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Arbitrating Under Foreign Laws: Russian Experience Shows Possible Pitfalls

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Attorneys whose clients engage in business abroad should think twice about agreeing to arbitration provisions in their clients' business agreements that require disputes to be arbitrated in foreign arbitrations pursuant to the laws of a foreign country. Arbitration is not the same everywhere, and a prevailing party's ability to sustain an arbitration or enforce an arbitration award in a foreign country may be foreclosed for reasons that are beyond any U.S. court's scope of review. The Russian approach to arbitration provides an object lesson of the possible pitfalls one may face when arbitrating within the international arena.

Under the Arbitrazh Procedure Code (APC) of the Russian Federation of 2002, arbitration awards may be reviewed and set aside by arbitrazh courts.[1] A decision to set aside an arbitration award is made by a single judge, and a hearing takes place notwithstanding a party's failure to appear if the party is deemed to have been properly notified of the hearing.

Arbitration awards rendered in the Russian Federation may set aside for numerous reasons, including the alleged invalidity of the arbitration agreement or the issuance of the award on a dispute which is allegedly not subject to

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[1]The term "arbitrazh" is historical and does not refer to arbitration; arbitrazh courts are Russia's state commercial courts.

Second Circuit Precludes Taking Arbitrator's Deposition For Manifest Disregard

Peter Benner
Contributing Editor

While overturning the district court's vacatur of an arbitrator's award regarding a post-sale price adjustment for the purchase of stock for manifest disregard of the law, in *Hoeft v. MVL Group, Inc.*, 2003 U.S. App. LEXIS 18166 (2d Cir. 2003), the Second Circuit Court of Appeals recently reaffirmed narrow circumstances under which an arbitrator may be deposed.

The case involved a dispute over the amount of a deferred payment for securities that the parties had agreed in the sale contract to resolve by binding arbitration before a designated arbitrator who was a CPA. At issue was a purchase price adjustment based on EBITDA, defined as: "income from operation before interest expense, provisions for income taxes, interest and other investment income, other income, depreciation and amortization, *which shall be determined in accordance with generally accepted accounting principles consistently applied...*" Id. at *3-4 (emphasis added).

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arbitration. An award may also set aside if it allegedly violates fundamental norms of Russian law. Likewise, the provisions of Russian law which deal with the enforcement of foreign arbitral awards provide grounds on which the enforcement may be rejected. Notably, such grounds include the alleged exclusive competence of Russian courts over the subject matter of the dispute, the existence of a prior Russian court decision on the same dispute between the same parties, or the pendency of a previously filed case on the same dispute between the same parties in a Russian court. Therefore, even if the arbitration takes place outside of Russia, Russian law may prevent the enforcement of the award if the court purportedly finds that the dispute is not subject to arbitration under Russian law.

One of the predicates used to set aside arbitration agreements is the alleged non-arbitrability of disputes under Russian law and the exclusive competence of Russian courts to adjudicate certain controversies. The APC specifically lists the types of cases which are not subject to arbitration in disputes involving foreign parties. Such cases include disputes regarding state property and the privatization of state property, disputes over real property located in Russia and claims of rights thereto, disputes involving intellectual property rights requiring the issuance of a patent or certificate in Russia, disputes involving claims seeking invalidation of recordings in a state registry (such as, e.g., recordings of title to real property or motor vehicle), and disputes over issues regarding the foundation, liquidation and registration of legal entities in Russia and challenging decisions of the management bodies of such legal entities. As can be seen, this list covers a range of controversies, from sale contracts to corporate matters, which cannot be resolved through arbitration in Russia. At the same time, such broad provisions make it easy for a biased court to invalidate an arbitration agreement and set aside a domestic, or refuse to enforce a foreign, arbitration award. Moreover, aside from this general list, a number of statutes regulating specific types of economic activities provide for non-arbitrability of disputes. Counsel advising their clients on conducting business in Russia are cautioned to carefully research the specific provisions of Russian law applicable to their clients' business.

Numerous foreign businesses have encountered serious problems in Russia in enforcing arbitration agreements because Russian courts have invalidated arbitration agreements for reasons beyond those covered by the letter of the APC. For example, in a recent case, a dispute arose between foreign and Russian investors in a Russian company in the oil industry. The company's foundation agreement provided a "right of first refusal" for each investor to purchase the shares of the other and required the resolution of all disputes between the Russian company, the foreign investor, and the Russian corporate shareholder before the Stockholm Chamber of Commerce. With this protection, the foreign party made a substantial investment in the Russian entity. Nonetheless, the Russian shareholder was able to avoid the arbitration agreement by simply filing for bankruptcy in Russia and having the court hold that the bankruptcy vitiated the provisions of the foundation agreement and permitted it to transfer its shares to another company. The successor company then successfully argued that it was not bound by the arbitration provision because it was not a party to the foundation agreement.

In a related dispute regarding the ownership of shares in the Russian company, the Russian shareholder joined as a third party in a case, a government agency unrelated to the dispute whose participation in the action was clearly unnecessary. Under the influence of Russian shareholder the court held that because of the presence of this agency in the action, the dispute was not arbitrable and was within the exclusive jurisdiction of that court, and thereafter reached a result procured by the Russian shareholder, even though Russian law was clear that litigation of the broader dispute should have been stayed pending resolution of the arbitrable dispute. Given the problems of Russian law, a careful attorney will advise a client not only to provide for arbitration outside of Russia, but also provide that the validity of the arbitration provision itself is governed by non-Russian law.

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Importantly, the existence of an arbitration agreement or the pendency of arbitration proceedings does not prevent a party from obtaining "security measures," i.e., preliminary injunctive relief, from an arbitrazh court, thereby nullifying the effect of the arbitration agreement. Once an influenced court thus acquires control over the property in controversy, it then may easily use one the above techniques to invalidate the arbitration agreement and obtain subject matter jurisdiction over the dispute, and then issue the required decision.

Although not arising from an arbitration, the case of *Films by Jove, Inc. v. Berov*, 250 F. Supp. 2d 156 (E.D.N.Y. 2003) illuminates the hazards of submitting a matter to the Russian arbitrazh courts for any purpose. In *Films by Jove, Inc.*, the United States District Court for the Eastern District of New York refused to follow a decision of the Russian Supreme Arbitrazh court, finding that the decision had been obtained through corruption of the Russian judicial system.

In *Films by Jove, Inc.*, an American company, as well as Russian plaintiffs, brought an action for copyright infringement based on the allegation that the American company had received an exclusive license to control certain Russian cartoons, which has been owned by the Soviet state. Judgment was entered in favor of the plaintiffs on August 27, 2001 based on the American court's interpretation of the relevant Russian laws. Not long thereafter, on December 18, 2001, in parallel litigation between the parties in Russia, the Russian Supreme Arbitrazh Court ("SAC") issued a contrary decision interpreting the same Russian laws. The defendants filed a motion for reconsideration of the August 27, 2001 decision, arguing that the American court should adopt the subsequent interpretation of the SAC. Judge David G. Trager denied the motion, holding that the decision of the SAC was clearly the fruit of corruption.

The American court first held that "evidence that the judiciary was dominated by the political branches of the government...would support a conclusion that the legal system was one whose judgments are not entitled to recognition." *Id*. at 207. The court found that "plaintiffs have presented specific evidence indicating that the decision was, in fact, animated by coordinated efforts on the part of the Russian government...[to] recapture[e]...the state property rights that were acquired nearly a decade earlier by an American investor." *Id*. at 196. The American court found that the SAC case file contained documents, discovered by the plaintiffs' attorney, indicating that a representative of the SAC attended an *ex parte* "consultation meeting" with a number of the Russian Government officials, including the Deputy Chairman of the Russian Government and a representative of the Administration of the Russian President. The participants of the meeting "expressed the intent to 'ask [V.A. Yakovlev, the Chief Justice of the SAC] to carry out...the court supervision over the case[.]" *Id*. at 209. In a subsequent memorandum to A.A. Arifulin, another Justice of the SAC, a Russian government official conveyed the "necessity...[for] the reinforcement of control on behalf of the General Prosecutor's Office and the [SAC] over the decisions of [arbitrazh] courts [in this case]." *Id*. at 210.

Based on this evidence, and its independent review of the relevant Russian law and the SAC decision, the American court found:

> [T]he memorandum sent to [SAC] Judge A.A. Arifullin does not simply relay a request

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> for [SAC] intervention in the [Soyuzmultfilm] litigations, but rather specifically conveys the Russian government's view concerning the "necessity by all state organs to provide the protection of interests of the Russian Federation."...[W]hat is alleged to have happened here [is] improper ex parte collaboration between representatives of the executive branch and the judiciary. …
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> [T]he consultation meeting documents...demonstrate that the December 18, 2001 decision...resulted from a concerted attempt on the part of Russian government officials to assert state property interests that certain of these officials may feel were improvidently (or improperly) transferred to private ownership[.]

Id. at 211.

These circumstances warranted only one possible conclusion by the American court:

> [The SAC's] analysis is plainly erroneous,...unjustifiably departs from the universal understanding [of the fundamental principles of law, and][i]t is...apparent that the [SAC's] December 18, 2001 decision was strongly influenced, if not coerced, by the efforts of various Russian government officials seeking to promote "state interests." Under these circumstances, the [SAC's] decision is entitled to no deference.

Id. at 216.

In the past, some American courts have been reluctant to find that the Russian court system is so corrupt that it cannot provide an adequate forum, even in the face of overwhelming evidence, including statements of the US Department of State, Russian government officials, American and Russian scholars, and international organizations. Of course, other American courts have found courts of foreign countries, including Russia, inadequate and some American states do not even recognize the

The arbitrator found for the sellers, rejecting the application of GAAP because EBITDA is not a GAAP term. The sellers sought to confirm the award in District Court pursuant to the Federal Arbitration Act, 9 U.S.C. §§1-16 (1999). The purchaser moved to vacate the award, asserting four grounds, including the arbitrator's prejudgment of the dispute and manifest disregard of the law by failing to apply GAAP. Id. at *8. The purchaser sought, and the district court approved, the court supervised deposition of the arbitrator. In proceeding with the deposition, the purchaser, over the seller's objection, questioned the arbitrator "regarding his understanding of the calculation of EBITDA under the [purchase agreement]" and "the substance of his decision making process in calculating … EBITDA, including the role of GAAP in his calculation." (Id.), but did not inquire on the issue of prejudgment of the dispute. It was the seller's position, which the district court rejected, that the deposition of the arbitrator, who was an