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How Can U.S. Secondary Sanctions as Foreign Overriding Mandatory Rules Intervene in Arbitration Disputes Arising from the Ukraine-Russia Conflict?

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Designed by the United States ("U.S.") government to enhance the success of its primary sanctions programs, secondary sanctions are intended to prevent, on a global basis, third parties from trading with countries that are subject to sanctions. In a dispute involving the transfer of U.S. dollars between two non-U.S. persons located outside U.S. jurisdiction, these U.S. secondary sanctions can be applied to the substance of arbitration proceedings even if the applicable law—be it the law selected by the parties, the law of the place of the arbitration, the law of the place of contractual performance, or the law of the place of enforcement—does not prescribe the application of U.S. laws.

Therefore, individuals and businesses dealing with the Ukraine/Russia conflict, or generally any other sanctions programs such as Iran and North Korea, must be aware of the implications of U.S. secondary sanctions on the outcome of their proceedings, given the U.S. view that those laws are mandatory rules. This post will review this U.S. view by examining the role of U.S. financial system in enforcing economic sanctions regulations in order to offer a number of tips for arbitrators dealing with sanctioned persons.

A Hypothetical Arbitration Scenario Involving a Sanctioned Person

Let's imagine a claimant, Russian company, that has entered into a contract governed by Swiss law in which it undertook to sell certain products to Respondent, a French company. The cause of the arbitration, seated in Singapore, is Respondent's refusal to pay Claimant's invoices on the basis of sanctions imposed against Russia by the U.S. Claimant argues that the Respondent has no business operations in the U.S., and does not hold a bank account in U.S. banks, and thus has no reason to invoke U.S. sanctions as a ground to refuse its payments. Respondent contends that its U.S. dollar account in China with a Chinese bank was determined to be the only payment method, and the transfer of U.S. dollars from this account to Russia will violate U.S. sanctions. The arbitrator, a U.S. national, strives to answer the following questions:

- Can U.S. sanctions be applied to this arbitration dispute despite the fact that U.S. law is not selected to be a part of the governing rules?
- Can the transfer of funds from a non-U.S. bank outside U.S. jurisdiction constitute a U.S. sanctions violation?

Understanding U.S. Secondary Sanctions within U.S. Financial System

The answer to the above questions is positive. U.S. secondary sanctions regimes, which target non-U.S. natural and legal persons acting outside U.S. jurisdiction, are unique and incomparable to other countries' economic sanctions programs; not all countries are willing to impose secondary sanctions due to the problem of extraterritoriality, nor do they have appropriate enforcement mechanisms to guarantee the success of their secondary sanctions programs. In the case of the U.S., however, the critical role of the dollar in global commerce has enabled the U.S. government to monitor and detect transactions denominated in the U.S. dollar. This monitoring system mainly includes the Federal Reserve's system (Fedwire Funds Service) and the Clearing House Interbank Payment System (CHIPS), two key payment systems that process domestic and international fund transfers in the U.S. financial market. The financial institutions and banks operating inside or outside U.S. jurisdiction that use Fedwire or CHIPS are exposed to the U.S. federal laws and the laws of the State of New York because a U.S. party (a bank or financial institution) operating under these laws is ultimately engaged in the dollar clearing process.

A prominent case demonstrating that the U.S. regards its secondary sanctions as mandatory rules by virtue of the dollar is the settlement agreement between the Office of Foreign Assets Control (OFAC) and the British Arab Commercial Bank (BACB). In this case, the BACB transferred U.S. dollars to a sanctioned client. However, the dollar transaction did not directly involve a U.S. bank. Rather, the BACB's dollar source was a non-U.S. financial institution whose source of the U.S. dollar inflows was two other non-U.S. financial institutions, which ultimately received their dollars through correspondent accounts with U.S. banks. This indirect transfer of funds from a U.S. bank's correspondent account established a nexus to U.S. jurisdiction, which enabled OFAC to investigate and enforce U.S. secondary sanctions. The significant role of correspondent accounts in detecting sanctions violations and establishing a jurisdictional nexus has been seen in other OFAC settlement agreements, such as the Union de Banques Arabes et Françaises (UBAF), BNP Paribas, TransTel, Lloyds Bank, Tokyo-Mitsubishi Bank, and First Bank SA of Romania, to name a few examples.

The Legal Grounds: The Exportation of Services and Facilitation of Significant Transactions

The relevant question to be answered here is, "which sections of U.S. secondary sanctions give such a vast authority to OFAC to impose sanctions through correspondent accounts?" The U.S. sanctions programs are divided into "secondary comprehensive sanctions" and "secondary smart sanctions." In secondary comprehensive sanctions, which are a combination of both secondary and comprehensive sanctions, non-U.S. persons outside U.S. jurisdiction are forbidden from conducting almost all sorts of financial relations with a sanctioned country and its citizens. If certain countries, including Syria, North Korea, Iran, Cuba, and Ukraine/Russia, are involved, non-U.S. persons must refrain from "exportation of services" from the U.S. to those countries and individuals and businesses thereof without obtaining a license from OFAC. In *United States vs. Banki* and *United States vs. Zarrab*, the courts clarified that whether or not they are performed for a fee, the exportation of services from the U.S. occurs, *inter alia*, when a non-U.S. person completes dollar-denominated transfers to a sanctioned person either directly from a U.S. bank or indirectly through foreign banks' correspondent accounts connected ultimately to U.S. banks. According to *Zarrab*, this connection provides a sufficient domestic nexus between non-U.S. persons and U.S. jurisdiction. The implication of "exportation of services" argument on arbitration is that any transfer of dollars from the sanctioned party to, e.g., an arbitration institution, arbitrator, counsel, or award-winning party, through correspondent accounts ultimately connected

to the U.S. financial system can violate U.S. secondary sanctions unless a license has been issued by the OFAC or such a transaction is excluded from the scope of the sanctions program.

In secondary smart sanctions, which are a combination of secondary and smart sanctions, non-U.S. persons outside the U.S. jurisdiction are prohibited from conducting certain financial relations with certain individuals, businesses, and entities targeted by U.S. secondary sanctions. In five prominent sanctions programs, including Hizballah, Hong Kong, North Korea, Iran, and Ukraine/Russia-related sanctions, the phrase "facilitation/conduct of significant transactions" establishes a ground for imposing secondary sanctions against non-U.S. persons outside U.S. jurisdiction who provide any form of assistance, including the transmission of currency or any other value, to specific sanctioned individuals, businesses, and entities from those countries. What constitutes a significant transaction depends on various factors, such as the size, number, frequency, and nature of the transactions, among others. OFAC's enforcement actions published on its website reveal that from 2003 to 2022, the "facilitation/conduct of significant transactions" has not been invoked as a legal ground to target non-U.S. persons outside of U.S. jurisdiction. However, in OFAC's view, a facilitator/conductor can also be sanctioned by the performing direct or indirect transfer of U.S. dollars through correspondent accounts connected to U.S. banks. The implication of the facilitator/conductor argument on arbitration is that if someone not involved in arbitration provides funds to or for a sanctioned party involved in the arbitration process (e.g., third-party funders), a potential violation of U.S. sanctions can also occur unless a license has been obtained from the OFAC or such a transaction is excluded from the scope of the sanctions program.

Tips for Arbitrators

In the above secondary sanctions regimes, OFAC enforcement actions can reach the targets of sanctions wherever they are located due to the role of the U.S. dollar in subjecting its users to U.S. laws and U.S. jurisdiction. Therefore, in arbitration proceedings involving a sanctioned party, the extraterritorial reach of U.S. sanctions regulations must be taken into consideration irrespective of the applicable laws if the respective sanctions program contains the "exportation of services" or "facilitation/conduct of significant transactions" components. In sanctions regimes without those two components, such as sanctions targeting Venezuela, the financial transactions in U.S. dollars between a Venezuelan citizen and a non-U.S. person outside U.S. jurisdiction do not necessarily constitute a breach of sanctions.

In programs containing those two components, such as sanctions targeting Russia, all those involved should examine whether the performance of obligations is tied only to the transfer of U.S. dollars or, for example, an alternative currency clause exists to replace the dollar.

Finally, when the transaction is determined to be executed only by the transfer of U.S. dollars, of concern is whether the source of the foreign bank's dollar inflow is a U.S. bank directly (or foreign branches of financial institutions incorporated in the U.S.) or a foreign bank's correspondent account that is indirectly funded by dollars in the custody of a U.S. bank. If the source of the bank's dollar inflow is correspondent accounts directly or indirectly connected to U.S. banks, U.S. secondary sanctions will likely be applied to the dispute as foreign overriding mandatory rules. Otherwise, if the foreign bank uses its own dollar reserve with no connection to the U.S. financial system, secondary sanctions need not be applied to the dispute. The bank's awareness of the involvement of U.S. banks as its source of dollar inflows and so its refusal to perform such a transaction signals its implementation of a risk-based approach to sanctions compliance, the guideline of which is articulated and published by the U.S. Department of the Treasury.

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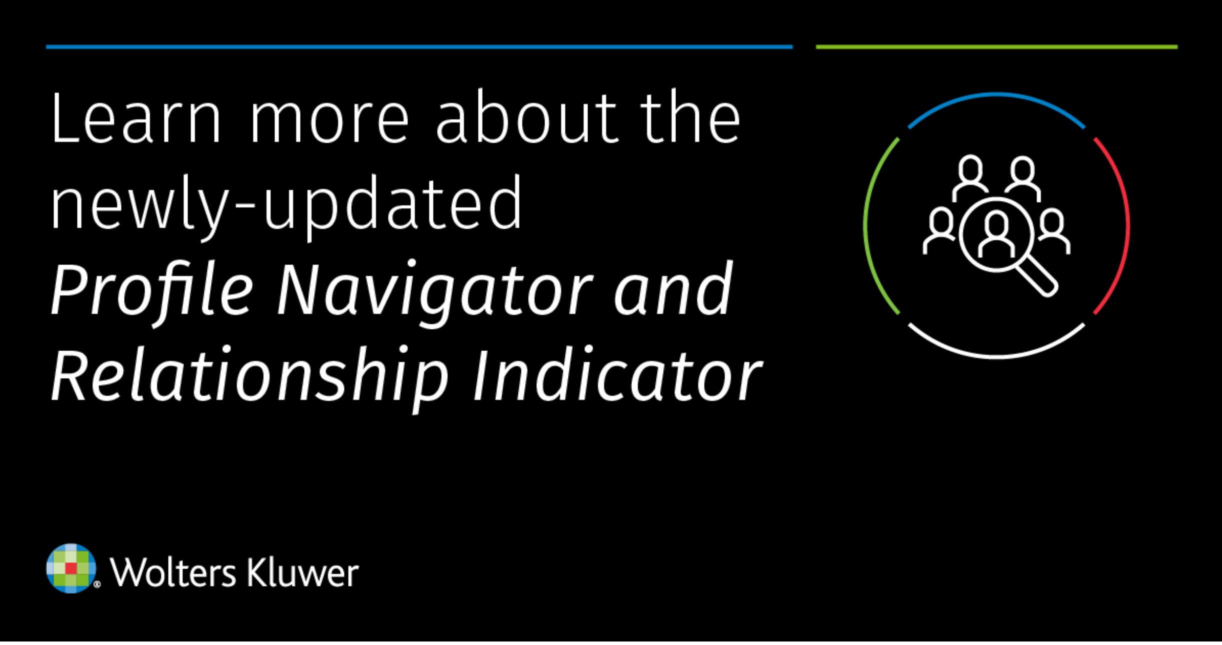

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