DISPUTE RESOLUTION JOURNAL®

A Publication of the American Arbitration Association®-
International Centre for Dispute Resolution®

September-October 2024 Volume 78, Number 3

Dispute Resolution Journal®

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International Centre for Dispute Resolution®

Volume 78, Number 3 September-October 2024

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DISPUTE RESOLUTION JOURNAL®

The Journal of the American Arbitration Association®-International Centre for Dispute Resolution® (AAA®-ICDR®)

ISSN 1074-8105 (print) and 25733-606X (digital).

Article Submissions

Direct editorial inquiries and send materials for publication to: Steven A. Meyerowitz, Editor-in-Chief, Meyerowitz Communications Inc., 26910 Grand Central Parkway, #18R, Floral Park, NY 11005, smeyerowitz@meyerowitzcommunications.com, 631.291.5541.

Material for publication is welcomed—articles, decisions, or other items of interest to arbitrators and mediators, attorneys and law firms, in-house counsel, corporate officers, government agencies and their counsel, senior business executives, and anyone interested in dispute resolution.

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ISSN 1074-8105 (print) and 25733-606X (digital).

The cover of this journal features the painting *Close Hauled*, a drawing by Rockwell Kent, 1930, electrotype on paper.

Publishing Staff
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Production Editor: Sharon D. Ray
Cover Design: Sharon D. Ray

Cite this publication as:

Dispute Resolution Journal® (The Journal of the American Arbitration Association®-International Centre for Dispute Resolution® (AAA®-ICDR®))

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120 Broadway, Floor 21
New York, NY 10271

POSTMASTER: Send address changes to American Arbitration Association-International Centre for Dispute Resolution, 120 Broadway, 21st Floor, New York, NY 10271

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Russia: Investment Protection and Arbitration—Part 1

Volodymyr Yaremko, Vadym Miller, and Vladlena Lavrushyna[1]

In this first of a series, the authors discuss the options that foreign investors with assets and operations in Russia have available to them and how different options may impact their investment protection and chances of bringing credible arbitration claims.

In a business advisory, dated February 23, 2024, the U.S. government warns businesses and individuals of serious legal, financial, and reputational risks entailed in maintaining operations in Russia (the Advisory).[2] It highlights that by staying in Russia, foreign investors may face penalties—including economic sanctions, export controls, and import restrictions—imposed by the United States and its allies and partners, and risk becoming involved in Russia's military actions against Ukraine and violations of international law.

In light of the Advisory, it is important for foreign investors with assets and operations in Russia to know the options available to them and how different options may impact their investment protection and chances of bringing credible arbitration claims. This theme is the focus of Part 1 of this new series, titled "Russia: Investment Protection and Arbitration."

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[2] The Advisory has been issued by the U.S. Department of State, the U.S. Department of the Treasury, the U.S. Department of Commerce, and the U.S. Department of Labor. In addition to Russia, the Advisory covers the Russia-occupied territories of Ukraine.

Dispute Resolution Journal® | September-October 2024, Vol. 78, No. 3, pp. 265-269.

ISSN 1074-8105 (print) | ISSN 25733-606X (digital).

Purpose of the Advisory

While appreciating that the choice of whether and how to continue operations in Russia, suspend such operations, or exit the Russian market is ultimately up to the businesses, individuals and organizations, through the Advisory the U.S. government seeks to (1) highlight the operational, legal, economic, and reputational risks associated with their Russian business operations and relationships, and (2) urges them to undertake heightened compliance due diligence and human rights due diligence to evaluate potential involvement in violations and identify ways to mitigate associated risks.

Closer Look at the Legal Risks

The Advisory acknowledges that while the "serious risks" stemming from operating in Russia may be mitigated by rigorous due diligence, "substantial risk is likely to remain." Key legal risks which investors should be aware of include:

- Russian legislation (post-invasion) allowing regional governments to nationalize assets of businesses from "unfriendly states";[3]
- A decree by the Russian president of March 3, 2023, enabling external management by the Russian State in businesses failing to perform State defense contracts during martial law, essentially leading to partial nationalization; and
- Other recently enacted legislation restricting dividend payments, fund transfers, and sales of interests in fuel and energy sectors for businesses affiliated with "unfriendly states."

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[3] According to the Federal Law No. 127-F3, dated June 4, 2018, "On Measures to Influence (Oppose) Unfriendly Acts by the United States of America and Other Foreign States," the "unfriendly states" are defined as foreign States "committing unfriendly actions against Russian Federation, citizens of Russian Federation or Russian legal entities."

Non-resident businesses selling their assets in Russia face further burdensome rules, including a requirement for approval from a government commission and an imposition of a discount on assets sold to Russian investors. Recent regulations also require a mandatory asset valuation, a 50 percent discount on sales, and a 10 percent contribution to the State budget from the sale proceeds. In the circumstances, foreign businesses are expected to rarely sell Russian assets to third-country investors as investors have been, and will continue to be, cautious in light of tightening sanctions and rising geopolitical tensions.

There has been a notable increase in new and prospective cross-border commercial and investment disputes involving Russia and foreign investors, including in the banking, food and beverage, oil and gas, manufacturing, technology, and transport sectors (among others). In the current unpredictable legal landscape, and with Russia being bound by over 60 Bilateral Investment Treaties (BITs), including with what the Russian authorities describe as "unfriendly states" (such as the United States and EU member states, as well as Japan, Canada, Switzerland, Republic of Korea, Ukraine, and the United Kingdom), foreign businesses and individuals operating in Russia should carefully consider the manner in which they conduct business in Russia and assess its impact on their investment protection prospects.

Options for Foreign Investors with Assets/Operations in Russia

At a high level, foreign investors with assets and operations in Russia currently have three primary options open to them. They could:

1. Maintain operations in Russia and fully comply with the existing regime.
2. Opt to sell their business under the imposed rules, for example, to Russian investors.
3. Refuse to participate in the existing regime and explore the possibility of selling their business to third-country (non-Russian) investors.

The path chosen by businesses may not only have major commercial, financial, and reputational implications, but could significantly influence their prospects of safeguarding property rights in potential investment arbitration against Russia, as well as the level of compensation payable in any arbitration.

In the first scenario, if a business opts to remain in the Russian market and continue operations under the existing regime, its grounds to claim a violation by Russia of substantive protections under the applicable BIT could be severely weakened. While engaging with the existing legal regime does not entirely preclude the possibility of initiating investment arbitration, it significantly constrains the basis for future investment claims. It may be difficult to pursue investment claims in circumstances where the wronged party ostensibly agreed to operate within the legal and business framework that it would argue had the effect of infringing its rights. It is noteworthy that the Advisory states that such businesses could also be perceived as directly or indirectly supporting Russia's war effort due to legislation that forces them to directly support Russia's military and are hence "at risk of being implicated in Russia's violations of international law and human rights abuses."

In the second scenario, when a business sells its assets under Russian regulations, the prospects for protecting its investment are slightly higher. At the same time, adhering to the legal framework and the restrictions currently in effect in Russia (thus arguably providing implied consent to their application) could diminish the likelihood of obtaining compensation in an investment claim. However, companies that comply with the regime imposed by Russia might nevertheless argue that they acquiesced under pressure and are challenging the regime's compatibility with the international investment protection standards outlined in the applicable BITs.

In the third scenario, where businesses refuse to comply with the Russian regime, or if third-country investors take over the assets, the likelihood of successfully protecting investments through arbitration rises significantly. However, this comes at a cost of facing an increased risk of (1) retaliatory State action and/or (2) asset expropriation by the Russian authorities. A credible claim of expropriation may arise if Russia either denies the transfer of shares to non-Russian investors or fails to provide fair market value (or any) compensation when expropriating the foreign company's assets. Further, since Russia discriminates between investors from "friendly" or "unfriendly" states and its regulations specifically target "unfriendly states" and associated organizations, investors could argue that this is contrary to the fair and equitable treatment standard found in almost all of Russia's BITs. Other types of BIT claims are also foreseeable in the circumstances, but the precise nature of the claims will depend on the provisions of the relevant BIT.

Conclusion

Whether international businesses choose to maintain operations in Russia, sell to Russian investors, or explore a transfer of assets to non-Russian entities, these decisions (and their timing) will materially impact their ability to safeguard investment rights in potential international arbitration (or other) proceedings involving Russia.