Applicable Law in Disputes Concerning Economic Sanctions: A Procedural Framework for Arbitral Tribunals

by KARL-HEINZ BÖCKSTIEGEL *

ABSTRACT

As the recent economic sanctions decided by the United States and the European Union against Russia may soon be expected to lead to disputes either by commercial arbitrations or sometimes also by investment arbitrations, this paper shortly outlines the procedural framework and major considerations for international arbitral tribunals, if economic sanctions are somehow relevant aspects of the dispute they have to decide. The determination of the law to be applied by arbitral tribunals with regard to economic sanctions is subject to a number of considerations and scenarios with some complexity. Not all effects and results can easily be determined by the parties and their lawyers in advance in a contract or before a given dispute at hand. Tribunals have discretion in a number of scenarios. As a rule of thumb, that discretion is smaller if the economic sanctions are provided in the procedural or substantive law directly found to be applicable to the dispute at hand. And the discretion is wider with regard to economic sanctions by third states where Article 7 of the Rome Convention has to be applied.

I. INTRODUCTORY REMARK

The recent economic sanctions decided by the United States and the European Union against Russia may soon be expected to lead to disputes either by commercial arbitrations or sometimes also by investment arbitrations. This paper has a limited purpose. As it relies on an oral presentation the author gave at a

* Independent Arbitrator; Prof. Emeritus for International Business Law at University of Cologne; Practice as arbitrator and president of arbitration tribunals in many national and international arbitrations of ICSID, ECT, ICC, LCIA, NAFTA, CAFTA, UNCITRAL, PCA, DIS, AAA, SCC, Swiss Rules, VIAC, disputes between states, and others.


ARBITRATION INTERNATIONAL, Vol. 30, No. 4
© LCIA, 2014

605
recent ICC Conference on ‘Economic Sanctions in the Global Economy’, it does not discuss the many general legal aspects of international economic sanctions. Its focus is solely to outline shortly the procedural framework and major considerations for international arbitral tribunals, if economic sanctions are somehow relevant aspects of the dispute they have to decide.

The experience of the author is particularly based on his practice as President of the Iran – United States Claims Tribunal, as Panel Chairman of the United Nations Compensation Commission on Claims against Iraq, and as an arbitrator in cases dealing with sanctions he had in international commercial arbitrations between private enterprises and investment arbitration disputes between foreign investors and the host state of the investment.¹

Due to the arbitrators’ obligation to respect confidentiality, examples of individual cases cannot be quoted, though some of them may be known by other sources in the media. However, as an illustration of the complexity of the issues that could face international arbitral tribunals, two decisions rendered by international tribunals involving economic sanctions are worth mentioning briefly.

In *Bosphorus Hava Yollari (BHY) v. Ireland (ECHR)*,² the applicant was a Turkish airline, which leased two Boeing aircraft from Yugoslav Airlines in 1992. In 1991, the United Nations issued sanctions against the Federal Republic of Yugoslavia (FRY) because of the armed conflict and massive human rights violations that were occurring there. In 1993, the UN Security Council adopted Resolution 820, which called on States to impound aircraft in their territories ‘in which a majority or controlling interest is held by a person or undertaking in or operating’ from the FRY. While one of the leased aircraft was at Dublin Airport, for maintenance service, it was impounded by the Irish authorities pursuant to EC Regulation 990/93, which implemented UN Security Council Resolution 820. BHY’s challenge of the impoundment of the aircraft was successful before the High Court, which concluded that Article 8 of the EC Regulation did not apply to the aircraft and the decision to impound was therefore ‘ultra vires’. The Supreme Court, on appeal, referred the question of whether Article 8 of that Regulation applied to the aircraft to the European Court of Justice (ECJ). This issue was disputed because, although the aircraft was property of the Yugoslav Airlines, it was leased by the Turkish airline. The ECJ held that the Regulation applied to the aircraft. The applicant asserted that Ireland exercised discretion in the implementation of the sanctions that was subject to review in accordance with Article 1 of Protocol 1 of the Convention. The Court found against the applicants’ submissions, finding that the EC Regulation was ‘generally applicable’ and ‘binding in its entirety’, and that the interference with the property was therefore ‘not the result of an exercise of discretion by the Irish authorities, either under EC or Irish law, but rather amounted to compliance by the Irish State with its legal

¹ The author’s experience does not include and the paper does not discuss disputes between states in the framework of the World Trade Organization.

obligations flowing from EC law and, in particular, Article 8 of EC Regulation 990/93'. The Court then had to strike a balance between Ireland's obligations towards the EC on the one hand, and the rights under the ECHR Convention on the other. The Court stated that an interference with the property rights had occurred, and that 'compliance with EC law by a Contracting Party constitutes a legitimate general interest' as required by Article 1 of Protocol No. 1 of the ECHR Convention.

The complex interplay between UN sanctions, EC law and the ECHR Convention in the Bosphorus case sheds some light on potential overlapping regimes that could clash as a result of economic sanctions in the context of an investment treaty arbitration. A domestic regime's application of UN economic sanctions could give rise to a claim for expropriation under a bilateral or multilateral treaty, for example.

Another such example is the Kadi case, which sheds some light on potential issues concerning the fundamental right to be heard under EC law as a result of UN sanctions and asset freezing. The Kadi case was one of a series of annulment actions brought before the Court of First Instance of the European Communities (EC) that were directed against numerous EC regulations that implemented UN Security Council-imposed sanctions in the form of asset freezing orders against individuals suspected of involvement in Taliban and Al-Qaeda terrorist activities. The applicant, whose assets had been frozen as a result of the Community legislation, challenged the legality of the freezing orders, alleging that they infringed upon his right to property, his right to a fair hearing and his right to seek judicial review. One major challenge was whether the Court of First Instance of the EC could exercise review of regulations implementing UN sanctions given that said review could be considered an indirect challenge of the UN itself. The Court of First Instance concluded that it had the power to review the implementing regulations to ensure that they complied with human rights obligations. Moreover, the Court of First Instance held that it had the power to 'to check, indirectly, the lawfulness of the resolutions of the Security Council in question with regard to jus cogens, understood as a body of higher rules of public international law binding on all subjects of international law, including the bodies of the United Nations, and from which no derogation is possible' (paragraph 226). As observed by Professor Reinisch, '[t]his must be seen as a strong confirmation of the view already adopted by the International Criminal Tribunal for the Former Yugoslavia (ICTY) that the UN Security Council is not legibus solutus, i.e. totally free to act in its unfettered political discretion, but has to respect certain core obligations such as the peremptory norms of international law referred to in Article 53 of the Vienna Convention on the Law of Treaties (VCLT)'.

---

4 See Introductory Note by Professor August Reinisch, 45 I.L.M. 77 (2006).
5 Ibid., at 78.
concluded that the EC freezing legislation had not violated the applicant’s fundamental rights to be heard in respect of his property.

One can imagine a scenario whereby a denial of justice claim could be made in an investment arbitration on the basis of asset freezing pursuant to other types of economic sanctions as well. The question of whether arbitral tribunals have the power to check the authority of domestic legal systems when those domestic authorities are merely implementing UN Security Council Resolutions or other types of economic sanctions may therefore become an increasingly relevant question. In sum, arbitral tribunals may be called upon to review the impact or administration of economic sanctions in terms of expropriation, denial of justice or other types of investment treaty claims.

II. INTERNATIONAL COMMERCIAL ARBITRATION

(a) General Determination of the Applicable Law

Before one can address the considerations regarding economic sanctions, since these are part of the applicable law, one has shortly to recall the framework for the determination of the applicable procedural and substantive law by arbitral tribunals.

Regarding the Procedural Law: Disputes of commercial arbitration are conducted as ad-hoc or institutional arbitrations.

In ad-hoc arbitrations, the parties are free to determine the applicable rules, but in practice, most ad-hoc arbitration clauses refer to the Arbitration Rules of UNCITRAL, because otherwise, if a respondent party does not appoint an arbitrator from its side or the parties cannot agree on a chairman of the tribunal, such a default appointment has to be done by a national court. Since a major reason for the parties to submit their disputes to international arbitration is, for a number of reasons, that they do not want to submit their dispute to national courts, they want to avoid such a situation. The UNCITRAL Rules provide for such a default situation that the Permanent Court of Arbitration at The Hague acts as ‘Appointing Authority’ and for a procedure to select a missing arbitrator or chairman of a tribunal. The UNCITRAL Rules, which have been updated in a new version of 2010, also provide for a procedural framework for the conduct of the arbitration. In so far, they bring ad-hoc arbitrations close to institutional arbitration.

For similar reasons, institutional arbitration is the dispute settlement much more frequently chosen by the parties. It refers to arbitration rules of international non-governmental institutions such as the ICC or the LCIA, or to arbitration institutions in particular countries such as the DIS in Germany, SCC in Sweden, the AAA in the United States, or the Swiss Rules in Switzerland. These institutions provide frequently modernized arbitration rules which then are the primarily applicable procedural framework for the dispute. They normally will not contain any specific provisions relevant for economic sanctions.
However, all commercial arbitrations are also subject to the arbitration law of the state where the parties have placed the legal seat of the arbitration. This applicable law will on one hand normally provide a wide discretion to the parties and the arbitrators on the procedure, but may on the other hand contain some mandatory provisions limiting that discretion. Such mandatory provisions may in some states be relevant for economic sanctions, particularly regarding jurisdiction, procedural orders, or possible relief granted in the award of the arbitral tribunal, if they are considered as being part of public policy of the respective state.

Regarding the applicable substantive law, economic sanctions come more into play.

It is part of the generally recognized freedom of contracts that parties can freely choose the law which should be applied to their contract. Without going into details of some very few limitations in the private international law of certain states, this freedom of the choice of contract is also expressly recognized in the arbitration rules mentioned above. In so far as the parties have not included a choice of law clause in their contract, these arbitration rules provide that the tribunal has to determine the applicable substantive law.

To avoid misunderstanding, it should be pointed out that the parties or the arbitrators do not have to elect the substantive law at the seat of arbitration, but may select a substantive law of a state which is not the state where the seat of arbitration has been placed. Thus, in an arbitration seated for example in France, the parties or the arbitrators may nevertheless decide that the applicable substantive law is that of Switzerland.

Either the mandatory provisions of the applicable national law determined in this way, or mandatory provisions of other states or international organizations may become relevant regarding economic sanctions.

(b) Law Applicable to Economic Sanctions

Economic sanctions may have to be examined, and possibly applied by an arbitral tribunal in the following scenarios:

(1) If the applicable substantive law of a state, determined as indicated above, includes economic sanctions, these have to be applied by the arbitrators in deciding the dispute at hand.

(2) But also the law of the forum state, though in principle only applicable to the procedure of the arbitration, may have to applied, if it contains economic sanctions and these are considered as part of the public policy of that state.

(3) If economic sanctions are part of mandatory public international law, such as those set by the Security Council of the United Nations, they will have to be applied by the arbitral tribunal.

(4) If economic sanctions are part of mandatory European Law, they may have to be applied by the tribunal, if the seat of arbitration is within the European Union or if the applicable substantive law, determined as indicated above, is that of a member state of the EU.
(5) But even economic sanctions of third states may become relevant, if Article 7 of the Rome Article 7 of the Rome Convention on Law Applicable to Contractual Obligations in EU Member States is to be applied by the tribunal:

Article 7
Mandatory rules

1. When applying under this Convention the law of a country, effect may be given to the mandatory rules of the law of another country with which the situation has a close connection, if and in so far as, under the law of the latter country, those rules must be applied whatever the law applicable to the contract. In considering whether to give effect to these mandatory rules, regard shall be had to their nature and purpose and to the consequences of their application or non-application.

As can be seen from the last sentence of this provision, a wide discretion is granted in its application and thus also to the arbitral tribunal.

(6) Some states, in particular the United States sometimes, demand the extra-territorial application of some of their economic sanctions.

As is well known, a number of states, including European States, have passed blocking statutes or counter-measures against such extra-territorial demands. In so far as, according to the scenarios given above, the law of such states is applicable, beyond the application of Article 7 of the Rome Convention, the tribunal cannot apply such extra-territorial laws. And as seen, even in application of Article 7 the tribunal has a wide discretion in this regard.

However, even if the extra-territorial law of a third state is not applied, the tribunal will have to examine whether the performance of certain obligations under a contract is factually or legally not possible for a party due to such sanctions. If that is so, the party may rely on force majeure and the tribunal cannot order this particular performance.

However, it is not un-frequent in cases of commercial arbitration that either states themselves or state entities or state enterprises are parties to the dispute. In fact, in recent years, an average of about 10% of all ICC arbitrations involved such state parties. In such cases, sometimes the state party tries to rely on the sanctions of its own state to avoid performance of certain contractual obligations. This is a rather complicated issue which I have researched and dealt with in another publication. It raises a series of tests for the arbitral tribunal. Going into detail is not possible in this paper except that these or similar principles have been used by arbitral tribunals in many cases. In principle it can be said that tribunals have generally concluded that a state party cannot rely on laws or administrative acts of its own state to avoid performance of contractual obligations. This must also apply to economic sanctions.

(7) Beyond the above scenarios for the application of economic sanctions through the applicable law determined by the tribunal, frequently specific **contractual provisions** included by the parties in the contract which is disputed in the arbitration may become relevant and have to be respected by the tribunal.

When negotiating and concluding the contract, the parties may have known existing or expected new economic sanctions of some sort and included specific provisions in this regard. This may have been done by expressly including a list of what is to be recognized or not recognized as force majeure under the contract. Or specific provisions may expressly rule which of the parties has to bear which risk including the risk of interference by law or administrative acts. Such provisions may then expressly or by interpretation or implication include a reference to economic sanctions. I have recently had to chair an arbitration between oil companies and a state enterprise which provided a whole set of complex rulings in this regard.

However, as we know from arbitrations involving anti-trust provisions, the parties cannot contractually waive their right to rely on mandatory rules of the applicable law to the effect that the arbitral tribunal would be obliged to disregard such mandatory rules. Again, this would also have to apply to economic sanctions if they are to be applied according to the scenarios given above.

**III. INTERNATIONAL INVESTMENT ARBITRATION**

International investment arbitration typically has a foreign investor raising claims against the host state of its investment. Here, economic sanctions play a lesser role compared to commercial arbitration. However again, as an illustration of the complexity of the issues arising in relation to sanctions, reference may be made to two cases currently pending before the ECJ: Case T-315/01 *Yassin Abdullah Kadi v. Council of the European Union & Commission of the European Communities*, judgment of 21 September 2005, reported [2005] ECR II-3649; and Case Case C-415/05 (T-306/01) *Ahmed Ali Yusuf, Al Barakaat International Foundation v. Council of the European Union & Commission of the European Communities*, judgment 4 of 21 September 2005, reported [2005] ECR II-3533.

(a) **Treaty Arbitrations**

In investment arbitrations based solely on treaties of public international law such as the Energy Charter Treaty, or on regional treaties such as CAFTA or NAFTA, only mandatory economic sanctions provided in public international law such as of the UN Security Council have to be applied. But economic sanctions will seldom come into play in such cases, because the relief sought will mostly not include any obligations for which economic sanctions are relevant, but rather include claims regarding alleged expropriations or other measures of the host state allegedly in breach of a treaty.
Arbitrations under the ICSID Convention, however, are not pure treaty arbitrations. While the procedural law is indeed only the law of that treaty, the substantive law to be applied by the tribunal will be, as provided by Article 42.1 of the Convention, the law agreed by the parties, otherwise the law of the host state, and such rules of international law as may be applicable. Therefore, in so far as economic sanctions are either provided by mandatory rules of the host state or by public international law, they are to be applied in so far as they are relevant for the dispute.

Arbitrations under Rules of Non-governmental Institutions

In recent years, there is a growing trend to submit investment arbitrations not to traditional institutions for treaty arbitration, but to the rules of arbitration institutions which have been created and mostly used for commercial arbitration. This is not the place to go into detail why this is so. But, in addition to the considerable number of commercial arbitration cases in which state entities are parties as mentioned above, also investment cases are now more often submitted to the rules of international non-governmental institutions such as the ICC or the LCIA, or to national arbitration institutions such as that of the Stockholm Chamber of Commerce.

Such submissions are often provided as additional options either by multilateral treaties such as NAFTA or CAFTA, or by Bilateral Investment Treaties (BITs) between states, or by specific agreement between the host state or its state entity and the foreign investor.

In such scenarios, the applicable procedural law will be, in addition to the arbitration rules of the institution, the arbitration law at the seat of the arbitration. And the above mentioned scenarios for the application of economic sanctions may occur.

The applicable substantive law will also be determined in the same way as described above for commercial arbitration. This is particularly so if the submission is made in an arbitration based on an investment contract between a state entity and the foreign investor. If, however, the submission to this kind of arbitration is made in a treaty such as a BIT, the substantive provisions for the protection of foreign investment in the respective treaty are the primarily applicable substantive law. These will normally not contain any specific rules on economic sanctions.

IV. CONCLUSION

As can be seen, the determination of the law to be applied by arbitral tribunals with regard to economic sanctions is subject to a number of considerations and scenarios with some complexity.

Not all effects and results can easily be determined by the parties and their lawyers in advance in a contract or before a given dispute at hand. This is
particularly so in view of the options of interpretation of the applicable rules and
in view of the wide discretion arbitral tribunals have according to these rules. As a
rule of thumb, that discretion is smaller if the economic sanctions are provided in
the procedural or substantive law directly found to be applicable to the dispute at
hand. And the discretion is wider with regard to economic sanctions by third states
where Article 7 of the Rome Convention has to be applied.