CLIENT UPDATE

PRESIDIUM OF HIGHER *ARBITRAZH* COURT PROVIDES GUIDANCE ON THE CONCEPT OF PUBLIC POLICY

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On April 1, 2013, the Higher *Arbitrazh* Court of the Russian Federation ("**HAC**") published Information Letter No. 156 dated February 26, 2013 on its website, in which it approved the Review of *Arbitrazh* Court Practice in Applying the Public Policy Exception as a Ground for Refusal to Recognize and Enforce Foreign Judgments and Arbitral Awards (the "**Review**") and recommended that it be used as a guidance by all *arbitrazh* courts.

Violation of public policy is one of the classic and perhaps the most frequently invoked objections to the recognition and enforcement in Russia of foreign judgments and arbitral awards. For this reason, it has been of vital importance for Russian court practice that a more precise definition of public policy, and the extent to which this concept should be applied, be formulated. The Review sets forth the legal positions of HAC based on specific cases where violation of public policy has been invoked. HAC's positions on most of the cases discussed in the Review correspond to the prevailing understanding of public policy in other countries and are aimed at precluding unreasonably broad interpretations of this concept by Russian courts.

Some of the more important innovations made by HAC and discussed in this update include:

- The introduction of a more narrow definition of public policy than that previously applied. Based on the new definition proposed by HAC, the possibility that a foreign court judgment or arbitral award could be contrary to the public interest or could affect large-scale social groups does not automatically serve as grounds *per se* for the refusal to recognize or enforce such judgment or award in Russia.
- HAC stresses that the courts may not refuse to recognize or enforce foreign court judgments or arbitral awards on the grounds of violation of public policy in cases where the alleged violation is based on the mere circumstance that the judgment or award was grounded in the rules of foreign substantive or procedural law unknown in Russian law or applied differently under Russian law than in the foreign jurisdiction.
- The Review emphasizes that a clear distinction must always be made between the public policy exception and other procedural grounds for refusal to recognize or enforce a foreign judgment or award (such as, *e.g.*, failure to serve proper notice to the respondent), and that it is inadmissible to apply the public policy exception as a common "all-inclusive" ground for refusal to recognize or enforce foreign court judgments or arbitral awards in Russia, rather than invoking the relevant specific.

Strictly speaking, the Review only addresses the application of the public policy exception in the context of case law on the recognition and enforcement of foreign court judgments or arbitral awards, and does not touch upon the question of the setting aside of international commercial arbitration awards rendered in Russia. However, given the parallels between the legal grounds for setting aside international commercial arbitration awards made in Russia and the legal grounds for refusal to recognize and enforce foreign court judgments and arbitral awards in Russia, it may be assumed that the legal positions formulated by HAC should also be taken into consideration by the Russian courts when hearing these types of cases.

PUBLIC ORDER AS A GROUND FOR THE REFUSAL TO RECOGNIZE AND ENFORCE FOREIGN COURT JUDGMENTS AND ARBITRAL AWARDS, AND AS A GROUND TO SET ASIDE RUSSIAN ARBITRAL AWARDS

Violation of public policy is the universal legal ground used in certain cases to block the recognition and enforcement in Russia of a foreign court judgment or arbitral award. It is of fundamental importance as a practical tool, since in most cases violation of public policy is the only possible ground for a refusal to recognize and enforce a foreign arbitral award or court judgment in Russia in terms of the substance of the award or judgment and the

substantive law issues related thereto, whereas the remaining possible grounds generally involve procedural issues (the foreign court or arbitral tribunal was not competent to hear the case, a summons was not served on the defendant, the judgment is not final, etc.).[1]

It is also worth noting that the concept of violation of public policy applies not only when considering petitions to recognize and enforce foreign court judgments and arbitral awards in Russia, but also petitions to set aside international commercial arbitration awards made in Russia (e.g., by the International Commercial Arbitration Court ("ICAC") at the Russian Chamber of Commerce and Industry).[2] Notwithstanding that the Review does not *per se* cover the setting aside of international commercial arbitration awards made in Russia, the legal positions set forth by HAC can clearly be taken into consideration in respect of this category of cases as well should the issue of the interpretation of the concept of public policy arise.

THE CONCEPT OF PUBLIC POLICY

Neither international treaties nor the domestic laws of Russia elaborate on the concept of public policy. This has led to the Russian courts often interpreting the concept of public policy extremely broadly. In particular, in paragraph 29 of the Review of *Arbitrazh* Court Practice in Respect of the Recognition and Enforcement of Foreign Court Judgments, Challenges to Arbitral Awards, and Issuance of Writs of Execution for the Enforcement of Arbitral Awards, the HAC Presidium had noted that Russian public policy assumes "*the good faith and equality of the parties entering into a private relationship, as well as a proportionality between the extent of the civil liability and the culpable wrong*".[3] In other words, the HAC Presidium was proposing that violation of public policy be understood to mean violation of the basic tenets or principles of Russian law.

In recent years the Russian courts have extensively applied the following more narrow definition, which suggested that in ruling on whether there was a violation of public

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1 Refusal to recognize foreign arbitral awards citing violation of public policy is envisaged in Article V.2(b) of the 1958 Convention on the Recognition and Enforcement of Foreign Arbitral Awards (the "New York Convention"), Article 36.1(2) of Law of the Russian Federation No. 5338-I on International Commercial Arbitration dated July 7, 1993 (the "ICA Law"), and Articles 244.2 and 244.1(7) of the *Arbitrazh* Procedure Code of the Russian Federation ("APC"). The right to refuse to recognize foreign court judgments on the grounds of violation of public policy is provided for in a number of multilateral and bilateral mutual legal assistance treaties, as well as Articles 244.1(7) and 244.2 of the APC. It should be noted that the Review does not touch upon the thorny issue of the recognition and enforcement in Russia of a foreign judgment handed down by a court in a jurisdiction with which Russia has not signed a mutual legal assistance treaty. The absence of such treaty in itself could, in certain circumstances, serve as a ground for refusal to recognize and enforce a foreign court judgment in Russia.

2 Article 34.2(2) of the ICA Law and Article 233.4 of the APC.

3 This review was approved under Information Letter No. 96 of the HAC Presidium dated December 22, 2005.

policy, the potential implications of such violation also be borne in mind; in particular, whether it would be damaging to the sovereignty or security of the state, or affect large-scale social groups, etc.: "*An international arbitration award may be found to be contrary to Russian public policy if its execution should lead to activities either expressly prohibited by law or damaging to the sovereignty or security of the state, or affecting large-scale social groups, and that are incompatible with the fundamental principles of the state's economic, political or legal systems, or affecting the constitutional rights and freedoms of individuals, or violating the basic principles of civil law, such as equality of parties, inviolability of property, and freedom of contract.*"[4] However, even this definition left a considerable margin for a broad interpretation of the concept of public policy.

Paragraph 1 of the Review contains a new definition of public policy: "…*for the purposes of applying these rules* [meaning the rules set forth in Article V.2(b) of the New York Convention and Article 244.1(7) of the APC – Auth.] *public policy is understood to mean the fundamental legal tenets/principles that are most imperative, universal, of special social and public significance, and that form the core for the state's economic, political or legal systems. In particular, this includes actions expressly prohibited by the internationally mandatory norms of Russian law (Article 1192 of the Civil Code of the Russian Federation) if such actions damage the sovereignty or security of the state, affect large-scale social groups, or violate the constitutional rights and freedoms of individuals*".

It is important to note that the new definition contained in paragraph 1 of the Review narrows the concept of public policy; in particular, actions affecting large-scale social groups or violating the constitutional rights of individuals may no longer be automatically classified as violations of Russian public policy.

Based on the new definition of public policy, in order to establish whether or not a violation of Russian public policy has occurred, it must be established that (1) the actions violate the fundamental principles of Russian law[5] or are expressly prohibited by the internationally mandatory norms of Russian law[6]; and (2) such violation damages the

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4 *See*, in particular, HAC Rulings No. BAC-5156/12 dated April 28, 2012, No. BAC-14119/11 dated December 12, 2011, No. BAC-14097/11 dated December 5, 2011, No. BAC-2861/11 dated April 18, 2011, No. BAC-3436/09 dated May 18, 2009, No. 4223/07 dated May 8, 2007.

5 In practice, complex issues may arise as to whether the purported violation by the foreign judgment or arbitral award of one or other of an individual's constitutional rights might also be a violation of the fundamental norms of Russian law. The Review does not address this question.

6 In accordance with Art. 1192.1 of the Russian Civil Code, internationally mandatory norms (rules of immediate application) are those mandatory norms that govern the relevant relations by virtue of a reference therein or in view of their particular significance regardless of the law applicable in accordance with the provisions of private international law. As a rule, such norms include public law provisions that can trigger invalidation of a transaction or inability to perform obligations (antimonopoly and currency regulation, licensing and establishing quotas on imports and exports,

sovereignty or security of the state, violates the constitutional rights and freedoms of individuals, or affects large-scale social groups. Furthermore, the definition of public policy no longer includes violation of such civil law principles as equality of parties, inviolability of property, and freedom of contract. Previously, Russian debtors against whom foreign judgments or arbitral awards had been handed down had often, in practice, argued that the foreign court or arbitral tribunal had failed to follow these principles (as well as the principle of legality) and been able to prove that such violations were contrary to Russian public policy. The absence of any reference to these principles in the new definition of public policy reduces the probability that such arguments will continue to be used successfully.

Such a narrow interpretation of the concept of public policy which converges to a considerable extent with accepted Western standards[7] preserves the underlying philosophy that, in ruling on whether a violation of public policy has taken place, a Russian court cannot review an award or judgment on the merits of the case. Paragraph 1 of the Review emphasizes that this basic principle, which is expressly formulated in Article 243.4 of the APC only to cover foreign court judgments, applies equally to foreign arbitral awards.

A FRAMEWORK FOR APPLYING THE PUBLIC POLICY EXCEPTION

Paragraph 2 of the Review states that a Russian court may evaluate whether a foreign award or judgment conforms to Russian public policy not only on the petition of a party to the dispute, but also on its own initiative. This conclusion is in accordance with Article V of the New York Convention, whose paragraph 1 sets forth the grounds for refusal to recognize and enforce an arbitral award that apply only at the request of the party against which the award is invoked, while the grounds provided for in Article V, paragraph 2 (violation of public policy and non-arbitrability of the dispute) may be applied by the competent court on its own initiative.

The clarification provided in paragraph 4 of the Review is of vital importance in this regard: the court is to apply the public policy exception only in exceptional cases when no

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embargoes on the supply of goods, etc.). For an example of the classification of a rule as and internationally mandatory norm, please see HAC Ruling No. BAC-5611/11 dated June 22, 2011. (The Russian court deemed certain provisions of Federal Law No. 57-FZ on Foreign Investment in Commercial Entities of Strategic Importance dated April 29, 2008 internationally mandatory.)

7 The foreign approach to the notion of public policy is expressed, for instance, in the International Law Association Recommendations on the Application of Public Policy as a Ground for Refusing Recognition and Enforcement of International Arbitral Awards (2002).

other special grounds for refusal to recognize and enforce a foreign award or judgment apply. The Review gives the example of a respondent that cited failure to give proper notice of the venue and date of an oral hearing. This ground is mentioned specifically in Article V.1(b) of the New York Convention, therefore in this case there is no reason to cite the public policy exception. In practice, such delineation between applying the public policy exception and applying other grounds for refusal to recognize and enforce an arbitral award is of great importance, because most of the other special grounds (including failure to give proper notice of arbitration proceedings to a party) may only be applied on the condition that the party against which the award is invoked cites the relevant ground and submits the necessary evidence.

At the same time, the right of a court to examine at its own initiative whether the implications of the execution of an arbitral award conform to public policy does not release a party from the obligation to provide the court with evidence to substantiate the existence of a conflict with public policy so long as the party has cited such ground in petitioning for refusal to recognize and enforce a foreign judgment. This is addressed in paragraph 3 of the Review. The party must, in the first instance, show that there are negative implications for its rights and lawful interests should the foreign award or judgment be enforced. In the same vein, paragraph 8 of the Review concludes that failure by a foreign legal entity to comply with the proper procedure for approving major transactions provided for by its *lex personalis* is not evidence of violation of Russian public policy, since the rules governing special procedures for approving major transactions serve to protect the shareholders/participants of such foreign company and, therefore, violation of these norms cannot give rise to violation of the rights of the other party under the transaction.

DISPARITY BETWEEN THE NORMS OF RUSSIAN AND FOREIGN LAW AS A POTENTIAL GROUND TO APPLY THE PUBLIC POLICY EXCEPTION

In practice, in many cases violations of Russian public policy arise where the foreign award or judgment is based on the application of particular concepts of foreign law unknown in Russian law or applied differently under Russian law than in the foreign country where the award or judgment was handed down. In this connection the Review contains a number of important, progressive conclusions.

Of key importance is paragraph 5 of the Review, which emphasizes that the recognition and enforcement of a foreign award cannot violate Russian public policy merely on the basis that Russian law does not have norms identical to those of the applicable foreign law. An example is given where the parties decided on foreign law as the governing law of their contract and included a section on warranties and representations. Following a

breach of one of the representations (that the distributor had a valid license for pharmaceutical operations) the foreign arbitration tribunal ordered the party at fault to pay liquidated damages in the amount provided for in the contract. Paragraph 5 points out that, where a foreign arbitral tribunal renders an award that generally complies with the fundamental principles of the Russian legal system, the mere fact that there is no concept in Russian civil law that fully corresponds to the legal institution (concept) of warranties and representations (in the meaning in which such institution applies under English law)[8] cannot serve as a ground for applying the public policy exception and refusing to enforce the foreign arbitral award on this ground.

Paragraph 6 of the Review also states that a departure by a foreign arbitral tribunal from the principle whereby civil liability presupposes a compensation for the losses of a creditor (the so-called "compensatory" nature of civil liability) of itself does not serve as evidence of violation of Russian public policy. Paragraph 6 of the Review sets forth the example of a case where a foreign arbitral award provided for the payment of liquidated damages by a party. In accordance with the position of HAC, the fact that the amount of the liquidated damages exceeded the amount of the actual losses sustained by the creditor cannot serve as evidence of the punitive nature of the liquidated damages and a violation of Russian public policy. It is pointed out that a number of Russian civil law institutions (such as penalty clauses, compensation for infringement of exclusive intellectual property rights) also diverge somewhat from the strictly compensatory nature of civil liability.

However, paragraph 6 of the Review also notes that the Russian courts have great leeway in their discretion in determining whether the punitive element of the liability might not be substantial enough to come into conflict with Russian public policy. The Russian courts are to be guided by the fact that the imposition of penalties shall in particular be a violation of Russian public policy where the amount of such penalties is abnormally high (e.g., exceeding many times the amount of the losses that the parties could have reasonably foreseen at execution of the contract) or, if at the time of agreeing the penalties there were clear signs of abuse of freedom of contract (in the form of exploitation of the reduced bargaining power of the debtor, violation of the public interests or the interests of third parties, etc.). The conclusion may, therefore, be drawn that HAC, having acknowledged the permissibility of deviating from strictly compensatory civil liability, has also preserved the broad scope of the discretion of the Russian courts to find imposed penalties excessive (which would allow for a finding that the enforcement of an award or judgment for the recovery of such penalties would be contrary to Russian public policy).

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[8] It is worth noting that the draft amendments to the Russian Civil Code approved so far in the first reading by the Russian Duma envisage the inclusion of a new Article 431.2 "Representations".

Paragraph 7 of the Review states that the imposition by a foreign court of an obligation on a Russian party to deposit security for the other party's costs as a condition of filing an appeal cannot, as a general rule, be deemed as evidence of violation of Russian public policy. Applying the concept of security for costs, which the European Court of Human Rights has embraced as conforming to the fundamental guarantees of access to a fair trial, is not contrary to Russian public policy, despite such legal concept not being known in Russian procedural law.

Paragraph 9 of the Review states that the existence of the concept of joint marital assets in Russian law does not preclude the recognition and enforcement in Russia of a foreign arbitral award to recover funds from a Russian national whose spouse was not involved in the arbitration proceedings. The Review notes that the rules of Russian family and civil law envisage the possibility of issuing a writ of execution on the personal property of one spouse and, if such property is insufficient, on the portion of joint marital assets to which such spouse is entitled. The Review also makes special mention of the fact that the debtor's spouse did not duly petition the court for invalidation of the transaction on the basis of which the award for recovery of the respective amount was made.

BREACH OF PROCEDURAL STANDARDS AS A POTENTIAL GROUND FOR APPLYING THE PUBLIC POLICY EXCEPTION

Paragraph 12 of the Review states that public policy has a procedural as well as a substantive law element. In other words, a violation of public policy could just as readily take place in a situation where a foreign award or judgment is handed down with violations of the fundamental principles of due process, which of themselves do not form a separate special ground for refusal to recognize and enforce a foreign award or judgment. The Review cites an example where one of the arbitrators chosen was a person who held the position of head of the legal department of the parent company of one of the parties, and the arbitration institution rejected a challenge duly mounted by the other party in the course of the arbitration proceedings. The Russian courts ruled that a clear and manifest breach of the principle of the impartiality and independence of arbitrators may serve as a ground for applying the public policy exception.

However, reservations as to the impartiality and independence of arbitrators do not always qualify as a ground for applying the public policy exception. Paragraph 11 of the Review includes an example of a less intense conflict of interests than in the previous example: an arbitrator chosen by a party had been chosen repeatedly over the course of the last three years by the same party to act as an arbitrator in other disputes. The arbitrator timely disclosed this information to the parties. The other party did not take the opportunity to

exercise its right to file a challenge against such arbitrator and was, therefore, deemed to have waived its right to raise any further objections on the grounds of the questionable impartiality and independence of the arbitrator. In this case the court ruled that there were no grounds for applying the public policy exception.

It is noteworthy that the original version of the Review tabled for the consideration of the HAC Presidium on December 20, 2012 included one other important example of violation of the procedural element of Russian public policy (paragraph 11 of the original version of the Review).[9] This had to do with a situation where an arbitral award is rendered by a so-called "truncated tribunal" (two of three arbitrators) because in the concluding stage of the arbitration proceedings it transpires that one of the arbitrators is unable to perform the functions of an arbitrator (e.g., in connection with the death of the arbitrator). The original version of the Review stated that such award made in the absence of any arbitrator chosen by a party is contrary to Russian public policy because it violates the principle of equality of the parties to a dispute.

In the ensuing discussion, this section of the draft Review drew serious criticism. Those who objected stated that all arbitrators (whether chosen by a party or appointed by the arbitration institution) must comply with a uniform standard of impartiality and independence, therefore the inability of an arbitrator chosen by a party to take part in making an award in the concluding stage of arbitration proceedings cannot serve as proof of violation of the principle of equality of the parties. This contentious issue was removed from the final draft of the Review.[10]

COMMERCIAL BRIBERY AS A POTENTIAL GROUND FOR APPLYING THE PUBLIC POLICY EXCEPTION

Paragraph 2 of the Review includes another example where the Russian courts have ruled that there were sufficient grounds to refuse to recognize and enforce a foreign arbitral award for reasons of public policy. In this matter, the Russian court was considering a petition for the recognition and enforcement in Russia of a foreign arbitral award and was shown a final verdict of a Russian court handing down a criminal sentence under Article 204.3 of the Russian Criminal Code ("Commercial Bribery") for the director of a Russian

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9 *See* the original version of the Review on the official HAC website at: http://www.arbitr.ru/upimg/C216FE2E282B463CA0D4617DA8DAFE8F_20dec.pdf (March 6, 2013).

10 The matter of whether an arbitral award may be rendered by a "truncated" tribunal was previously considered in Decree of the HAC Presidium No. 4325/10 dated July 20, 2010. In the case in question, the highest Russian court instance established that the award made by the International Commercial Arbitration Court of the Russian Chamber of Commerce and Industry was contrary to public policy on the ground that an arbitrator chosen by one of the parties had not taken part in rendering the award as he had died immediately after the oral proceedings were completed.

federal state unitary enterprise who had knowingly entered into a contract on behalf of the enterprise on unfavorable terms, of which the representatives of the counterparty were aware at the time that the contract was executed, having bribed the director of the enterprise. It is important to understand that the controversial arbitral award related only to the imposition of a penalty under a contract that effectively was not being performed by either party, rather than payment for goods or services that had actually been supplied or rendered.

CONCLUSIONS

Analysis of the Review indicates that on the whole it is geared towards a narrow interpretation of the concept of public policy and aimed at bringing it into line with established practice in the West. Of the twelve examples cited in the Review, there were only two where the Russian courts supported the conclusion that there had been a violation of Russian public policy. The two examples include the cases discussed above of the giving of a commercial bribe to a director by the representatives of the other party (paragraph 2 of the Review) and the flagrant violation of the principle of the impartiality and independence of arbitrators (paragraph 12 of the Review). It is a key feature of all of the other cited examples that HAC has shown that a broader interpretation of the concept of public policy is inadmissible. We believe that this will facilitate the development of more acceptable Russian court practice in cases related to the recognition and enforcement of foreign arbitral awards and court judgments. Of particular importance is the HAC conclusion that Russian public policy is not affected by foreign awards or judgments that are based on the application of foreign substantive and procedural law institutions that do not exist in Russian law.

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Please do not hesitate to contact us with any questions.

April 10, 2013