

# The Expansive Tendency of Unilateral Economic Sanction: Impacts on International Commercial Arbitration and the Blueprint for Solution

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**Abstract.** The expansive tendency of unilateral economic sanction in the 21st century has fundamentally influenced the contractual relationship among private persons, and further continuously given rise to numerous commercial disputes referred to the arbitral tribunal to seek settlement, which poses multiple impacts on international commercial arbitration, including the choices of arbitral institution and the arbitral seat, the arbitrability of dispute, the settlement of substantive issue, and the recognition and enforcement of arbitral award, leaving a perplexing predicament for the arbitral tribunal that find itself trapped in the vague nature of economic sanction and the tough decision as to whether to apply the economic sanction. In consideration of such thorny task confronted by the arbitral tribunal concerning economic sanction, a blueprint for solution must be drawn incorporating a comprehensive review system on economic sanction entrenched on the compromising theory and enshrining a four-step approach, which is highly practicable through three progressive stages, from global initiative to widespread and consistent arbitral practice, and eventually to reach an international binding convention with the majority of States worldwide having become its State party.

**Keywords:** Unilateral Economic Sanction; Impact of Economic Sanction; International Commercial Arbitration; Compromising Theory; Four-step Approach.

## 1. Introduction: the Expansive Tendency of Unilateral Economic Sanction

Unilateral economic sanction has a long-standing root in the history of human civilization which can date back to 2500 years ago, when the Megarian Decree (circa BCE 432), by which Athens barred trade with Megara and denied the Megarians access to Athenian ports was issued as a diplomatic measure against the Megarians for having cultivated Athenian land and killing an Athenian herald [1]. At the early stage of the use of economic sanction, such action was only taken as a countermeasure by the injured State against the wrongful act committed by the Victimizing State. However, ever since the human civilization advanced to the era of globalization and industrial revolution in the late 15th century, unilateral economic sanction has gradually shifted from a defensive approach to a proactive one as weapon in modern warfare [2]. The progress of such tendency was further facilitated significantly after the World War II particularly. Nowadays, it is no surprise to say that the 21<sup>st</sup> century is highlighted with the unprecedentedly widespread existence of economic sanction, when the degree of geopolitical tension in numerous areas around the world remains extremely high.

Currently, unilateral economic sanction has been widely considered as a major player that not only undermines the international order among States well established under public international law, but also disrupts the international order of commercial transaction among private persons from different countries, which usually takes form of asset freezes, import tariffs, trade barriers, travel bans, and embargoes, etc [3]. In practice, the most typical representative of countries that favor and frequently resort to unilateral economic sanction is the US. It is estimated that around 26 countries and regions worldwide are currently covered by the US sanctions program, including many influential players in global economy like China, Russia, and Hong Kong [4], where enormous amount of cross-border commercial activities take place everyday. Specifically, the US implemented embargo on certain

goods and commodities, considerable increase of tariff targeting various countries and regions, and ban on trade with the sanctioned individuals or companies, etc [5].

All these arbitrary abuse of State power to implement unilateral economic sanction like the US has contributed to the context of the expansive tendency of unilateral economic sanction, under which

commercial activities between private persons fall under strict regulation, and the normal order of international commercial transaction is tremendously debased and destabilized, which can be revealed from the fact that international commercial contracts concluded between private persons in the sanctioning State, sanctioned State and third States are prohibited from being performed or even rendered null and void. When one party demands continued performance while the other refuses to perform on the ground of economic sanction, international commercial disputes can arise easily.

In cases that involve an arbitration clause in the contracts, the disputes would be referred to international commercial arbitration tribunals. And the arbitral tribunal is hence confronted with a series of intractable tasks to tackle: whether unilateral economic sanction shall apply? How should the arbitral tribunal identify unilateral economic sanction? Does unilateral economic sanction constitute a justifiable cause of non-performance of a contract by the parties, such as *force majeure* and hardship? How should the arbitral tribunal guarantee the recognition and enforcement of the arbitral award by dealing carefully with the applicability of economic sanction and the substantive issue?

What lies behind the dilemma encountered by arbitral tribunal is the essential conflict between private international which aims to safeguard the performance of commercial contract and public international law that empowers States to realize its foreign policy by virtue of economic sanction. Traditional legal theory tend to adopt a dichotomy approach, dividing the legal sectors into public law and private law. However, thesedays, with the fusion between public law and private law emerging constantly, the traditional boundary between public law and private law is being increasingly blurred [6], following which the issue regarding unilateral economic sanction under international commercial arbitration stands out.

Despite the legality of unilateral sanction under public international law remaining uncertain and controversial, which may probably takes a long pathway forward to settle [7], there is no doubt that under private international law, the international commercial arbitration is already suffering immense impediment from the expansive tendency of unilateral economic sanction giving rise to considerable amount of cross-border disputes. Moreover, unilateral economic sanction essentially as embodiment of mandatory rules and public order at domestic level is something, to which international commercial arbitration can never turn a blind eye, and the arbitral tribunal's disposal of such sanction-related cases inevitably fall into intricate quandary in which the arbitral tribunal will find itself trapped in the vague nature of economic sanction and the tough decision as to whether to apply the economic sanction. Therefore, a comprehensive blueprint for solution to arbitral tribunal in dealing with the sanction-related cases must be drawn to remedy the negative impacts imposed by the unilateral economic sanction.

Realizing the urgency of it, this article analyses the impacts of unilateral economic sanction on international commercial arbitration in various regards, encompassing *firstly*, the arbitrability of dispute; *secondly*, the settlement of substantive issue; and *thirdly*, the recognition and enforcement of arbitral award. Furthermore, the article puts forward a systematic and well-rounded blueprint for solution, namely a comprehensive review system enshrining a four-step approach, which is highly practicable through three progressive stages from global initiative to widespread and consistent arbitral practice, and eventually to reach an international binding convention with the majority of States having become its State parties.

## 2. Impacts Arising from the Economic Sanction upon International Commercial Arbitration

### 2.1 At the Pre-contractual Stage: the Choices of Arbitral Institution and Arbitral Seat

The selection of the arbitral institution and the location of the arbitration is critically important to both parties involved. Unless otherwise specified, the rules of the chosen arbitral institution and the laws governing the seat of arbitration will take precedence. For instance, in cases involving sanctioned Russian entities, a 2015 survey by the International Chamber of Commerce (“ICC”) and other institutions indicated that EU sanctions target only specific institutions and individuals, not preventing sanctioned parties from starting arbitration within EU institutions [8]. Additionally, this survey highlighted that EU arbitral institutions remain neutral and independent in disputes involving Russian entities [9]. Nevertheless, a 2022 survey by the Russian Arbitration Association (“RAA”) revealed that over 20% of Russian respondents had experienced refusals from EU arbitral institutions for arbitration administration or requests due to economic sanctions. Consequently, to circumvent the legal ramifications associated with the seat of arbitration's laws, Russian parties have recognized Asian arbitral institutions, such as the Singapore International Arbitration Centre (“SIAC”), the Hong Kong International Arbitration Centre (“HKIAC”), and ad hoc arbitration, as viable alternatives [10].

The aforementioned facts suggest that while arbitration is rooted in party autonomy and arbitral institutions are generally viewed as neutral and highly authoritative, the imposition of unilateral economic sanctions has potentially compromised their neutral, efficient, and independent image. Parties, particularly those from sanctioned countries, are increasingly opting for arbitral institutions in more neutral and friendly jurisdictions to mitigate the adverse effects of sanctions on their disputes.

### 2.2 At the Preliminary Stage: the Arbitrability of Dispute

Arbitrability indicates whether a dispute is “arbitrable”, i.e. capable of being settled by arbitration [11]. In cases concerning economic sanction, the question about arbitrability will be raised. Essentially, arbitrability is a statutory matter based on public policy which limits the scope of arbitration and further determines whether a specific dispute can be resolved by arbitration [12]. Thus, States have the power to formulate their own criteria of arbitrability as confirmed by the Convention on the Recognition and Enforcement of Foreign Arbitral Awards (“New York Convention”) and the UNCITRAL Model Law on International Commercial Arbitration (“UNCITRAL Model Law”) [13]. Such sole discretion of State is the core factor that leads to the obstruction for arbitral tribunal to arbitrate cases concerning economic sanction.

The mainstream opinions broadly support the arbitral tribunal to arbitrate cases concerning economic sanction on the ground that since disputes involving overriding mandatory provisions are arbitrable in general, disputes concerning economic sanction as a specific form of overriding mandatory provision are likewise arbitrable, such as the *La Compagnie National Air France v. Arab Airlines* case, where the French national airline, Air France, challenged the jurisdiction of the arbitral tribunal by arguing that the contractual obligations cannot be performed and the dispute was not arbitrable on the basis of the international embargo measures imposed by the United Nations Security Council against Libya [14]. Both the Superior Court of Montreal and the Quebec Court of Appeal held that the arbitrability issue shall be determined by the arbitral tribunal rather than the Court, since arbitration is a consequence of autonomy in arbitration agreement between both parties [15].

However, the existing practice of arbitral tribunals when dealing with these sanction-related cases, at times presents a conflicting conclusion regarding the arbitrability of dispute. In *Fincantieri-Cantieri Navali Italian Spa v. Ministry of Defense, Armament and Supply Directorate of Iraq*, after the Swiss Federal Court affirmed the jurisdiction of the arbitral tribunal over the case, the Italian party again requested to the Court of First Instance of Genoa to invalidate the arbitration clause [16]. The Genoa Court of First Instance held that the case was not arbitrable under the Italian legislation on trade embargo measures against Iran, and therefore the case shall subject the jurisdiction of Italian Courts [17].

In conclusion, it is manifest that State's attitude towards cases entailing economic sanction can vary significantly depending on their own national interests and political standpoint, and the arbitrability of dispute arising out of economic sanction becomes an issue at stake.

### 2.3 At the Pivotal Stage: the Settlement of Substantive Issue

When disputes emanating from economic sanction arise, triggering international commercial arbitration, arbitral tribunal's settlement of the substantive issue can be fairly difficult. Parties whose performance of the contract is hindered by economic sanction will be seeking to extricate themselves from obligations by claiming either *force majeure* or hardship, as economic sanction are normally considered cause for exemption whether under common law, civil law or private international law. Thus, the arbitral tribunal will have to assess the given economic sanction and further deal with its applicability which is a complicated matter due to the vague nature of economic sanction that has not been defined on a consensual basis within the existing jurisprudence.

Before determining the applicability of economic sanction, a preliminary issue about the nature of economic sanction must be addressed in advance, since the different natures of economic sanction will lead to various pathways for evaluating their applicability, and therefore results in disparate conclusions. Currently, there are three types of theories to understand the applicability of sanctions in a dispute, comprising:

*Firstly*, the datum theory that characterize economic sanction as pure facts that may have an impact on contractual relations. The datum theory is grounded on the "public law taboo" theory which points out the territorial nature of public law whose effects can not extend extraterritorially, and no State will accept and recognize the effects of law from other States [18]. The application of such theory will greatly promote the efficiency of arbitral tribunal in dealing with the merit of sanction-related cases, since it only needs to follow the traditional approach of evaluating the factual circumstances that can arguably constitute *force majeure* or hardship under common law, civil law or private international law, like war, terrorist attacks, a pandemic, a flood, earthquake and hurricane.

*Second of all*, there exists the legal norm theory giving effect to economic sanction applicable in all situations regardless of the law governing the underlying contract. The rationale behind the legal norm theory is the concept of the "overriding mandatory provisions" which refers to those purporting to respond to essential needs and therefore proclaim themselves applicable to all situations falling within its purview irrespective of the applicable law [19]. Economic sanction fits into the category of overriding mandatory provisions, since a distinctive feature of it is that it strives to prohibit the performance of all transactions falling within their scope, irrespective of the law governing these transactions [20]. When the arbitral tribunal adopts such theory, the legal nature of economic sanction is acknowledged and highlighted, but it also leads to an onerous task on the tribunal to examine whether the relevant requirements to constitute an "overriding mandatory provisions are" are satisfied.

*Lastly*, a compromising theory between the datum theory and the legal norm theory is drawn, according to which the economic sanction affecting the performance of a contract shall be taken into account as fact whereas those influencing the validity of a contract shall apply as law [21]. By way of example, Dr. Brunner characterized export or import restrictions, embargos, and other economic sanctions as "legal impediments," and then divided them into the following two types: (i) "directly applicable rules" that "may cause the invalidity of the contract in whole or in part," and (ii) "a factual element" which justifies "an exemption for non-performance" [22]. Following such dichotomy theory, the arbitral tribunal obtains more flexibility in handling the merits of sanction-related cases, while retaining the benefits arising from both of the datum theory and legal norm theory.

Applying various theories to define the nature of the given economic sanction leads to different conclusion concerning the applicability of the sanction, and further has a fundamental bearing on the arbitral tribunal's resolution of the substantive dispute about whether the economic sanction constitute ground to justify the non-performance of the defaulting party. In brief, the involvement of economic sanction in arbitral cases traps the arbitral tribunal in a predicament in which no pathway

leading to correct direction has ever been trodden, and therefore imposes a burdensome and tough task on the tribunal to decide and handle the merits of these cases.

## **2.4 At the Final Stage: the Recognition and Enforcement of Arbitral Award**

It is a widely recognized principle that a State holds the authority to reject the enforcement of an arbitral award within its jurisdiction based on public policy considerations [23]. The New York Convention's drafting history suggests that if the enforcement of an arbitral award significantly contradicts the core values or interests of the State, the domestic Court is granted extensive discretion to refuse the recognition and enforcement of such awards [24]. Consequently, in sanction-related cases, the existence of unilateral economic sanctions as a form of public policy from the sanctioning State creates a high risk that the Court where enforcement is sought may use its discretion, rooted in its domestic public policy, to deny recognition and enforcement of the award.

To curb the broad discretion of States based on domestic public policy, which might adversely affect the recognition and enforcement of sanction-related awards, it is commonly accepted that public policy should be narrowly defined as an exception. In 2002, the International Law Association released the Final Report on Public Policy as a Bar to Enforcement of International Arbitral Awards ("**Final Report**"), which points out that, despite the difficulty in clearly separating domestic public policy from international public policy, there are generally accepted standards for refusing recognition and enforcement of an arbitral award. These standards fall under transnational public policy, which includes: (i) fundamental principles of the State, such as those of justice and morality that the State aims to protect, even if not directly relevant; (ii) "directly applicable rules" or "rules of public policy" serving the fundamental political, social, and economic interests of the State; and (iii) obligations the State owes to other States or international organizations [25].

Numerous States have adopted the concept of transnational public policy to facilitate the recognition and enforcement of arbitral awards, which is more restrictive than domestic public policy. For instance, in *Sofregaz v. Iranian Natural Gas Storage Company*, the Paris Court of Appeal dealt with the effects of UN, EU, and US economic sanctions against Iran. The Court validated the legitimacy of the UN and EU sanctions based on their alignment with transnational public policy but dismissed the application of US sanctions due to a lack of international consensus [26].

The adoption of transnational public policy is still progressing towards broader international agreement, which is a gradual process. However, sanctioning States and their political allies are likely to continue exercising broad discretion based on domestic public policy to deny the recognition and enforcement of sanction-related awards. This creates substantial barriers for parties seeking to finalize the international commercial arbitration process.

## **3. The Blueprint for Solution: a Comprehensive Review System Enshrining a Four-step Approach Rooted in the Compromising Theory Implemented through three Progressive Stages**

### **3.1 Theoretical Basis for the Review System: the Compromising Theory**

As discussed above, the compromising theory characterizes economic sanction into fact or law pursuant to whether the sanction only bears on the performance of the contractual obligations or further affects the validity of the underlying contract. The mode of consideration behind the compromising theory adopts a typical private international law mindset, whose application is based on the link between the sanctioning State and the contract. For example, in the view of the compromising theory, in the first place, only the economic sanction adopted by the State of governing law shall apply, while in the second place, for the economic sanctions implemented by other States to apply, despite their direct impediment obstructing the performance of the contract in question, there must exist a sufficiently close link between the sanctioning State and the contract in question [27].

In contrast to the datum theory and legal norm theory, the compromising theory has greater advantage serving as the theoretical basis for a systematic solution to address the nature and applicability of economic sanction in those sanction-related cases. *First of all*, the datum theory is too arbitrary by defining all economic sanctions as pure facts. Despite datum theory's benefit in circumventing the difficulty in deciding on the legal applicability of economic sanction, it fundamentally disregards the salient public law nature of economic sanction as an overriding mandatory provision. *Secondly*, with respect to the legal norm theory, although it highlights the "overriding mandatory provision" nature of economic sanction by identifying all of them as law, it not only inflicts an extremely burdensome task on the arbitral tribunals to scrutinize the legal and factual circumstances relating to all economic sanctions, but also potentially leads to a conflict of law issue by giving effect to multiple laws of economic sanction from States involved. Relatively speaking, the compromising theory can combine the strengths of the both while evading their drawbacks to the largest extent.

By applying the compromising theory, the arbitral tribunal is able to adopt a case-by-case approach in analyzing whether the economic sanction affects the performance of contract only or further influences the validity of the underlying contract, so as to distinguish the economic sanction as fact or law.

### **3.2 Core Pillar in the Review System: the Four-step Approach**

#### **3.2.1 The first step: determining the States whose economic sanction shall be taken into account**

In light of the immense flexibility of international commercial transaction that confers full-extent discretion on both parties to select the seat of arbitration, the governing law of the contract, the place of performance, etc, the most complicated sanction-related case in practice can be envisaged, which involves four different States in the course of arbitral proceedings, covering the State of arbitral seat, the State of governing law, the State where the contract is performed, and the parent States of both parties. Any economic sanction implemented by the four States above will have substantial impact on either the validity of underlying contract or the performance of contractual obligations.

Regarding the economic sanction from the State of arbitral seat, the prevailing perspective about the legal consequences emanating from the choice of arbitral seat emphasizes the territoriality and judicial nature of arbitration, asserting that the power of the arbitral tribunal and the legal effect of the arbitral award are regulated by the legal system of the State of arbitration, and subject to the supervision and control of the judicial organs of the State of arbitration [28]. The mandatory provision and public policy as the most fundamental and crucial part of the legal system of the State of arbitral seat plays a vital role in the arbitral proceedings conducted by the arbitral tribunal. And the economic sanction implemented by the State of arbitral seat as which falls under mandatory provision and public policy shall not be disregarded by the arbitral tribunal, leading to the Court's annulment of arbitral award subsequently otherwise. Such argument can also find support by analogy with the previous Court's cases.

In *Regina v. HM Treasury and Bank of England*, the EU Court rejects the applicability of UK's economic sanction which prohibited a bank from transferring money, despite UK law as the governing law of the underlying contract, on the basis that the place of forum is the EU, and the UK's economic sanction was too strict and inconsistent with the EU's economic sanction law [29]. Notwithstanding the difference between the arbitral seat and the place of forum, both concepts share a common nature, and therefore the Court's case is likewise of great referential to the arbitral tribunal.

Concerning the economic sanction from the State of governing law, under the doctrine of party autonomy, the governing law chosen by parties upon mutual consent will apply to the entire underlying contract. If the State of governing law enacts an act of economic sanction pertaining to the subject matter of the contract, the validity of contract may be potentially debased. In *Government & Ministries of the Republic of Iraq v. Armamenti e Aerospazio SpA et al.*, the Supreme Court of Cassation of Italy nullified the underlying contract governed by the French law, in accordance with

the EU economic sanction contained in the Regulation (EEC) 2340/1990 and Regulation (EEC) 3155/1990, since the EU sanctions form part of the governing French law [30].

Respecting the economic sanction from State where the contract is performed or the parent States of parties, when an economic sanction is implemented by these States, impediment will be created to obstruct the performance of contractual obligations. As in *Mamancochet Mining Limited v Aegis Managing Agency Limited*, the defendants as a group of UK insurers ultimately owned or controlled by US persons refused to pay an insurance claim in accordance with President Trump's announcement in 2018, that the US was reimposing secondary sanctions with respect to Iran, leading to a commercial dispute that was referred to the English High Court [31].

In summary, founded on the compromising theory, in a realistic and most complicated sanction-related case, there are only four States whose economic sanction shall be taken into consideration, namely the State of arbitral seat, the State of governing law, the State where the contract is performed, and the parent States of both parties. After nailing down the range of States whose economic sanction shall be taken into account, the arbitral tribunal has completed the first step, based on which it can conduct further analysis on the nature of the economic sanction in question.

### **3.2.2 The second step: characterizing economic sanction into fact or law by analyzing their consequences**

After the first step is settled, the arbitral tribunals shall turn to the step of distinguishing the nature of the sanction and characterize them into law or fact, by analyzing their legal consequences that affects the performance of the contract only or further affects the validity of the underlying contract. The significance of the characterizing step is to set a foundation for the subsequent evaluation of the economic sanction for the arbitral tribunal, since different characterization can lead to disparate pathway for consideration. Analyzing the legal consequences of the given economic sanction on contractual relationship can be quite complicated, since under the most intricate circumstance which involves the economic sanctions imposed by four different States respectively, namely the State of arbitral seat, the State of governing law, the State where the contract is performed, and the parent States of both parties, all sanctions can either affect the performance of contractual obligations only or further affect the validity of contract, and further fall within either fact or law under the compromising theory. Therefore, a case-by-case analysis must be conducted by the tribunal to draw a conclusion on the nature of economic sanction in question.

Despite the intricacy of the characterizing step, the arbitral tribunal may seek help from the existing jurisprudence. Instances of economic sanction that characterize as law can be found in the previous cases. In *Beverly Overseas SA v. Aleman et al/Privredna Banka Zagreb*, the Court ruled on the invalidity of a contract on basis of the resolution 713 of 25.09.1991 of the U.N. Security Council regarding the embargo of the supply of arms in the territory of ex-Yugoslavia which characterize as law and therefore nullify the contract in question [32].

As for those economic sanctions that categorize as facts, precedents can also provide precious guidance for the arbitral tribunal in figuring it out In *LLC Eurochem North-West-2 -v- Societe Generale SA & others*, the performance of monetary obligation by a group of European banks was hindered by the EU economic sanctions that prohibit the making funds available to or for the benefit of sanctioned Russian banks, and the European banks are concerned about the high risk of breaching the EU economic sanction, and decided not to transfer the payment of €12 million, in which the Court took account of the economic sanction as a fact while handling the merit of the case [33]. Similarly, in *Bright Shipping Limited v Changhong Group (HK) Limited*, the defendant failed to pay costs ordered by the court, citing the risk of US secondary sanctions due to indirect ties with sanctioned Iranian entities, and the Hong Kong Court treated the US secondary sanction a fact in assessing whether the defendant's claim is reasonable [34].

The paramount importance to line out the distinction between the economic sanctions that characterize as law and those considered as facts is to set a solid foundation that leads to two different pathway for further evaluation which will conclusively decides whether the defaulting party's liabilities can be discharged under the comprehensive review system.

### **3.2.3 The third step: identifying whether the given economic sanction constitutes overriding mandatory provision from a domestic perspective**

Regarding economic sanctions that characterize as facts, there is nothing special between them and those normal events that may cause impediment to the performance of contract, such as war, terrorist attacks, pandemic, flood, earthquake, or hurricane. Therefore, the arbitral tribunal only needs to follow the traditional track to evaluate whether the economic sanction in question as a fact satisfy the relevant requirements of *force majeure* or hardship to conclusively decide whether the non-performing party shall be liable for their default. While the most knotty task to tackle lies in those economic sanctions of legal nature. In considering whether the given economic sanction of legal nature justify the non-performance of the defaulting party, the concept of overriding mandatory provision can serve as a good standard to assess whether the specific sanction possesses primary legitimacy at domestic level.

Article 9 of the Regulation (EC) No 593/2008 of the European Parliament and of the Council of 17 June 2008 on the law applicable to contractual obligations (“**Rome I Regulation**”), provides a strict and all-encompassing definition of overriding mandatory provisions. According to this article, these provisions are crucial for a country to safeguard its public interests, including its political, social, or economic systems. Therefore, they apply to any situation within their reach, regardless of the law that would normally govern the contract under the Regulation [35]. To be classified as a mandatory provision under Article 9, two criteria must be met: firstly, under domestic law, such a provision cannot be waived by any agreement; and secondly, in the realm of conflict of laws, the provision is directly enforced regardless of the contract's chosen applicable law.

When determining whether a provision is overriding and mandatory, its nature and purpose, along with the implications of its enforcement or lack thereof, must be considered [36]. Existing instances of overriding mandatory provisions include public law regulations like antitrust laws and import/export restrictions, as well as private law rules that protect weaker parties in contracts, such as those related to consumer and employment law [37]. Although the Rome I Regulation is confined to judicial proceedings and does not apply to arbitration, its detailed discussion on overriding mandatory provisions serves as a significant point of reference for arbitral tribunals in understanding and defining such provisions.

The rationale behind the insertion of “overriding mandatory provision” criterion into the review system is to primarily set a firewall at domestic level against those arbitrary and groundless unilateral economic sanctions implemented by States at their sole discretion, and further limit their destructive legal consequences to the cross-border contractual relations under private international law. Only when the economic sanction of a State is so crucial to safeguard its public interests, without which the State’s essential interests will suffer devastating consequences, may the economic sanction go under further consideration to decide whether it is able to inflict implication on the realm of private international law, and further affects the commercial activities of private persons at an international level. If the economic sanction fails to constitute an “overriding mandatory provision”, it fails to obtain any legal effects at the primary stage of review from a domestic perspective, and the defaulting party’s claim to justify its non-performance by invoking unilateral economic sanction in the course of arbitral proceedings must be dismissed.

### **3.2.4 The fourth step: ascertaining whether the given economic sanction falls within the scope of transnational public policy from an international perspective**

Even if the economic sanction qualifies as an overriding mandatory provision, it only indicates that the sanction is crucial in protecting the public interests of the State and passes the initial stage of domestic review. However, this alone does not legitimize the sanction’s impact on international commercial activities involving private individuals. For instance, on 6 August 2014, Russia imposed a one-year embargo on the import of most agricultural products from countries that had either implemented economic sanctions against Russia or supported such measures [38]. This included the United States, the European Union, Norway, Canada, and Australia. The Russian economic sanction

might be seen as an overriding mandatory provision based on the criteria mentioned earlier. The sanction, as a countermeasure to those from Western countries, aims to pressure them into lifting their sanctions on Russia. This can arguably be viewed as protecting Russia's social and economic interests, thus constituting an overriding mandatory provision.

However, from an international standpoint, it is clear that the arbitrary enforcement of Russian sanctions on commercial contracts or transactions involving private parties cannot be justified under international law, despite claims of protecting essential public interests. Given the numerous cases of unilateral economic sanctions similar to the Russian example, all purporting to protect domestic public interests, there is an urgent need for a new review mechanism from an international perspective. This mechanism would serve as a final safeguard against the arbitrary use of unilateral economic sanctions by states claiming to protect their essential public interests. The concept of transnational public policy could provide the foundational support for establishing such a review mechanism.

Transnational public policy does not reflect the public policy of any specific State, but rather encompasses values and morals that are universally or widely accepted beyond State borders [39]. More importantly, this concept is continually evolving, adapting, and developing alongside the progression of international trade, exhibiting a strong degree of adaptability and sustainability [40]. Examples of transnational public policies include the prohibition of corruption, smuggling, drug trafficking, and the export of cultural heritage items [41]. Procedural principles like fair hearing and due process are also considered part of these shared moral values [42].

When an arbitral tribunal faces an economic sanction issue and reaches the fourth step of evaluating the sanction within the review system, the application-worthiness test becomes crucial. This test examines the financial or socio-economic objectives and the underlying policies of the public policy in question. It involves three key considerations [43]: *firstly*, the shared values test, which determines if the protected value is fundamental and aligns with the principles of transnational public policy; *secondly*, the rule's broad applicability, indicating that the rule is genuinely transnational and widely accepted, thus supporting its application-worthiness; *and thirdly*, evaluating whether the outcome of applying such public policy is appropriate in the given context.

Specifically, the shared value test, as the first component of the application-worthiness test, involves evaluating the underlying purposes and objectives of the economic sanction or other mandatory rule. Public international law provides an excellent framework for this purpose, offering tools to avoid arbitrators relying solely on personal moral judgment [44]. The supranational nature of transnational public policy necessitates it being grounded in the collective opinion of nations. Since public international law significantly shapes these collective opinions, it should be given substantial weight in this assessment. Widely accepted treaties and conventions can serve as a robust foundation for evaluating the acceptability of certain public policies.

The second component involves determining when a rule is sufficiently universally accepted to qualify as transnational public policy. This wide acceptance is essential and can be evidenced by widely ratified treaties or legislative measures adopted by numerous States [45]. Ultimately, applying transnational public policy rules should lead to outcomes that genuinely protect the interests they aim to safeguard. For instance, if enforcing an economic sanction as a transnational public policy rule poses a disproportionate risk of penal or financial sanctions, such as loss of export licenses, its application would not be appropriate [46].

When an economic sanction passes the application-worthiness test and qualifies as transnational public policy, it significantly impacts the contract's validity, rendering it null or void. This discharges both parties' obligations and restores any performed obligations to their original state. Conversely, if an arbitral tribunal finds that an economic sanction, despite being an overriding mandatory provision, does not constitute transnational public policy, it will not enforce the sanction. Consequently, the defaulting party cannot justify its non-performance of contractual obligations based on the invoked economic sanction.

### **3.3 Guarantee for the Implementation of the Review System: the Three Progressive Stages**

#### **3.3.1 The first stage: global initiative bearing the review system issued by the UNCITRAL from a soft law perspective**

In view of the impossibility to formulate an international convention enforcing the review system at the initial stage, a global initiative of soft law nature can be a pragmatic start point for the comprehensive review system upon economic sanction expounded above to come into existence alternatively. Although soft law are not legally binding, it may lead to binding treaty or customary international law [47], indicating its significant status and paramount importance in promoting international consensus on a particular issue and further forming binding convention relating to the subject matter.

Under the existing legal framework of private international law, the most representative and authoritative international organization which is most appropriate to undertake such task to issue an initiative of soft law nature is the United Nations Commission on International Trade Law (“UNCITRAL”). The UNCITRAL, as a subsidiary organ of the United Nations in the field of international trade law, with the purpose of promoting the harmonization and unification of international trade law, currently has 70 member States which are broadly representative of geographic regions and economic as well as legal systems, including 14 African States, 14 Asian States, 8 Eastern European States, 10 Latin American and Caribbean States and 14 Western European and other States [48]. Under the UNCITRAL, there exists a Working Group on Dispute Resolution (“Working Group II”) that is committed to researching and resolving the latest hotspot and difficult issues in the field of international commercial dispute settlement encompassing the international commercial arbitration [49], which is able to undertake the substantive work on the establishment of such comprehensive review system illuminated above.

In terms of the concrete legislative approach, the UNCITRAL has adopted a flexible and effective approach to the modernization and harmonization of international trade law, comprising three main types of approach [50]: *firstly*, the legislative approach; *secondly*, contractual approach; and *thirdly*, the explanatory approach. And it is suggested that such global initiative takes form as a Model law falling under the legislative approach, which refers to a legislative text that is recommended to States for enactment as part of their national law [51]. Under such approach, the Working Group II can formulate a comprehensive legislative text which follows the description of the review system upon economic sanction laid out above through the procedure of working group session first by formally adopting a report for submission to the annual session of the UNCITRAL. Then the member States of the UNCITRAL will decide whether to finalize and adopt the draft text by consensus in the first place, and voting in the second place. Even if the legislative approach of formulating a model law cannot be accomplished, the UNCITRAL can still resort to the explanatory approach by formulating a practice guide prepared for the use of judges and legal practitioners, like the UNCITRAL Model Law on Cross-Border Insolvency: the judicial perspective, developed in conjunction with judges and other insolvency experts to provide information and assistance to judges with respect to questions arising under the Model Law on Cross-Border Insolvency [52].

To put it all into a nutshell, it can be found that the UNCITRAL’ issuance of such global initiative that bears the review system not only has a practical and tangible pathway to achieve within its own operation system which comports with its function, but also best serve the aim of formulating such soft law which is to pave way for the establishment of a binding convention in the future by raising international consensus among States in advance.

#### **3.3.2 The second stage: widespread practice of arbitral tribunals following the review system contained in the initiative from the perspective of arbitral practice**

Following the global initiative issued by UNCITRAL, which involves a comprehensive review system, arbitral tribunals across the globe can utilize the recommended guidelines and solutions for adjudicating various sanction-related cases. Although this initiative is classified as soft law, meaning it encompasses norms not enforceable by public force [53], tribunals have the discretion to apply it

as they see fit. Numerous major institutional arbitration rules grant arbitral tribunals extensive discretion concerning procedural matters.

For example, Article 25(1) of the ICC Rules mandates that “the arbitral tribunal shall proceed within as short a time as possible to establish the facts of the case by all appropriate means” [54]. Similarly, Article 14(2) of the London Court of International Arbitration (“LCIA”) Rules states that “unless otherwise agreed by the parties under Article 14.1, the Arbitral Tribunal shall have the widest discretion to discharge its duties allowed under such law(s) or rules of law as the Arbitral Tribunal may determine to be applicable” [55]. Additionally, Article 17(1) of the UNCITRAL Rules, Article 16(1) of the American Arbitration Association (“AAA”) Rules, and Article 17(1) of the Australian Centre for International Commercial Arbitration (“ACICA”) Rules all contain provisions that allow the arbitral tribunal to conduct the arbitration in a manner it deems appropriate, subject to the applicable rules [56].

With the establishment of widespread arbitral practice to follow the UNCITRAL’s initiative that bears the review system, the initiative will become more and more influential in the arena of international commercial arbitration, and obtains increasing legal effects, which paves way for the review system to be enshrined in an international convention at the final stage, thereby giving mandatory effect to the review system of soft law nature.

### **3.3.3 The final stage: establishment of an international convention enforcing the review system from a hard law perspective**

The ultimate goal and the ideal scenario will be the establishment of an international convention enshrining the comprehensive review system illuminated above, with a vast majority of States having become its State parties, and thus converting the review system from a soft law that lacks bindingness into a hard law that is enforceable, as only when the review system acquires a hard law nature and is able to impose obligations on States to obey, will the existing problems incurred by economic sanction upon international commercial arbitration be eliminated profoundly.

Perhaps the most salient issue emanating from the review system’s lack of binding effect is the recognition and enforcement of arbitral awards, even though the initiative formulated by the UNCITRAL can be followed by numerous arbitral tribunals contributing to widespread arbitral practice, the State nonetheless enjoys the supreme power to refuse the recognition and enforcement of the award at its sole discretion on the ground of public policy, especially for these sanction-related awards, based on the State exclusive judicial sovereignty over its own territory.

The only way to restrain the State’s unlimited discretion and even abuse of public policy and restore the negatively impacted circumstance of international commercial arbitration suffering from economic sanction is to establish an international convention that enforces the review system and obliges all State parties to comply. The principle *pacta sunt servanda* as a fundamental principle of public international also regarded as customary international law has imposed an obligation on all States to abide by what they have acceded to, the violation of which gives rise to an internationally wrongful act of State that further entails State responsibility [57].

What’s more, the UNCITRAL can again takes the leading role in pushing and achieving such sinking task to formulate a convention concerning the economic sanction by convening a diplomatic conference, and States subsequently are able to formally deposit a binding instrument of ratification or accession with the depositary to become a State party to the convention.

When the stage of establishing an international convention concerning the review system upon economic sanction is finalized, all those impacts stemming from unilateral economic sanctions implemented by States will vanish automatically, and the normal order of cross-border commercial activities will revert to the original state where the legal relationships among private persons is protected from the unilateral acts of States that bear a strong public law character.

## 4. Conclusion

This paper has examined the expansive tendency of unilateral economic sanctions and their profound implications on international commercial arbitration. It has navigated through the historical context and evolution of economic sanctions, dissected their legal frameworks, and scrutinized their multifaceted impacts on arbitration processes. From the distortion of arbitral neutrality to the erosion of parties' rights, unilateral sanctions pose significant challenges that undermine the efficacy and fairness of international commercial arbitration.

The preceding analysis reveals a clear trajectory: unilateral economic sanctions have proliferated as tools of foreign policy, often wielded without adequate regard for their broader legal and economic repercussions. This unchecked expansion has led to a series of adverse effects on arbitration, including jurisdictional conflicts, enforcement hurdles, and the politicization of arbitral proceedings. Moreover, the paper highlights the inadequacies in existing legal instruments and arbitral rules to effectively counterbalance these challenges, underscoring the necessity for comprehensive reform.

Looking forward, the paper proposes a forward-thinking blueprint to mitigate the adverse effects of unilateral economic sanctions on international arbitration. This blueprint advocates for the adoption of harmonized legal standards, the strengthening of arbitral institutions' autonomy, and the promotion of diplomatic dialogues to foster cooperative dispute resolution mechanisms. It emphasizes the need for a multilateral approach, where states, international organizations, and arbitration bodies collaborate to establish a robust framework that safeguards the integrity and impartiality of arbitration.

The expansive reach of unilateral economic sanctions is a testament to the interconnectedness of global commerce and politics. As such, the international community must rise to the challenge, ensuring that arbitration remains a viable and impartial means of resolving cross-border commercial disputes. By embracing the proposed reforms, stakeholders can fortify the arbitration system against the destabilizing effects of sanctions, preserving its role as a cornerstone of international trade and investment.

In conclusion, while unilateral economic sanctions present formidable obstacles, they also offer an impetus for innovation and reform within the realm of international commercial arbitration. The path forward lies in concerted efforts to balance state sovereignty with the principles of fairness and justice, fostering an arbitration environment that is resilient, equitable, and conducive to global economic stability. Through such endeavors, the international arbitration community can navigate the complexities of unilateral sanctions, ensuring that arbitration continues to serve as a beacon of dispute resolution in an increasingly tumultuous world.

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