

# The Impact of Sanctions on Arbitration: A Recent Case Study Involving the EU Sanctions Regime

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In the case of *Ministry of Defence and Support for Armed Forces of the Islamic Republic of Iran v International Military Services Ltd* [2019] EWHC 1994 (Comm), the High Court examined in detail the effect of the EU sanctions regime against Iran in the context of the enforcement of arbitral awards.

The High Court found that EU sanctions precluded Iran’s Ministry of Defence (“MODSAF”) from enforcing the interest element of an ICC award against International Military Services Limited, a UK state-owned supplier of military vehicles (“IMS”), which would have accrued during the period MODSAF has been subject to EU sanctions. The judgment provides insight into the approach of the English courts in interpreting sanctions regimes and suggests that English courts may be sympathetic under certain circumstances to the argument that obligations owed to EU sanctioned entities should be suspended while sanctions remain in place.

Although this case dealt with the application of the EU sanctions regime at the enforcement stage, the same analysis may also be relevant to the merits phase of certain international arbitration proceedings, given the prevalence of arbitral institution rules that hold that arbitral tribunals should make all efforts to ensure that an award is enforceable.

**For further discussion of sanctions in the context of arbitrations, see details of our forthcoming seminar on Sanctions in International Arbitration at Hong Kong Arbitration Week 2019 [here](#).**

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## Factual background

The underlying dispute arose out of two supply contracts entered into in the 1970s under which IMS agreed to supply military vehicles to MODSAF. Following the Iranian revolution, both contracts were terminated, giving rise to disputes which were heard in two related ICC arbitrations in the Hague, the first one initiated by MODSAF and the second by IMS.

The first arbitration resulted in an award to MODSAF for sums payable under the terminated contracts, interest on those sums, and legal costs in respect of the arbitration (the “First Award”). The second arbitration was also resolved in MODSAF’s favour, for the same reasons the tribunal gave in the First Award, and MODSAF was awarded its costs (the “Second Award”).

MODSAF applied to enforce the awards in England under section 101 of the Arbitration Act 1996 but the proceedings were adjourned pending the determination of a challenge to the arbitration awards brought by IMS in the Netherlands. IMS paid into court a substantial sum by way of security for the awards, as a condition of the adjournment of the English proceedings.

The Court of Appeal in the Hague partially set aside the First Award, decreasing IMS’s liability for balances outstanding under the two terminated supply contracts. The Supreme Court of the Netherlands dismissed MODSAF’s appeal against that decision.

During the set aside proceedings, MODSAF was sanctioned under EU Council Regulation 423/2007 concerning restrictive measures against Iran (most recently succeeded by EU Council Regulation 267/2012).

MODSAF in any event subsequently filed an application in the English High Court seeking an order for judgment to be entered in terms of the awards and a declaration that the security for the awards that had been paid into court on the adjournment of the original enforcement proceedings should be held for the benefit of MODSAF.

Although it was common ground between the parties that the sums due to MODSAF under the First Award and Second Award could not be paid due to the effect of the sanctions regime, MODSAF maintained that

there was no reason why the court could not enter judgment in terms of the awards under the Arbitration Act 1996.

Relying upon Articles 38 and 42 of the EU Council Regulation 267/2012 (the “EU Regulation”), IMS argued that MODSAF was not entitled to enforce the interest component of the First Award in respect of the period during which MODSAF has been designated as a sanctioned entity.

## The determination of the Court

After a thorough examination of the relevant provisions of the EU Regulation, Mr Justice Phillips in the High Court ruled in favour of IMS, finding that the EU Regulation bars MODSAF from enforcing the interest aspect of the First Award in respect of the period during which MODSAF has been the subject of sanctions.

In passing, Mr Justice Phillips noted that his conclusion was in keeping with the stance taken by the Office of Financial Sanctions Implementation of HM Treasury (“OFSI”). As set forth in OFSI’s official guidance:

“If a court has ordered a judgment in favour of a person subject to an asset freeze, under EU regulations, and there are no licensing grounds to allow the payment to be made, the third party cannot be made subject to any further liability (such as accruing interest) for their non-payment while the sanctions continue to apply”.

## Interpretation of EU instruments generally

In order to guide his interpretation of the EU Regulation and its application to the facts of the present case, Mr Justice Phillips restated the key principles that guide the proper interpretation of EU instruments.

Mr Justice Phillips noted that both the language and the purpose of EU legislation, in turn, ought to be considered during the interpretative process, and the degree of emphasis on purpose is what distinguishes the interpretative method applied to EU instruments from that traditionally applied to English statutes. It was noted that the well-established EU principle of proportionality must also inform the interpretation of EU instruments. This requires EU instruments to be interpreted such that:

“[T]he measures sought to be implemented by them are appropriate for attaining the legitimate objective pursued by the instrument and do not go beyond what is necessary to achieve those objectives”.

### **Interpretation of Article 38 of the EU Regulation**

Article 38 of the EU Regulation states that:

“No claims in connection with any contract or transaction the performance of which had been affected, directly or indirectly, in whole or in part, by the measures imposed under [the EU Regulation]...shall be satisfied, if they are made by...designated persons”.

In accordance with the key principles of interpreting EU instruments outlined above, Mr Justice Phillips turned first to the language of Article 38. It was common ground that enforcement proceedings under section 101 of the Arbitration Act 1996 was a “*claim*” for the purposes of Article 38 of the EU Regulation; the definition of “*claim*” in Article 1(c) of the EU Regulation was decisive.

The parties were in disagreement however on the question of whether the First Award could properly be described as a “*transaction*” to which Article 38 of the EU Regulation relates. Although Mr Justice Phillips found that there was force in the contention that it was unusual to describe the First Award as being a “*transaction*”, this was nonetheless the proper application of Article 38 in light of the very broad definition given to this term in Article 1(d) of the EU Regulation.

In order to ensure that Article 38 of the EU Regulation was being interpreted properly, Mr Justice Phillips then turned to the purpose of that provision, which was eventually deemed to reinforce the result of the interpretation of the language of Article 38. This required a review of the English court and European Court of Justice authorities dealing with the corresponding clause to Article 38 in EU Regulation 1110/2008 (the immediate predecessor to the EU Regulation). Mr Justice Phillips concluded:

“I consider that the purpose of Article 38 is to prevent civil claims being brought against a party as a result of the fact that their performance of a contract or transaction was impeded by the operation of the sanctions. I am satisfied that the application of Article 38 to prevent MODSAF

from enforcing the interest component of the [First] Award in respect of the sanctions period falls well within that purpose”.

### **Interpretation of Article 42 of the EU Regulation**

Although the determination that Article 38 of the EU Regulation operated to preclude IMS from incurring interest liability on the First Award while MODSAF was the subject of sanctions, Mr Justice Phillips still considered Article 42 and its applicability to the facts of the case. In relevant part, Article 42 provides as follows:

“[T]he refusal to make funds...available, carried out in good faith on the basis that such action is in accordance with [the EU] Regulation, shall not give rise to liability of any kind on the part of the natural or legal person, entity or body implementing it...”.

The purpose of Article 42 was held to be to afford protection to persons who have mistakenly, but in good faith, frozen or refused to make funds available to counterparties by reference to the EU Regulation. Given this purpose, it was held that the actual scope of this provision is narrower than a plain reading of its language might indicate. It follows that Mr Justice Phillips concluded that Article 42 of the EU Regulation was not applicable to the facts of the case, given that IMS had refused funds by the appropriate (and not mistaken) reference to Article 38.

### **Implications of the ruling on parties contracting with sanctioned entities**

The High Court judgment is interesting for the purposive rather than literalist approach Mr Justice Phillips applied in his interpretation of each of the key sanctions provisions, coming to the common sense position that a prohibition against one party claiming against another for failure to pay as a result of sanctions must be widely interpreted to cover claims for accrued interest. Parties who have suspended or intend to suspend performance of their contractual obligations to sanctioned entities may find this interpretative approach reassuring.

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