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The Impact of Economic Sanctions on the Validity of Arbitration Agreements and Arbitrability

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Abstract: The emergence of the Russia-Ukraine conflict, therefore presents seismic movements in the global politics, leading towards economic sanctions against Russia as a prominent mechanism in the conflict and diplomatic pressure among many. The sanctions would not only restrict economic activities in and out of Russia but also draw attention to the security of international commercial norms and dispute resolution mechanisms. Justifiably, commercial economic sanctions have recently played a growing critical role in transnational trade. The enterprises that come under sanctions face the dilemma of how to fulfill the contracts and agreements while under the sanctions. This paper tries to raise and discuss the issue of the validity of the international commercial arbitration clause and the arbitrability of the disputes in the background of the economic sanction. It will study through a case analysis the disputes related to the validity of the arbitration clause and the arbitrability of disputes under sanctions. A further approach of comparison is used to look into the different stands taken by diverse authorities on these issues. The work finds that though economic sanctions prove some difficulties, the independence of an arbitration clause, as well as the arbitrability principles, still continue to get wide support. In sanction conditions, arbitration is still an effective and proper method of resolving disputes.

Keywords: International Arbitration, Economic Sanctions, The Validity of the Arbitration Clause, Arbitrability.

1. Introduction

With the speeding up of globalization, international arbitration has slowly come to be the first choice for fixing international business disputes, because of its leeway and quickness. Though economic sanctions are used far and wide as tools of international politics and diplomacy, they have started to bear a big impact on international business arbitration.

Statistics show that since the early 2000s, incidents involving economic sanctions have happened quite often worldwide, with a major preference for developed nations imposing one-sided sanctions on other states. The first wave began in 2001 with the U.S. sanctions against Iran, followed by the EU sanctions for Russia, and then another set of measures for Middle-Eastern nations to continue amplifying the effects of economic sanctions. For instance, following the Ukraine crisis in 2014, the EU and the U.S. imposed severe sanctions on Russia, resulting in an estimated 3-4% contraction in Russia's GDP over the subsequent years [1]. Trade between Russia and Western countries declined sharply, and numerous multinational corporations encountered significant operational barriers in the Russian market. The economic sanctions do not only put restrictions on the commercial activities of

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the states under which they are imposed, but they raise a new challenge to the field of international arbitration: whether or not the arbitration clause will stand and whether or not the dispute resolution process can proceed through arbitration under sanction conditions. These have been questions of a good deal of debate by both scholars and professionals.

This article considers the influence of economic sanctions on the validity of the arbitration clause and on the arbitrability of disputes. It examines the challenges that confront the arbitral system in the background of sanctions. It further provides strategies in response. The ultimate purpose of this paper is to lay out the reference points against which the viability of international commercial arbitration is to be assessed in such trying conditions.

2. The validity of the arbitration clause

The arbitration clause has for long been regarded as the cornerstone of dispute resolution in international commercial arbitration. Issues pertaining to its validity have also remained to feature prominently in relative discussions. In an economy that is facing sanctions, the autonomy of an arbitration clause holds itself with validity, particularly when the clause's principal contract is to be invalidated. This chapter reviews the principle of autonomy in the validity of the arbitration clause with a view of how it applies to practice internationally and, in addition, takes a closer look at specific instances that may amount to invalidity of an arbitration clause.

2.1. The principle of autonomy of the arbitration clause

In global business arbitration, legal experts typically see the arbitration as a standalone lawful term. This denotes that even if the presence of penalties makes the primary contract likely invalid or ends it, the validation of the arbitration clause continues [2]. As a procedural agreement for dispute resolution, the arbitration clause is typically capable of surviving independently from the fate of the underlying contract. This principle of autonomy provides parties with a stable path to dispute resolution under sanction conditions, thereby safeguarding their procedural rights from being undermined by impediments to the performance of the substantive contract.

2.2. International application of the principle of autonomy of the arbitration clause

In March 2019, Czechoslovak Export Ltd filed a claim before a Ukrainian court seeking to invalidate a contract it had signed with the Ukrainian state enterprise Konotop Aircraft Repair Plant “Aviakon”. The claimant alleged that the contract was in violation of a resolution from the National Security and Defense Council of Ukraine, which had placed personal economic sanctions on Rostec, a Russian corporation that was allegedly associated with Czechoslovak. As a result, the company asserted that the contract's arbitration clause was also considered in violation of the National Security and Defense Council of Ukraine, which led to the company's claim.

In response, Aviakon's filed a counterclaim that challenged the jurisdiction of the Ukrainian court and proposed that the dispute should be referred to the International Commercial Arbitration Court (ICAC) at the Ukrainian Chamber of Commerce and Industry, in accordance to the arbitration clause in the contract.

The case was ultimately brought before the Supreme Court of Ukraine, which dismissed Czechoslovak Export Ltd’s claims. The Court upheld the concept of the arbitration clause's autonomy, it stated that the presence of sanctions did not automatically undermine the agreement on arbitration. It emphasized that arbitration clauses are typically considered to include all types of disputes between the parties, including disputes regarding the legitimacy of the underlying contract, unless the issue is explicitly excluded from the clause's jurisdiction.

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The Court continued to reason that allowing one party to bypass the arbitration process on the grounds of the main contract's inefficacy would lead to a procedural misuse, this would undermine the arbitration process itself. It reemphasized that the arbitration clause and the primary contract should be considered as separate legal instruments, and the inefficacy of the primary contract does not constitute an impediment to the validity of the arbitration clause.

Through this decision, the Supreme Court confirmed that the question of how sanctions affect the parties must be decided by the arbiter, rather than by the court, regarding the validity of the arbitration clause [3].

2.3. Special circumstances of invalidity of the arbitration clause under economic sanctions

In international commercial arbitration, an arbitration clause is considered to be malicious if it's perceived as a means of avoiding economic punishment. This situation typically arises when the parties, by selecting arbitration as a dispute resolution method, attempt to bypass mandatory provisions of domestic or EU law that would otherwise apply. Judicial practices in countries such as Germany and Austria provide valuable reference points in this regard.

Under the legal frameworks of the European Union and certain member states, if the practical effect of an arbitration clause is to exclude the application of compulsory legal norms--such as securities regulation rules or protections for commercial agents--then the court may declare the agreement invalid. This position is rooted in the principle of effect utile, which maintains that the core policy goals of the law should not be undermined by the procedural choices of the parties [4].

The Federal Court of Justice of Germany (BGH) has explicitly stated that an arbitration clause is invalid if its substance leads to the circumvention of mandatory rules in German securities law (such as by choosing a foreign arbitral seat or applying foreign law) [5]. In addition, the Higher Regional Court of Munich (OLG München) ruled in one case that an arbitration clause referring to the courts of California and applying California law was invalid because California law did not provide for compensation rights for agents equivalent to those under the Commercial Agents Directive. The court emphasized that if the procedural choice involves an "obvious danger" of circumventing mandatory regulations, the agreement should be deemed invalid [6].

These rulings established the “obvious danger” standard: if the choice of arbitration procedure of the parties presents a substantial risk of circumventing mandatory regulations, the relevant arbitration clause may be declared invalid [7]. However, in cross-border commercial practice, since selecting a foreign arbitral institution is a routine business arrangement, proving the parties’ intentional intent to evade sanctions faces significant evidentiary challenges [8].

3. Arbitrability of disputes under economic sanctions

Arbitrability is one of the core issues in international commercial arbitration, as it determines whether a dispute can be resolved through arbitration. Economic sanctions, as mandatory regulations employed by a state to protect its national security, foreign policy, or public interests, often involve issues of state sovereignty and public policy. As such, the ability to resolve disputes regarding economic sanctions is a subject of significant discussion.

Scholars and arbitration experts generally believe that the use of economic punishment does not negatively impact the ability to resolve a dispute. Although sanction rules possess characteristics of public policy, and traditionally, disputes involving violations of public policy are not arbitrable, this does not imply that disputes involving economic sanctions automatically lose their arbitrability [2]. Conversely, the common practice of arbitral tribunals and domestic courts is to consider the public nature of the sanctions during the substantive portion of the award, rather than immediately denied

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the arbability of the dispute. This position has been affirmed in judicial decisions across various jurisdictions, reflecting the capacity of arbitration to accommodate complex public law issues.

3.1. The mainstream position supporting arbitrability: the arbitral tribunal's primary jurisdiction

In international commercial arbitration, the mainstream view holds that disputes involving economic sanctions should be arbitrable. This position was illustrated very clearly in the case of La Compagnie Nationale Air France v. Libyan Arab Airlines. The case stemmed from a dispute over an air services contract between Air France and Libyan Arab Airlines. In 1993, the United Nations Security Council enacted Resolution 883, which specifically stated that no lawsuit should be associated with any contract that was subject to international sanctions in Libya [9]. Based on the contract's provisions, Air France alleged that the performance of the contract had been impaired by sanctions, they should be considered non-arbitrable in regards to the UN sanctions.

In response to this dispute involving international sanctions, the arbitral tribunal, in its interim award of 1998, clearly rejected the argument and affirmed its jurisdiction over the matter [10]. This ruling was later supported by the Canadian judiciary: The Superior Court of Montreal initially dismissed the application to annul the arbitral award, emphasizing that the issue of arbitrability falls within the exclusive competence of the arbitral tribunal. The Quebec Court of Appeal, in its 2003 decision, explained that, according to the UNCITRAL Rules for Arbitration and the Quebec Code of Civil Law, domestic courts have no authority to intervene in the tribunal's determination of arbitrability. The court specifically pointed out that the existence of sanctions does not alter the commercial nature of the dispute; any public policy considerations should be addressed at the substantive stage of the proceedings, rather than being used as a basis to deny arbitrability. The court also recognized that the arbiter should consider the public's perspective on the sanctions when deciding on them [11].

The rules established in this instance have a significant impact on similar future instances. The decision clearly distinguishes between procedural and substantive issues, categorizing public policy issues related to sanctions as part of the substantive review. This approach preserves the autonomy of arbitration while balancing national interests with arbitral independence by retaining the court's role in reviewing public policy during the enforcement process.

3.2. The exception to arbitrability: the primacy of public policy

In international arbitration practice, although the mainstream view supports the arbitrability of disputes involving economic sanctions, some jurisdictions take a restrictive stance based on public policy considerations. This divergence is particularly apparent in the case of Fincantieri-Cantieri Navali Italiani SpA v. the Ministry of Defense, Armament and Supply Department of Iraq. [12], where different legal systems reached opposite conclusions on the arbitrability of the same dispute.

The case involved two different companies that built ships in Italy and the Ministry of Defense of Iraq regarding a contract to supply military goods. After the United Nations imposes sanctions on Iraq in 1990, the contract's performance is impaired. When a Syrian agent sought legal advice regarding unpaid commissions, the Italian companies denied that the dispute was arbitrable due to the sanctions. Instead, the issue was considered to be non-arbitrable due to the context of the dispute. The ICC's arbiter, in the decision that was made during the interim period, distinguished the importance of the sanction's regime as a legal concept from the formal issue of whether or not the party was eligible to participate in the process, affirming that although the sanctions might affect the substantive rights and obligations under the contract, they did not strip the tribunal of its jurisdiction [12].

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This position was later supported by the Swiss Federal Tribunal, which, citing Article 177 of the Swiss Private International Law, which grants broad authority to the arbitrator [13], emphasized that public policy considerations should only impact the substantive level, not the ability to resolve the dispute through arbitration [13].

However, the Court of Appeal of Genoa in Italy upheld a different decision [14]. It held that, according to Italian law, including rules regarding international sanctions, the dispute was not arbitrable, because it directly involved state public policy [14]. The Court particularly pointed out that Italy's domestic legislation implementing UN sanctions has mandatory provisions, and such disputes must be exclusively adjudicated by judicial authorities.

This ruling highlights the international divide on the arbitrability of sanctions-related disputes, reflecting different national views on the relationship between arbitration and public policy. While the Swiss court emphasized the functional role of arbitration in resolving disputes, the Italian court focused more on the necessity for the state to uphold public policy through its judicial system. This difference is especially pronounced in cases involving sensitive issues like military sanctions.

Following the outbreak of the Russia-Ukraine conflict, Russia further reinforced its public policy-first stance through legislation. In 2022, Russia enacted the “Sanctions Protection Law”, which stipulates that when Russian parties are unable to effectively obtain relief through foreign arbitration due to foreign sanctions, the arbitration agreement originally providing for dispute resolution by a foreign institution becomes invalid, and the dispute is to be exclusively handled by Russian courts [15].

This legislative model elevates public policy considerations to a new level, forming a sharp contrast to the traditional practices of countries like Italy. Unlike Italian courts, which balance public policy and arbitration autonomy on a case-by-case basis, Russia has explicitly negated the arbitrability of disputes involving Russian sanctions through statutory law and granted exclusive jurisdiction to its courts. While this mechanism may be rational in protecting the rights of sanctioned entities, its unilateral denial of the effectiveness of international arbitration agreements presents a significant challenge to the international arbitration system, which is built on the principle of party autonomy. As geopolitical tensions continue, this trend of reinforcing judicial sovereignty may further influence the landscape of international dispute resolution.

4. Challenges and responses

International economic sanctions have had a dramatic impact on the world of business and law, creating a new series of challenges for arbitration. The challenges not only increase the difficulty of cross-border dispute resolution but also lead to problems such as duplicative litigation, inconsistent arbitrability, and public policy defenses. Such challenges go to the very heart of the effectiveness and integrity of any arbitral process, more especially where public policy is concerned. It is against this background that the following section attempts to address the above challenges by suggesting a bar on duplicative proceedings, the guarantee for the autonomy of the arbitral process through laid down coordinated paths and clear standards for arbitrability, and the protection of the enforceability of arbitral awards in sanctions-related cases by narrowly construing the public policy exception.

4.1. Parallel proceedings and exclusive jurisdiction mechanisms

International conflicts have greatly emphasized and safeguarded judicial sovereignty. This, however, has substantially challenged arbitral tribunals in dispute sanctions through the "Sanctions Protection Law" of Russia, which admits courts' interventions through injunctions and exclusive jurisdiction clauses under the title "Sanctions Protection Law". These provisions breed problems of parallel proceedings. The problems add not only additional costs to the parties on legal matter but also to

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more important issue reduce the efficiency and independence of arbitration. Such legitimacy challenges make the arbitral tribunal face it at the very initial stage of the proceedings.

Arbitration agreements should meet this in wording terms, including such exclusive jurisdiction clauses as would unambiguously point out that arbitration is the sole method of dispute resolution, with it all to be conducted at the arbitral seat along with the laws in effect. On this foundation, having already had the international arbitration institutions draw the parties' attention to the risks of duplicate proceedings and how to mitigate those risks, among other things, more based on the Hague Convention on Choice of Court Agreements, which, too, develops this procedural autonomy spirit further, more restrictions within the national courts' intervention on such arbitration agreements will be implemented, thus ensuring the independence and efficiency of arbitration.

4.2. Divergences in determining arbitrability and the construction of coordinated pathways

Economic sanctions fall in the category of public policy sanctions; disputes relating to public policy are known as non-disposable in some jurisdictions. Such disputes are likely to fall within the pale of challenge against their arbitrability. In certain cases, more particularly where quite sensible areas are involved, such as national security and foreign policy, the courts may hold the disputes as not falling within the pale of arbitrability. This approach expands the scope of non-arbitrable matters, which is detrimental to international dispute resolution.

To address this challenge, both courts and arbitral tribunals should base their decisions on the concept of party autonomy, which ensures that the parties have the ability to choose an arbiter is not undermined by economic sanctions. National arbitration and judicial practices have repeatedly indicated that public policy issues related to sanctions should be deferred to the substantive phase of proceedings, rather than being used to deny arbitrability at the procedural stage. Additionally, the legislative spirit and principles of the New York Convention should be fully leveraged, advocating for the determination of arbitrability standards to be left to the discretion of the respective arbitral tribunals in each jurisdiction [16].

4.3. Abuse and limitation of the public policy defense

At the time of recognition and enforcement, certain courts will not enforce arbitrated judgments that involve punitive measures because of the "public policy" involved. If such defenses are widely accepted, it would lead to the invalidation of the cross-border circulation of arbitral awards, severely undermining the uniform enforcement framework of the New York Convention.

To prevent the "public policy exception" from becoming a tool to circumvent enforcement obligations, courts of different countries should return to a "universalist" approach at the detection and enforcement stage. This approach should be grounded in the objectives and fundamental values of the New York Convention, offering a restrictive interpretation of "public policy" [17]. Only when the court determines that the recognition and enforcement of an award objectively violates applicable economic sanctions should it further examine whether the sanction qualifies as public policy in accordance with the definition of the New York Convention, thereby deciding whether the public policy exception defense can be invoked.

5. Conclusion

In conclusion, despite the challenges associated with economic sanctions, the validity of the arbitration clause and the arbitrability of the disputes in international commercial arbitration are still possible, the analysis in this study shows that these issues do not fundamentally undermine the arbitration mechanism. First, the concept of the arbitration's autonomy ensures that even if the main contract cannot be performed due to sanctions, the arbitration clause remains valid. Second, the

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mainstream view holds that disputes involving economic sanctions are typically arbitrable, with the sanction issues to be considered at the substantive stage of the proceedings, rather than being excluded at the procedural stage. Finally, although issues such as parallel proceedings and court intervention persist, the arbitration mechanism can still function effectively through the inclusion of exclusive jurisdiction clauses in arbitration agreements and the support of international conventions. Therefore, the international commercial arbitration system remains effective and applicable in the context of economic sanctions, continuing to provide a means for resolving cross-border disputes. you follow the "checklist" your paper will conform to the requirements of the publisher and facilitate a problem-free publication process.

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