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Economic Sanctions and Arbitration: Are We Ready?

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Economic Sanctions and Arbitration: Are We Ready?

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We live in a world today in which the foreign policy agenda of one country can insert itself at any moment into the business dealings of companies, persons, and governments across the globe. We are referring, of course, to the US government's increasingly frequent use of economic sanctions, export controls, and other trade restrictions as a tool of foreign policy ("US sanctions") and to the imposition of similar measures by other countries, often in response to US sanctions. Understanding, adjusting to, and minimizing the risks of these restrictions pose complex challenges for business persons, in-house and external counsel, compliance professionals, and other participants in international business transactions. While the compliance risks are difficult enough to navigate, US sanctions are not merely a compliance issue. Increasingly, US sanctions are giving rise to commercial disputes (many of which are subject to mandatory arbitration agreements) and even beginning to interfere with the smooth functioning of ongoing arbitration proceedings.

In this article, we explore some of the areas in which international commercial arbitration and US sanctions intersect. We begin, by way of background, with a brief overview of the scope and reach of US sanctions. Next, we discuss ways that parties can hedge against and/or mitigate the commercial and disputes risks to which US sanctions give rise (we do not address compliance risks arising from US sanctions—a topic that goes far beyond the scope of this article). We then discuss several ways in which US sanctions can interfere with the smooth functioning of an arbitration proceeding, before finally offering some concluding thoughts.

The Potential Scope and Reach of US Sanctions

US sanctions comprise a broad array of legal tools under related, but distinct, US laws that purport to authorize the President of the United States, as well as the US Congress, to impose restrictions on individuals, entities, and governments worldwide. Below we provide a very brief overview of the scope of these tools, as relevant to the intersection of international commercial arbitration and US sanctions.

"Primary" US sanctions impose direct restrictions on US persons (US businesses, citizens and lawful permanent residents, and anyone located in the United States) to engage in certain transactions (a) with individuals and entities placed on restricted lists (such as the Specially Designated Nationals or "SDN" List); (b) involving certain countries/territories, such as Cuba, Iran, North Korea, Syria, and the Crimea Region of Ukraine; or (c) involving

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specified governments, such as the government of Venezuela. The SDN List now includes thousands of entries and is one of several US lists that impose economic and trade restrictions. Of these various lists, the SDN List imposes the most severe restrictions. In addition, any entity that is, individually or in the aggregate, owned 50 percent or more by one or more entities on the SDN List is by operation of law considered to be an SDN.

Although "primary" sanctions, on their face, only impose direct legal restrictions on US persons, the US government takes a broad view of its jurisdiction to enforce these restrictions. In particular, the US government has sought and obtained civil and criminal penalties on many non-US persons (including non-US financial institutions, businesses, and individuals) by tying their actions to the "causing" of US persons to engage in sanctions violations. For example, the most common violation premised on this theory is the causing by a non-US bank of a US bank to process a transaction through a US branch where the transaction involves an SDN or sanctioned country. The result has been billions of dollars of penalties imposed on non-US banks. The US government has advanced a similar theory recently on the use by non-US parties of US-based IT resources, such as servers and service providers. For example, if a non-US person causes a US IT service provider to assist (even indirectly) an Iranian customer falling within the scope of US sanctions, the US government could take the position that the non-US party "caused" a violation of US sanctions and could seek penalties on that basis. The US government has also used other criminal theories, such as fraud, that have as their basis alleged misrepresentations made by non-US persons about their activities that implicate US sanctions.

Beyond "primary" sanctions, practitioners also generally refer to "secondary" or "extraterritorial" sanctions as those restrictions that the United States imposes on non-US individuals/entities not by imposing penalties but rather by threatening restrictions. For example, most US sanctions laws state that any person can be placed on the SDN List for materially assisting a person already on the SDN List. Thus, if the US government sanctions a non-US entity for acting against US foreign policy, other non-US persons that continue to engage in transactions with that entity could be placed on the SDN List. Beyond the general category of providing material assistance to an SDN entity, there are also a variety of specific behaviors, particularly but not exclusively involving Iran, that can trigger restrictions such as placement on the SDN List, loss of export license, restrictions on visas for senior executives, and others. (Examples of such specific behaviors include, without limitation: engaging in a significant transaction involving the Russian defense or intelligence sectors or facilitating a significant transaction or providing significant financial services for certain Iranian government entities or their agents, among many others.)

Finally, in addition to the US sanctions discussed above, the US government has also imposed restrictions under other kinds of laws, most notably export controls, that can have similar, significant impacts on business arrangements. For example, export controls can restrict supply chains and threaten criminal and civil penalties for reselling US-origin hardware, software, and technology (collectively, "items"), foreign-made items incorporating a specified percentage of US-origin items by value, or US technology-derived items, to the "wrong" customers—for example, entities listed on the "Entity List" administered by the US

Bureau of Industry and Security. The United States has also begun to impose certain import controls, primarily involving goods and services supplied by certain Chinese entities or entities operating in certain regions of China, that have had significant secondary impacts on the market.

The threat of penalties and restrictions from US sanctions—including for example loss of access to the US market, loss of access to US dollar accounts or connected financial services, and loss of key US export-controlled supplies—is so severe that it enables the US government to coerce compliance with US sanctions well outside the territorial jurisdiction of the United States. As a result, when entering into business arrangements, even parties with very few, if any, connections to the United States must consider whether and how the risks of existing and new US sanctions should be anticipated. This is especially so in regions and industries that carry a heightened risk of new sanctions (which, today, includes a large swath of the world that is the ongoing focus of US foreign policy and national security concerns, including China, Russia, Myanmar, the Middle East and Northern Africa, and parts of Latin America, and a diverse array of industries from technology to energy, aerospace, finance, and others).

Hedging against Future Commercial and Disputes Risks at the Contracting Stage

In entering into a commercial transaction with a counterparty, or in a region, with heightened sanctions risks, it is imperative to consider such risks not only from the perspective of compliance, but also from the perspective of anticipating, avoiding, and resolving related commercial disputes. A hypothetical scenario may best illustrate how to think about these risks.

A hypothetical Japanese company ("Company A") manufactures components that are used in consumer electronics products. Company A has a supply contract with Company B, which is a Chinese consumer electronics company. Under the contract, Company A has an obligation to supply a certain number of components to Company B each month and is potentially liable for damages in the event that it fails to meet the required supply.

Everything is going well in the relationship until suddenly one day, an *affiliate* of Company B is placed by the US Government on something called the "Entity List," for allegedly having participated in activities that are contrary to US national security interests. Under US law, it is a violation of export controls to export, re-export, or transfer, *inter alia,* certain US-origin technology-derived items to a company on the Entity List, without obtaining a special license from the US Department of Commerce.

When Company A's in-house counsel reads about this development in the newspaper, her first thought is: we have a *compliance* issue. The components we manufacture incorporate US-made chips. If we continue to supply our components to Company B, we might be accused by the US government of violating its export control laws or causing or aiding or abetting a violation.

As if that issue weren't thorny enough, the in-house counsel's next thought complicates matters further: if Company A stops performance under the contract, it could be accused by Company B of breach of contract, and potentially could be liable for significant damages. The in-house counsel rushes to pull up a copy of the relevant supply contract to see if it contains any applicable provisions that might excuse performance under

these circumstances. There is a force majeure clause, and an "illegality" clause, but nothing expressly mentioning sanctions or export controls.

If Company A has to prove that it would be "impossible" or "illegal" to perform the contract, would it be able to do so? The in-house counsel is concerned that there could be various obstacles. For example, does the US government have jurisdiction to prohibit a Japanese company from doing business with a Chinese company? Does US law even apply?

Another complexity is the fact that Company B itself was not placed on the Entity List. Only its affiliate was listed. There is a question as to whether selling to Company B could run afoul of the Entity List restrictions.

The Company A in-house counsel also notices that the supply contract is governed by Chinese law. China has recently enacted a "blocking statute" intended to prohibit companies from complying with unilateral sanctions measures imposed by other countries against a Chinese entity.[1)] If Company A refuses to perform the contract in order to comply with US law restrictions, will it be in breach of the Chinese blocking statute and potentially subject to liability under that law?

You can see that our hypothetical Company A is facing a minefield of compliance and commercial risks. In hindsight, there are certain steps that Company A could have taken at the time of contracting to avoid or mitigate some of those risks.

First, due diligence is essential. In the scenario above, ordinary "know your customer" due diligence may not have anticipated the US government's specific actions targeting Company B's affiliate. But in many cases, potential sanctions issues can be anticipated with proper diligence regarding the counterparty, its ownership chain, and the geopolitical context in which it operates. In our hypothetical, for example, diligence concerning recent US policy trends would have put Company A on notice that any business arrangement involving the supply of Company A items incorporating US-origin items to a Chinese company could face possible future US trade restrictions. Diligence thus allows savvy advisors to flag sanctions risks before contractual arrangements are finalized and to assist the parties in taking steps to properly evaluate and mitigate such potential future risks.

Second, parties can include in their contracts a "sanctions clause" wherever there is anticipated risk of US (or other) sanctions. This is now something that we recommend to many clients for their international transactions. A good sanctions clause would include, for example:

- Representations and warranties relating to compliance with specified sanctions and export controls regimes;
- Notice requirements in the event where either party becomes aware of actual or suspected violations of applicable sanctions laws; and
- A stipulation entitling either party to stop performance or terminate the contract without penalty in the event of certain triggering events in relation to actual primary sanctions violations or potential secondary sanctions risks (without tying such triggering events to a standard of "impossibility" or "illegality").

Third, another key mitigation strategy is to structure business arrangements that do or may

1) *See* Anti-foreign Sanctions Law of the People's Republic of China (effective 10 June 2021).

carry sanctions risk in a way that reduces the potential impact of a triggering event. For example, in the hypothetical scenario above, if the contract had a shorter term (with an option to renew at shorter intervals), even if ceasing performance were a "breach," the potential cost of that breach (in terms of a potential breach of contract liability) would be significantly lower than in the case of a long-term contract.

Without having taken one or more of the above mitigating steps at the contracting stage, a party in the position of our hypothetical Company A would need to consider other ways to mitigate its potential liability under the contract. One such way could be to seek from the US government (a) confirmation that continuing performance under the contract would not violate US sanctions (although such confirmation is extremely rare); and/or (b) a "license" to continue performance. In recent years, the practicality of both options (confirmation and license) has declined as the US government has only rarely provided either, and even in those rare cases has taken an inordinately long time (often more than one year) to do so. Another method would be to seek a ruling from an arbitral tribunal (assuming an arbitration agreement) that performance of its obligations under the supply contract is excused under a theory of force majeure, impossibility, or a related contract law doctrine. None of these options, however, are an adequate substitute for the preventative measures at the time of contracting discussed above.

The Impact of Sanctions on Arbitration Proceedings

It is also increasingly the case that imposition of US sanctions—on a party, its counsel, or even the arbitrators—can interfere with the smooth functioning of an arbitration proceeding in various ways.

Sanctions on a party. If one of the disputing parties is on, or subsequently added to, a sanctions or export controls list, various potential problems arise. For example:

- If there are any US parties, US banks, or US lawyers involved in the case, it may become necessary to seek and obtain a license from the US government before the arbitration can proceed as to those participants. This is because US parties may need permission to be involved in the dispute and/or be paid for their services, depending on the specific contours of the relevant sanctions if a sanctioned party is involved. (There are general licenses under various US sanctions programs that usually permit US lawyers to be involved in cases involving US law (including in arbitrations seated outside the United States), but the specific parties and subject matter must be checked against the applicable sanctions regulations because there are subtle differences among the various programs with respect to which legal services are generally authorized and which require specific authorization.)

- Providing confidential information to a sanctioned party, even in a written submission or as part of the disclosure process, arguably could violate the relevant sanctions or export controls regime, absent a license.

- At the stage when an award is issued, or a settlement reached, paying damages to, or even receiving a damages payment from the listed party could be a violation, absent a license. Moreover, when dealing with financial sanctions, any international bank transfer is

likely to be frozen and may take a long time to release. In a worst-case scenario, a payment that is not properly cleared with a bank ahead of time could be held for years before it is unblocked.

Sanctions on an arbitrator. What happens if one of the arbitrators becomes a target of US sanctions during an ongoing arbitration proceeding? Many in the arbitration community had not even considered such a possibility until a well-known international arbitrator, current Hong Kong Secretary for Justice Teresa Cheng, was sanctioned by the US government in August 2020 in relation to Hong Kong's implementation of national security legislation.[2] If such a sanction were imposed on an arbitrator sitting on a case, any US persons involved in the case might have to immediately withdraw because it is unlawful to receive services from a sanctioned person or to pay fees of any kind to that person. Even non-US participants would be unable to pay arbitrator fees to the arbitrator through US banks or using US dollars that would involve US banks.

Sanctions on counsel. What if one of the lawyers (or experts) in the case becomes a target of sanctions? If US sanctions are involved, the same issues of payments and services discussed above would arise. Sanctions imposed by other countries likewise have the potential to disrupt the arbitration process. The risk of counsel being targeted by sanctions was highlighted in March of 2021 when the PRC government issued sanctions against Essex Court Chambers in relation to a legal opinion issued by certain members of that chamber. In the immediate aftermath of the sanctions, several prominent arbitration practitioners left the Chambers.[3] The fallout from that episode is continuing to be felt across a range of cases.

Conclusion

As the foregoing demonstrates, US sanctions regimes (including export controls) have the potential to generate a wide variety of cross-border commercial disputes, many of which will be subject to arbitration. US sanctions—as well as unilateral or multilateral sanctions imposed by other countries—also have the potential to disrupt and interfere with ongoing arbitration proceedings in various ways. As the imposition of sanctions often comes without warning, it is particularly important for arbitration practitioners, corporate lawyers, and in-house counsel to be knowledgeable and prepared, and to take the necessary precautionary steps to mitigate commercial and disputes risks associated with such sanctions.

2) *See* U.S Department of Treasury, "Treasury Sanctions Individuals for Undermining Hong Kong's Autonomy," 7 August 2020, available at https://home.treasury.gov/news/press-releases/sm1088 (accessed 1 December 2021).

3) *See, e.g., "Leading arbitration silk leaves Essex Court Chambers for Brick Court,"* Global Legal Post, 19 April 2021, available at https://www.globallegalpost.com/news/leading-arbitration-silk-leaves-essex-court-chambers-for-brick-court-80738948 (accessed 1 December 2021).

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