role in the arbitral proceedings. While the strict legal necessity for such an authorisation may not always be apparent, very often an organisation or individual involved tend to take a super-conservative view to be on a safe side and to minimize risks, especially in view of risk of potential "secondary" sanctions, not to mention reputational risks.

For example, unless expressly authorized by OFAC, a U.S. person (whether a U.S. national or resident or a U.S. law firm) would be extremely uneasy accepting an appointment to act as an arbitrator, counsel, or expert in an arbitration involving an entity under blocking sanctions. Even a non-U.S. person needs to consider the risk of secondary sanctions if he or she gets involved in such an arbitration as it can be argued that an arbitral award may facilitate a "significant" transaction with a sanctioned entity that is prohibited by the U.S. sanctions.

A significant practical impediment is that the banks are likely to block/freeze any payments where either the payee or the payer is a sanctioned entity. This would lead to the possibility that any payment in U.S. dollars or euros under the arbitral award could be blocked. That risk would also apply to the payment of arbitration fees and costs and paying legal counsel and other parties in the arbitration proceedings.

Individuals under blocking sanctions may be prevented from participating in arbitration proceedings in person (*e.g.*, as a witness or party's representative) as their visa applications are likely to be denied. Even though it might be possible for them to participate via a video link, this raises the question of equality of the parties in the proceedings, which in itself may lead to a risk that the arbitral award could be invalidated.

Even though at present, at a time when many arbitration hearings take place on-line due to COVID-19 related concerns, this problem may appear academic, it does nevertheless have practical repercussions in the ordinary course of business, as most practitioners would agree that a party able to present its position in person may have advantage over a party having to access the proceedings via a video link. Of course, if all parties access the hearings on-line, there may be no downside for a sanctioned party.

There is also a more fundamental legal risk that arbitrators may approach sanctions provisions as a type of overriding mandatory provision depending on the applicable law and place of arbitration, which could influence the outcome of the dispute in a critical way[3].

Such risks have led many Russian entities, especially those under state control (and hence more susceptible to the potential risks of sanctions), to start opting for arbitration venues in Asia – Singapore and Hong Kong in particular – as opposed to more traditional arbitral forums in Europe. However, many concerns remain, as sanctions apply to U.S. and EU persons irrespective of their location, so there would still be a risk of secondary U.S. sanctions, and the problem with bank transfers would remain as well.

Important Recent Russian Law Development

The recent trend for Russian parties to choose Asian arbitral venues may be reinforced in view of the changes made to the Russian Arbitrazh Procedural Code which came into force on June 19, 2020 (**APC Amendment**)[4].

[3] See, for example: *Asoskov A.V.* "The Advantages of Arbitrating Russia-Related Disputes at HKIAC as a Permanent Arbitral Institution under Russian Law" // Asian Dispute Review. April 2020. P. 78.

[4] Federal Law No.171–FZ dated June 8, 2020 "On Amendments to the Arbitrazh Procedural Code of the Russian Federation in order to protect the rights of individuals and legal persons in connection with restrictive measures introduced by a foreign state, association of states and/or union and/or a state (interstate) institution of a foreign state or an association of states or a union of states".

The APC Amendment is aimed at protecting interests of parties which became subject to Russia related sanctions by extending exclusive jurisdiction of Russian state commercial "arbitrazh" courts over the disputes with such sanctioned parties. As a result, any prorogation or arbitration agreement entered into by a Russian sanctioned party and providing for an arbitral forum or a seat of arbitration in a jurisdiction that adopted Russia related sanctions is potentially unenforceable in Russia. Notably, the APC Amendment applies not just to Russian parties, but also to non-Russian parties which became subject to Russia related sanctions.

Pursuant to the APC Amendment, if a sanctioned party has submitted to the jurisdiction of a non-Russian court or an arbitration tribunal in a state where such party's "access to justice" might be limited by application of Russia related sanctions, then such sanctioned party is entitled to bring its claim into a Russian court.

As the APC Amendment does not explain what circumstances might be regarded as barring a party's access to justice, in theory any difficulty for a sanctioned person could be construed as a limitation of access to justice. Probably even the imposition of sanctions in itself could potentially be re-characterised as such.

If the sanctioned party's procedural opponent would still pursue a claim against a sanctioned party in a foreign court or arbitral tribunal in the above scenario, a sanctioned party may apply to Russian court for an anti-suit injunction.

Should an opposing party fail to comply with an anti-suit injunction granted by Russian court, the APC Amendment specifically entitles the Russian court to impose a penalty on the non-complying party in the amount of the entire claim brought in the foreign court or tribunal, plus any associated costs, in favour of the sanctioned party.

Of course, it is quite possible that an international arbitration tribunal will uphold the arbitration clause and continue with the arbitration, disregarding the Russian court's anti-suit injunction.

However, this would result in a significant risk in relation to any Russian assets of a non-sanctioned party pursuing a claim against a sanctioned party outside Russia, as the Russian court's penalty would be enforceable against any assets that non-sanctioned party may have in Russia.

Furthermore, the likelihood of enforcement of a foreign arbitral award in Russia in these circumstances would be close to zero. The enforcement of a foreign arbitral award under the auspices of the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958, to which Russia is of course a party, is likely to be barred due to the "public policy" argument based on the explicit provisions of the APC Amendment.

While the APC Amendment is silent on the subject which law a Russian court would apply in a scenario where it accepts jurisdiction over a non-Russian law governed agreement which was subject to the jurisdiction of a non-Russian court or arbitral tribunal, and though in theory a Russian court could attempt to apply foreign law by relying on expert advice, there is a high probability that Russian court would be inclined to apply Russian law.

So where does it leave parties to the cross-border deals with Russian parties?

While a sanctioned Russian party may benefit from its ability to move proceedings to its home turf in Russia, possibly under Russian law, its counterparty risks losing the benefit of choice of applicable law and venue for resolving disputes mutually agreed by the parties in the arbitration or prorogation agreement.

While there can be plenty of legalistic arguments that such state interference into the implementation of the will of the parties to a commercial contract goes against the principles of public and private international law, there can be counter-arguments that a state is entitled to protect the interests of its subjects in a situation when such subjects' legitimate interests are restricted by a foreign state, arguably on a questionable basis (whether imposition of unilateral sanctions by a state complies

with the principles of international law and the UN Charter is not discussed in this article).

The practical problem is that the risk of application of the APC Amendment to cross-border commercial transactions may inhibit ability of Russian parties to enter into such transactions as their foreign counterparties might be scared away, not just by Russia related sanctions, but now also by the protectionist measures taken by the Russian state, as they cannot rely on their ability to resolve possible disputes with their Russian counterparty in a mutually accepted neutral forum under applicable law agreed by the parties in their contract.

Therefore, it might seem that the APC Amendment effectively limits the ability of most parties, both Russian and non-Russian, to rely on international arbitration as a way to resolve commercial disputes, and might potentially diminish international dealmakers' appetite to transact with Russian counterparties.

There is however a notable exception, which I believe should allow the parties to continue their reliance on international arbitration in an arbitral institution of their choice and under applicable law chosen by them.

Choice of HKIAC as a possible solution

In my view the risk of application of the APC Amendment would be minimized if the following factors apply to the dispute in question: (i) the arbitral institution and the seat of arbitration are in a jurisdiction that did not impose any Russia related sanctions, (ii) the applicable law cannot be constructed as to include the sanctions provisions as overriding mandatory provisions, and (iii) the arbitration is administered by a Permanent Arbitral Institution recognized by the Russian Ministry of Justice.

If all of the above factors are met, it would be difficult for a sanctioned party to argue that its "access to justice" is unduly limited because of application of sanctions.

As of the date of this article the Hong Kong International Arbitration Centre (**HKIAC**) is the only well established and popular international arbitral venue that meets all of the above criteria.

First, Hong Kong has not imposed any Russia related sanctions.

Furthermore, the HKIAC is one of only two[5] non-Russian Permanent Arbitral Institutions (**PAI**), and the only non-EU PAI, that is accredited by the Russian Ministry of Justice[6].

The HKIAC PAI status is quite important for Russian law purposes. The key advantages secured by a PAI status as a matter of Russian law are as follows:

- only an arbitral institution with a PAI status can administer a dispute with a seat of arbitration in Russia (note that *ad hoc* arbitrations do not present a viable alternative due to limitations established by the Russian legislation with respect to this form of arbitration);
- certain corporate disputes are non-arbitrable for Russian law purposes, unless a dispute is administered by an arbitral institution with a PAI status;
- certain procurement contracts made by the state controlled Russian commercial companies such as, for example, Gazprom, Rosneft, Rosatom etc. are only arbitrable if the seat of arbitration is in Russia, and only a PAI can administer an arbitration with a seat in Russia;
- Russian courts may assist an arbitral tribunal in the taking of evidence, but only in the event that the arbitration is administered by a PAI and the seat of arbitration is in Russia;
- Only a PAI can serve as appointing authority or provide further assistance (e.g. holding deposits of advances of arbitration fees

[5] The other is the Vienna International Arbitral Centre (VIAC).

[6] See the HKIAC News Alert of April 9, 2019. "HKIAC First Foreign Arbitral Institution Permitted to Administer Disputes in Russia" (www.hkiac.org/news/hkiac-permitted-administer-disputes-russia).

and expenses, provision of hearing facilities, etc.) to *ad hoc* arbitrations with the seat in Russia;

- The parties to a dispute with a seat of arbitration in Russia are permitted to waive certain forms of judicial supervision and interference by Russian state courts provided the arbitration is administered by a PAI, enabling them to dis-apply Russian court's ability to (i) set aside an arbitral award, (ii) to grant an order in relation to a party's application challenging the tribunal's interim award on its jurisdiction, and (iii) to rule on the issues related to appointment or challenge of arbitrators and termination of their mandate on other grounds.

The Singapore International Arbitration Centre (**SIAC**) has also become popular with Russian parties, and Singapore has not imposed any Russia related sanctions. Should SIAC obtain the PAI status for Russian law purposes, its attraction as a viable alternative venue for resolution of Russia related disputes would further increase.

Of course, the above described advantages of HKIAC may not always be a hundred percent solution to all potential numerous sanctions related issues, however it certainly presents a viable alternative to more traditional arbitral venues in Europe and one may expect that its popularity in relation to Russia related disputes will continue to grow.