OFAC Should Loosen Restrictions On Arbitration Services

By **Javier Coronado Diaz** (February 29, 2024)

Javier Coronado Diaz

The Office of Foreign Assets Control, a vital arm of the U.S. Department of the Treasury, has broad authority to enforce economic sanctions that restrict commercial activities with targeted individuals, entities and countries.

For instance, on February 23, 2024, following the death of Aleksei Navalny and marking the second anniversary of Russia's further invasion of Ukraine, OFAC designated almost 300 individuals and entities pursuant to its Russia-related sanctions authorities.

Sanctions affect arbitrators, counsel and arbitration centers. Furthermore, they may have an impact on arbitral jurisdiction, arbitrability and award enforcement.

This commentary focuses on one implication of OFAC sanctions on arbitration proceedings: U.S. persons' inability to provide arbitration services to blocked parties.

Because the violation of sanctions may carry substantial civil and criminal penalties, sanctions deter the participation of U.S. persons in disputes involving blocked parties. However, in practice, these parties may find arbitration services outside the U.S.

For example, earlier this year it was reported that Power Machines, a Russian company under OFAC Sanctions since 2018, had secured a multimillion-dollar victory in an arbitration seated at the Singapore International Arbitration Centre.

While OFAC allows representation of blocked parties in U.S. court proceedings related to arbitration agreements and awards, it generally does not authorize representation in arbitration proceedings outside U.S. courts. Thus, the provision of legal services in such cases requires specific OFAC licensing.

OFAC should amend its regulations to allow the provision of legal services in connection with all U.S-based arbitration. Such an amendment would not only be in line with the U.S. federal policy favoring arbitration of commercial disputes, but might also allow for more streamlined OFAC licensing review.

OFAC Regulations Regarding Arbitration Services to Blocked Parties

Arbitration Services by Authorized OFAC Regulations

Generally, sanctions prohibit the provision of arbitration services to blocked parties unless specifically authorized by OFAC. Representation of blocked parties in arbitration proceedings before any U.S. federal, state or local court or agency is often authorized by OFAC regulations. However, there is no publicly available OFAC guidance or other legal authority confirming the type of arbitration proceedings that are covered by OFAC authorizations.

Accordingly, attorneys and law firms typically seek OFAC's specific license before (1) serving as arbitrators if arbitration participants are blocked parties, (2) participating in an arbitration with the arbitral seat in a sanctioned country, or (3) representing a blocked party

in an arbitration outside the U.S.

Indeed, OFAC may issue a specific license for a particular transaction otherwise prohibited by sanctions, if the activity is determined by OFAC to be in the interest of U.S. foreign policy.

OFAC Regulations Related to Iran: Unique Authorizations for the Provision of Arbitration Services

Iran-related sanctions provide arbitration service authorizations beyond U.S. courts. These include domestic U.S. arbitration representation, and the initiation and conduct of arbitral proceedings involving Iran.

The public record does not present OFAC's reasons for establishing such a framework.

Perhaps the broad authorization for arbitration services related to Iran was established by OFAC for the purpose of removing obstacles to the implementation of the Iran-U.S. Claims Tribunal, which is an arbitration forum for disputes between the governments of each country and the nationals of the other.

Reasons for Amending OFAC Regulations

Complexity of OFAC's Licensing Process

OFAC's specific licensing process for arbitration-related services is complex and time-consuming. To obtain a specific license, the interested party must file with OFAC an application providing a detailed description of the proposed transaction, and explaining why that transaction is in the foreign policy interests of the U.S.

Each application is reviewed by OFAC on a case-by-case basis. Following receipt of the application, OFAC may require additional information from the applicant, as well as consultation with other U.S. government agencies.

Moreover, there is no defined time frame for processing specific licenses. In practice, OFAC may take months to rule on simple transactions. License applications covering more complex transactions may take up to a year or longer.

OFAC's policy, as stated on its website, is that "[t]he length of time for determinations to be reached will vary depending on the complexity of the transactions under consideration, the scope and detail of interagency coordination, and the volume of similar applications awaiting consideration."

U.S. Policy Favors OFAC's Authorization For the Provision of Arbitration-Related Services

In 1925, Congress enacted the Federal Arbitration Act to break the barriers that some U.S. courts had placed on arbitration, and declare a national policy favoring arbitration of disputes.

Indeed, Section 2 of the act makes a written agreement to arbitrate "in any maritime transaction or a contract evidencing a transaction involving commerce ... valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."

The Federal Arbitration Act also grants federal courts the authority to both stay litigation proceedings and compel arbitration in cases where the dispute falls within the purview of a valid arbitration agreement.

Grounded in Congress' authority under the Commerce Clause, the arbitration act not only provides a procedural framework for federal court proceedings but also mandates the application of federal substantive law on arbitration in both state and federal courts. Critically, the act prevents state law attempts to undermine the enforceability of arbitration agreements.

As a result of this U.S. policy, arbitration agreements are everywhere today, from consumer agreements to employment contracts. Over 50,000 attorneys list arbitration as their practice area in the Martindale-Hubbell Law Directory.

Blocked Parties May Receive Arbitration Services Outside The U.S.

In practice, despite OFAC restrictions, blocked parties may receive arbitration services outside the U.S. The 2022 Russian Arbitration Association survey on the impact of sanctions on commercial arbitration is illustrative.

The Russian Arbitration Association concluded that "the users of arbitration have been actively gathering and exchanging knowledge of sanctions-related practices in arbitration and have since adapted their preferences for arbitration rules, seats, and applicable laws."

Critically, the survey anticipated a shift of Russia-related and sanctions-related arbitration cases to Asian-based arbitration centers.

The regulations of the European Union on Russia also illustrate the access that blocked parties may have to arbitration services outside the U.S.

Like the U.S., the EU has implemented economic sanctions targeting Russia since 2014, including the blocking of certain Russian entities. But unlike the U.S., the EU Council Regulations allow sanctioned entities to enter into "transactions which are strictly necessary to ensure access to judicial, administrative or arbitral proceedings in a Member State."

Accordingly, law firms and lawyers subject to EU jurisdiction may represent blocked parties in arbitral proceedings in a member state of the EU.

Downsides of Amending OFAC Regulations

Risk of Sanctions Evasion and Financial Crimes

Amending OFAC regulations to authorize any and all arbitration services may facilitate sanctions evasion and financial crimes, as bad actors could exploit arbitration's characteristics for illicit activities.

While there is no publication documenting the abuse of arbitration to evade OFAC sanctions, blocked parties are known for recruiting professionals to create corporate structures that aid sanctioned persons' evasion efforts.

For instance, on March 9, 2023, the Russia Elites, Proxies, and Oligarchs Task Force, comprised of the EU, other G7 countries and Australia, released a global advisory noting

that enablers of sanctions evasion may include lawyers, accountants, and trust and company services providers.

Moreover, bad actors can use arbitration in furtherance of money laundering and other financial crimes. For instance, criminals may establish two or more companies to enter into a sham transaction with an arbitration clause, so one of the companies can commence arbitration proceedings and seek payment of damages.

The parties in the arbitration pretend to engage in litigation, but ultimately the respondent does not defend the case. The arbitrators, who may or may not know about the illegal scheme, order the respondent to pay a sum of money, and the proceeds of criminal activity are laundered through the arbitration award.

Bad actors may abuse arbitration proceedings due to the inherent characteristics that arbitration has. The flexibility, informality and confidentiality of arbitration, while often advantageous, can potentially create an environment where financial crime is facilitated.

Challenges for U.S. Law Enforcement in International Investigations

Granting broad arbitration authorizations could pose challenges for U.S. law enforcement, especially concerning international investigations where obtaining evidence from foreign countries is complex and time-consuming.

To obtain information or evidence from a foreign country, the government may seek international cooperation under a mutual legal assistance treaty, or MLAT.

In the absence of an MLAT, the government can request assistance in obtaining evidence located abroad by means of a letter rogatory, foreign domestic law mechanisms, or comity and reciprocity.

However, these requests for international cooperation can take months, or even years, to execute. In fact, the information or evidence might be lost due to the passage of time while an MLAT request or other process is pending.

As noted by the U.S. Department of Justice in its 2022 report, "How To Strengthen International Law Enforcement Cooperation For Detecting, Investigating, And Prosecuting Criminal Activity Related To Digital Assets," foreign countries often have "differing standards regarding records retention, data privacy, and AML/ CFT requirements that may limit the scope of evidence available for collection."

The U.S. government may lack the ability to prevent disclosure of the information request to the investigation's targets, which could jeopardize law enforcement's capability to investigate and prosecute the criminal activity at issue.

Moreover, bad actors can take advantage of foreign entities lacking beneficial ownership disclosure requirements to obscure illicit activity.

Conclusion

The risks of sanctions evasion, as well as the challenges U.S. law enforcement faces in conducting international investigations, can explain why OFAC regulations should continue to restrict the representation of blocked parties in foreign arbitrations. Balancing regulatory safeguards with legitimate arbitration facilitation is essential. However, the U.S. government

is well-equipped to investigate and prosecute apparent violations of OFAC sanctions within U.S. territory.

In the U.S., the government can seek documentary, electronic or testimonial evidence by, for example, using undercover operatives, employing undercover agents, using electronic surveillance, issuing subpoenas, and/or executing search warrants.

Further, with the recent enactment of the Corporate Transparency Act, many companies in the U.S. are now required to disclose to the government their beneficial ownership information when they are formed — or for non-U.S. companies, when they register with a state to do business in the U.S.

The new U.S. requirements for the disclosure of beneficial ownership information to the federal government, once fully implemented, are expected to help facilitate law enforcement investigations.

Accordingly, and considering that the review and amendment of OFAC regulations regarding U.S. arbitration services is crucial to address evolving arbitration landscape demands, OFAC should consider amending regulations to allow U.S. arbitration services.

This reform would align with broader U.S. policy on arbitration, promote efficiency, and effectively address geopolitical and regulatory challenges.

Javier D. Coronado Diaz is a partner at Diaz Reus & Targ LLP.