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SUBSTANTIVE *ORDRE PUBLIC* IN RUSSIAN CASE LAW ON THE RECOGNITION, ENFORCEMENT AND SETTING ASIDE OF INTERNATIONAL ARBITRAL AWARDS

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I. INTRODUCTION

The recognition and enforcement of international arbitral awards in Russia is carried out in accordance with the rules established by the Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958 (the "New York Convention"), as well as by the Law of the Russian Federation "on International Commercial Arbitration" of 1993 and the Commercial ("*Arbitrazhnyi*") Procedure Code of 2002 (the "CPC"). The provisions in these Russian laws on recognition and enforcement essentially reproduce the relevant clauses in the New York Convention.

Under Article 244(1)(7) of the CPC and Article 36(1)(2) of the Russian Federation Law on International Commercial Arbitration, a Russian court may refuse to recognize and enforce an arbitral award if it is contrary to Russian public policy (*ordre public*). This ground is also stipulated in the New York Convention (Art. V(2)(b)). If the same Russian court determines that a Russian arbitral award violates Russian public policy, it may also set aside the award.[1] Therefore, the means by which Russian courts interpret the public policy clause may be a key factor for parties in international commercial arbitration.

Russian courts are generally prohibited from reviewing an arbitral award on the merits; however, the public policy clause establishes de facto an exception to this rule.[2] Public policy, in the context of the recognition and enforcement of international arbitral awards, is a broad and vague term; it encompasses both substantive and procedural law.[3] This article addresses the complicated scope of substantive public policy in Russia.

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[1] Art. 34(2)(2) of the Russian Federation Law on International Commercial Arbitration.

[2] *See, e.g.,* in German doctrine, REINHOLD GEIMER, INTERNATIONALES ZIVILPROZESSRECHT 1176 (R. 3909a) (5th ed. 2005).

[3] *See* on German doctrine, Otto Sandrock, *Gewöhnliche Fehler in Schiedsprüchen: Wann können sie zur Aufhebung des Schiedsspruchs führen?*, BETRIEBSBERATER 2175 (2001); *see* on Russian doctrine, Boris R. Karabelnikov, *Problema publichnogo poriadka pri privedenii v ispolnenie resheniy mezhdunarodnognyh kommercheskikh arbitrazhey* [*Public policy issue on recognition and enforcement of international arbitral awards*], 8 ZHURNAL ROSSIYSKOGO PRAVA [RUSSIAN LAW JOURNAL] 102 (2001).

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II. RUSSIAN PUBLIC POLICY

The High Commercial Court of the Russian Federation (the "HCC") formulated the most comprehensive definition of Russian Federation public policy:[4]

> The international arbitral award can be deemed to violate Russian Federation public policy if its enforcement would result in actions expressly forbidden by law or causing damage to the sovereignty or security of the state, affecting interests of large social groups, being incompatible with the fundamental principles of various states' economic, political and legal systems, disturbing citizens' rights and liberties, as well as being contrary to basic principles of civil legislation, such as equality of the participants, inviolability of property and freedom of contract.[5]

At first glance one may notice that this definition is not limited to legal aspects. Causing damage to the sovereignty or security of the state or affecting the interests of large social groups is more of a political matter and not necessarily a legal one. It should be noted that there are statements in Russian doctrine from which it follows that the public policy exception comprises political, *i.e.* non-legal aspects. Thus, for instance, T.N. Neshatayeva distinguishes public policy *stricto*

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[4] HCC judicial collegium decision of Dec. 6, 2007, No. 13452/07. The HCC heard a case on the enforcement of an award from the International Commercial Arbitration Court at the Russian Chamber of Commerce and Industry ("ICAC") compelling a Russian company to pay damages in the amount of $339,840 for the breach of a repair work contract in favor of a Ukrainian company. The HCC confirmed the lower court's conclusion that the award did not violate Russian public policy.

[5] (All translations into English are by Dmitry Davydenko unless otherwise indicated.) *See also*, a Moscow Circuit Federal Commercial Court ("FCC") ruling of April 3, 2003, No. КГ-А40/1672, where the same definition was used. The court considered an application of a Russian company to set aside on public policy grounds an ICAC award rendered in favor of an Irish company (1,588,636.20 Russian rubles debt and 1,882,471.14 Russian rubles damages). The applicant alleged that the arbitral tribunal misinterpreted the contract, erroneously found it duly concluded and misapplied the Civil Code provisions on remedies for breach of contract. The court formulated the above public policy definition to clarify that such allegations clearly fall beyond its scope.

In another case, the Moscow Circuit FCC ruling of Sept. 29, 2005, No. КГ-А40/9192-05 included a defense of state capacity interests in public policy. A Swiss company sought to enforce in Russia a German arbitration monetary award against a Russian company. The debtor was a former state-owned company privatized after the dissolution of the USSR. It argued that since the debt arose when the company was state-owned, the proper debtor was the Russian state, as the USSR's legal successor. On this ground it alleged that enforcing the award rendered against the wrong respondent was contrary to Russian public policy. However, both the first instance and cassation courts found that the enforcement in no way violated public policy which consists of "fundamentals of legal order, universally accepted morality principles, as well as state defense interests."

sensu and *lato sensu*. The former limits the public policy notion to fundamental principles of Russian law, whereas the latter also includes morality bases, core religious postulates, and main economic and cultural traditions, whether or not they are expressly established by law.[6]

However, a review of the case law shows that such broad interpretation is rare in practice. Only three cases were found in which political and economic reasons formed the basis for the non-enforcement of arbitral awards.

In particular, such grounds underlie the Commercial Court of Irkutsk Region decision[7] and Volgo-Vyatsky Circuit Federal Commercial Court ("FCC") ruling.[8] In the case of the former judgment, subsequently set aside by an HCC ruling,[9] a German company sought to enforce in Russia an ICAC award against a Russian municipal water and energy public utility for the recovery of €1,230,252.84 and $89,442.20. The court refused to enforce the award, inter alia, on the grounds that it was rendered against an entity of strategic importance to the municipality and to the whole region, that its enforcement would affect negatively the economic and social development of the municipality, and would affect the interests of large social groups, namely the population of the municipality. Hence, the court concluded that allowing recovery of the awarded amount would be incompatible with the principles of the economic and legal systems underlying the Russian Federation as a whole, and its constituent entities of the federation in particular. The High Commercial Court Presidium found no contravention of public policy in this case.

In the latter case, a Panamanian company applied for enforcement of an ICC award granting recovery of some $50,000 against a Russian joint stock company. The court of the first instance (a lower court) granted the application, but the cassation court quashed the lower court judgment, finding that the defendant appeared on a government-approved list of companies producing goods or services of strategic importance for state security; the court held that enforcement of the award would violate Russian public policy as the recovery of the awarded amount would lead to the debtor's insolvency, which would adversely affect the social and economic situation in the city of Nizhny Novgorod, the region, as well as the Russian Federation on the whole.[10] However, it should be mentioned that in both cases the courts also invoked other public policy considerations, such as the

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[6] T.N. NESHATAYEVA, MEZHDUNARODNOE CHASTNOE PRAVO I MEZHDUNARODNYI GRAZHDANSKIY PROTSESS [PRIVATE INTERNATIONAL LAW AND INTERNATIONAL CIVIL PROCEDURE] 560 (2004).

[7] Irkutsk Region Commercial Court decision of May 4, 2008 in case No. A19-2579/08-31-10. This decision was upheld by an East Siberia Circuit ruling of July 3, 2008 No. A19-2579-Ф02-3028/2008.

[8] Volgo-Vyatsky Circuit FCC ruling of Feb. 17, 2003, No. A43-10716/02-27-10исп.

[9] High Commercial Court Presidium ruling of Feb. 3, 2009, No. 10680/08.

[10] *See* Diane V. Tapola, *Recent Case Law on the Recognition and Enforcement of Foreign Arbitral Awards in Russia,* 22(4) J. INT'L. ARB. 331, 340-44, (2005); William R. Spiegelberger, *The Enforcement of Foreign Arbitral Awards in Russia: An Analysis of the Relevant Treaties, Laws and Cases*, 16 AM. REV. INT'L. ARB. 261, 298 (2005).

principles of the private parties' good faith and the inadmissibility of punitive damages.[11]

By contrast, the High Court of the Russian Federation (the "Russian High Court"), which was competent to consider cases on the recognition and enforcement of arbitral awards in commercial disputes before the 2002 procedural law reform,[12] interpreted public policy to mean bases of legal order expressly established by law.[13] In the case in question a French company sought to enforce an Arbitration Institute of the Stockholm Chamber of Commerce award against a Russian company, which claimed a violation of Russian public policy. The court defined the scope of Russian public policy as including, inter alia, its Constitutional and international treaty provisions. The court applied the public policy clause, referring to the violation of basic principles of Russian civil legislation.

The third case is a more recent one (Case No. A56-60007/2008). The Arbitration Institute of the Stockholm Chamber of Commerce awarded damages from a Russian company to a Swedish company in the amount of €20,000,000 caused by the breach of ship-construction contracts and an agreement on the optional acquisition of two vessels, as well as legal expenses. The court of the first instance (Saint Petersburg Commercial Court) on February 20, 2009 refused to grant the award recognition and enforcement, in particular, on the grounds that:

> The debtor is a strategic company. The main requestor of its production is the government. The state also has a special right to take part in the management of the company. The presented balance sheet and the net assets calculation show that enforcement of the award paralyzes the company's work for a prolonged period and may cause its insolvency, which would inflict damage not only to this particular company but also to the whole state, and the citizens' interests would be affected.

The cassation court (North-Western Circuit FCC) on April 24, 2009 rejected such reasoning, but upheld the lower court judgment on other grounds. In particular, it found that the relevant contract had not been entered into as it was not duly approved by the Swedish company's board of directors. The HCC judicial collegium on September 11, 2009 found that no public policy violation occurred, noting that the contract conclusion had been established by the arbitral tribunal, and transmitted the case to the HCC Presidium. The latter discovered that

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[11] On these principles see in detail below.

[12] In the period 1997-2002, two systems of Russian courts — courts of general jurisdiction and commercial courts — competed for competence to resolve cases related to international commercial arbitration activity. *See* ALEKSANDR I. MURANOV, ISPOLNENIE INOSTRANNYKH SUDEBNYKH I ARBITRAZHNYKH RESHENIY: KOMPETENTSIA ROSSIYSKIKH SUDOV [ENFORCEMENT OF FOREIGN JUDGMENTS AND ARBITRAL AWARDS: COMPETENCE OF RUSSIAN COURTS] 168 (2002). Currently such cases fall within the competence of commercial courts (Art. 32 of the CPC).

[13] Russian High Court decision of May 26, 2000, No. 5-Г00-59.

the arbitral award had been challenged by the debtor in the Svea Court of Appeal. The New York Convention (Article VI) and the Russian law on International Commercial Arbitration (Article 36(2)), which is based on the UNCITRAL Model Law, provide that the authority before which the application for enforcement of the award is sought may, if it considers it proper, adjourn the decision on the enforcement of the award if an application for the setting aside of the award has been made to a competent authority of the country in which, or under the law of which, the award was made. Also, Russian procedural law provides for a Russian court's discretion to suspend a case if another case is pending in a foreign court whose judgment might be relevant to the case in a Russian court. The HCC took this into account, and on November 3, 2009 suspended the hearing until the case in Sweden on the Russian debtor's complaint was resolved.

There is also a view in Russian legal doctrine that considers reference to non-legal criteria when applying the public policy clause to be unacceptable.[14]

A similar stance is taken by German law. For instance, the German Federal Court (the *Bundesgerichtshof*, "BGH") considers public policy to be violated if "the result of application of foreign law in the particular case would be contrary to the bases of the German legal order and the conceptions of justice that they embody."[15]

The reference to social, economic and political criteria in the context of public policy is questionable as it contradicts the constitutional principle of separation of powers,[16] in that it requires a judge to assess expediency rather than the legality of the recognition and enforcement of the arbitral award. In our opinion, these principles can fall under the scope of public policy only indirectly, through legal rules, and can be established only by the legislature. The definition cited by the HCC Presidium seems to take its roots in the socialistic legal doctrine which was alien to the principle of separation of powers and recognized much wider public implications of civil-law relations than modern Russian law.[17]

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[14] D.V. Afanasyev, *Narushenie publichnykh interesov kak osnovanie dlia izmenenia ili otmeny sudebnogo akta v poriadke nadzora* [*Violation of public interests as a ground for amending or setting aside a judgment by review procedure*], 1 ZAKONODATELSTVO I EKONOMIKA [LEGISLATION AND ECONOMICS] 30 (2006).

[15] "Mit diesem [ordre public] ist ein ausländisches Urteil nicht schon dann unvereinbar, wenn der deutsche Richter ─ hätte er den Prozeß entschieden ─ aufgrund zwingenden deutschen Rechts zu einem anderen Ergebnis gekommen wäre. Maßgeblich ist vielmehr, ob das Ergebnis der Anwendung ausländischen Rechts im konkreten Fall zu den *Grundgedanken der deutschen Regelungen und den in ihnen enthaltenen Gerechtigkeitsvorstellungen* in so starkem Widerspruch steht, daß es nach deutscher Vorstellung untragbar erscheint" (Translation by William Spiegelberger) (Emphasis added), Bundesgerichtshof [BGH], Judgment of April 21, 1998, Case No. XI ZR 377-97, 32 NJW 2358 (1998).

[16] Russian Constitution, Art. 10.

[17] E.A. SUKHANOV, 1 GRAZHDANSKOYE PRAVO [CIVIL LAW] 12 (3d ed. 2006). Same author in DIE NEUGESTALTUNG DES PRIVATRECHTS IN MITTELOSTEUROPA UND OSTEUROPA 130 (Norbert Horn ed., 2002).

Traces of the influence of Soviet doctrine can also be found in the Moscow Circuit Federal Commercial Court ("FCC") ruling on enforcement of an award from the Arbitration Court at the Moscow Chamber of Commerce and Industry regarding a dispute which arose from a meat supply contract between a German company and several Russian companies.[18] The ruling states that the public policy exception implies priority of state interests over private interests leading the court to conclude that "as the award in question was rendered upon a private dispute of the parties to a contract, it cannot affect the bases of the Russian legal order." This conclusion — wrong in its essence — left no trace in subsequent published case law. However, this judgment raises an issue of the correlation between public and private elements of the public policy exception.

Indeed, the abovementioned HCC ruling can be interpreted to mean that the exception only applies in cases where issues of public importance are involved, thus, implying that public interests prevail over private ones. The concept of sovereignty, which is traditionally given much importance in the context of recognition and enforcement of foreign judgments,[19] also speaks to such an interpretation.

Yet such approach would be too narrow. Apart from the protection of public interests, the public policy exception also serves to guarantee basic justice, the aim of which is to establish a balance of private law interests.[20] It should be noted, though, that despite the definition principally implying a priority for public interests, in practice — as will be shown below — cases where the courts try to restore the balance between private interests are more frequent.

It is a controversial issue in Russian case law whether public policy may be violated where the arbitral tribunal has applied Russian substantive law. There is an opinion that reference to the public policy violation may be relevant only if foreign (non-Russian) substantive law was applied to the dispute. Otherwise, only the failure to comply with the fundamental principles of procedural law may be referred to.[21] Yet there are judgments which find the public policy exception appropriate in such cases.[22]

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[18] Moscow Circuit FCC ruling of June 5, 2003, No. КГ-А40/2880-03.

[19] ELEONORA I GERASIMCHUK, DIE URTEILSANERKENNUNG IM DEUTSCH-RUSSISCHEN RECHTSVERKEHR [THE MUTUAL RECOGNITIOON AND ENFORCEMENT OF CIVIL LAW JUDGMENTS BETWEEN GERMANY AND RUSSIA] 134 (2007).

[20] These two dimensions are also set out in German doctrine. Thus, Geimer distinguishes "Machterhaltungs- und Gerechtigkeitsfunktion des ordre public"; Reinhold Geimer, *in* ZIVILPROZESSORDNUNG (Richard Zöllner ed., 25th ed. 2005). *See also* David Quinke, *Schiedsvereinbarungen und Eingriffsnormen,* 5 SCHIEDSVZ 246, 248 (2007).

[21] HCC decision of Dec. 6, 2007, No. 13452/07. In this case the award creditor referred, inter alia, to a violation of the freedom of contract principle. The court took into account that the arbitral tribunal applied Russian substantive law and held that the substantive public policy exception was not applicable; *see also* Moscow Circuit FCC ruling of Nov. 18, 2002, No. КГ-А40/7628-02. The debtor invoked the public policy exception with regard to various violations of the Russian Civil Code ("CC") provisions. The court found that compliance with Russian public policy is to be examined only where

It should be mentioned that German law allows the public policy exception where a non-German court applied German substantive law.[23] In our opinion, this stance, supported by the Russian legal doctrine,[24] is correct. As mentioned above, the public policy exception purports not only to shield public interests, but also to restore basic justice. An arbitral award can be fundamentally unjust regardless of the applicable law. Such fundamental injustice may result not only from non-compliance with the principles of procedural law, but also from principles of substantive law (be it Russian or foreign). Besides, as is specified in Russian legal doctrine, it may be caused by the very fact of the application of Russian law, despite conflict of laws principles.[25]

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the tribunal applies non-Russian substantive law. The court said that this followed from Article 1193 of the CC ("Public policy exception") which provides that foreign substantive law does not apply if the consequences of its application contradict Russian public policy.

[22] Russian High Court decision of Nov. 2, 1999, No. 5-Г99-86 (A Russian bank applied to the ICAC to recover a debt which arose from a loan agreement. The claim was satisfied. The debtor applied to a Russian court to set aside the award, invoking, in particular, the invalidity of the loan agreement and hence claiming a public policy violation. The court held that since the arbitral tribunal resolved the case on the basis of Russian law, the court could have applied the public policy exception only if Russian statutes were misapplied or misconstrued.); Moscow Circuit FCC ruling of April 17, 2003, No. КГ-А40/1964-03 (The Russian debtor referred to a violation by the ICAC in the award rendered in favor of a Polish bank of civil-law principles constituting part of Russian public policy. The court of the first instance said that the public policy exception was inapplicable as the dispute was resolved by the arbitral tribunal with the application of Russian substantive law. The court of cassation found that this conclusion was incorrect and the compliance of the award with basic principles of Russian civil law must be established in any event.).

[23] REINHOLD GEIMER, INTERNATIONALES ZIVILPROZESSRECHT 11(RN.29)(5th ed. 2005).

[24] Aleksander Muranov, *Primenenie mezhdunarodnym kommercheskim arbitrazhem rossiyskogo prava: nevozmozhnost ssylki na narushenie publichnogo poryadka Rossii? [Application of Russian law by international commercial arbitral tribunal: impossibility of reference to Russian public policy violation?],* 1 MOSKOVSKI JURNAL MEZHDUNARODNOGO PRAVA [MOSCOW J. INT'L LAW]174-94(2003).

[25] *Id*. at 182.

III. APPLICATION OF PUBLIC POLICY TO PROTECT PRIVATE INTERESTS

A. *General Observations: Fundamental Principles of Law; Whether the Award May Be Reviewed on the Merits*

In practice, compliance of an arbitral award with the Russian *ordre public* is usually limited to compliance with "the fundamental principles of law, i.e. its core bases which are universal, peremptory to the highest extent and are of particular general importance."[26] First of all, the courts[27] refer to the provisions of Article 1 of the Russian Civil Code ("CC") which specify the "Chief Principles of Civil Legislation."[28] It is also demonstrated below that in a number of cases the courts

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[26] Moscow Circuit FCC ruling of Feb. 14, 2006, No. КГ-А40/247-06. In this case a foreign company sought to set aside an award from the ICAC which refused to allow penalties and damages to be assessed against a Belarusian company. The applicant alleged that the award exempted the debtor from liability without legal grounds, which he considered contrary to public policy. Both the courts of the first instance and cassation considered public policy as limited to fundamental principles of law and social order and thus found no public policy violation.

[27] HCC Presidium ruling of March 20, 2007, No. 15421/06 (case on disaffirmation of a ICAC money award which was rendered in favor of a Russian company against a British Virgin Islands (BVI) company. The court held that, in accordance with the principle of the guarantee of the reinstatement of the civil rights in case of their violation, and their protection in the court specified in Article 1 of the CC, the court must examine whether the awarded penalty has a restorative or a punitive purpose); HCC Presidium ruling of Sept. 19, 2006, No. 5243/06 (case on enforcement of a monetary award from Stockholm arbitration court. The court referred to the same principle specified in Article 1 of the CC and concluded that awarding punitive penalties complies with Russian public policy unless its amount is disproportionate to the consequences of the breach of contract); Moscow Circuit FCC ruling of Oct. 13, 2008, No. КГ-А40/9254-08 (case on disaffirmation of the ICAC award confirming a right of a Russian lessee to require 10 years prolongation of the lease agreement on the same conditions as was established in the agreement itself. The court referred to the principle of equality of the private parties specified in Article 1 of the CC and found that the award violated this principle by compelling one of the parties to prolong the lease agreement on disadvantageous terms and conditions (the lease payment substantially lower than the market rate)); Povolzhski Circuit FCC ruling of Feb. 19, 2004, No. А06-1779У-4/03 (the court of the first instance set aside a monetary award rendered by the Arbitration Court at the Astrakhan Chamber of Commerce and Industry on public policy grounds, having established misapplication by the arbitral tribunal of specific rules of the CC governing the onerous services provision. However, the court of cassation reversed its judgment and held that only rules specified in Article 1 of the CC constitute elements of Russian public policy).

[28] Article 1. Chief Principles of the Civil Legislation

1. The civil legislation shall be based on recognizing the equality of participants in the relationships regulated by it, the inviolability of property, the freedom of agreement, the inadmissibly of anybody's arbitrary interference into the private

have formulated some other Russian civil-law principles. These courts partly relied on provisions of Section 1 of the CC, but in some cases inferred civil-law principles from the CC, Section IV, "Particular Obligations" or did not refer to any specific rules of law at all.

Some courts invoke the "principle of lawfulness" as a fundamental principle of law of the Russian Federation,[29] referring to Article 15(2) of the Russian Constitution, which provides that all state and municipal authorities, officials, individuals and their associations must abide by the Russian Constitution and laws. For example, the Irkutsk Region Commercial Court mentioned in a decision on the refusal to recognize and enforce a foreign arbitral award that "the principle of lawfulness implies that legal relations of the parties to the contract shall be in strict compliance with the civil legislation rules."[30] The court found that awarding a payment of funds under an unlawful contract as well as non-application by the arbitral tribunal of the substantive law agreed upon by the parties violated the lawfulness principle. This decision was subsequently set aside

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affairs, the necessity to freely exercise the civil rights, the guarantee of the reinstatement of the civil rights in case of their violation, and their protection in the court.

2. The citizens (natural persons) and the legal entities shall acquire and exercise their civil rights of their own free will and in their own interest. They shall be free to establish their rights and duties on the basis of an agreement and to define any terms of the agreement, which are not in contradiction with legislation.

The civil rights may be restricted on the basis of the Federal Law and only to the extent, to which it shall be necessary for the purposes of protecting the foundations of the constitutional system, morality, the health, the rights and the lawful interests of other persons, of providing for the defense of the country and for the state security.

3. Commodities, services and financial means shall move unhindered throughout the entire territory of the Russian Federation.

Restrictions on the movement of commodities and services shall be imposed in conformity with the Federal Law, if this is necessary to provide for security and to protect the human life and health, the environment and the cultural benefits.

Hereinafter we cite to this CC English translation from web site http://www.russian-civil-code.com.

[29] Irkutsk Region Commercial Court decision of May 4, 2008, No. A19-2579/08-31-10. *See* note 7 and accompanying text. *See also* Moscow City Commercial Court decision of Oct. 16, 2007, No., A40-31695/07-13-318; the lawfulness principle appeared to be recognized as part of Russian public policy in the West Siberia Circuit FCC ruling of Nov. 11, 2005, No. Ф04-8069/2005 (16756-A03-12). The debtor referred to a violation of the lawfulness principle, and the court did not expressly clarify if this principle is a part of Russian public policy but reviewed the award in light of the debtor's reasoning and found no violation of the legal rules in question.

[30] Irkutsk Region Commercial Court decision of May 4, 2008, No. A19-2579/08-31-10. *See* note 7 and accompanying text.

by a higher court.[31] At the same time, the HCC Presidium, in its decision of December 6, 2007 (discussed in Section II, *supra*), did not mention whether the principle of lawfulness may be invoked even hypothetically and what is its content. The inclusion of the principle of lawfulness into the scope of the Russian law fundamental principles is highly controversial as basically it leads to reviewing the arbitral award on the merits, which clearly contradicts the intent of the public policy exception. It should be noted that this reasoning has also been expressed in case law.[32] A German debtor alleged that the arbitral award rendered in favor of a Russian company contravened the legality principle and referred to misapplication of certain Russian rules of law. The court found that such reasoning amounted to an attempt to review the case on the merits.

Even assuming that the lawfulness principle can be cited as part of Russian public policy, its application must be limited to the most important law provision violation. Quoting a Russian lawyer and arbitrator, "the lawfulness principle operates in international commercial arbitration in an alleviated fashion, in a 'reduced mode.' The 'Law On International Commercial Arbitration' actually acknowledges the right of an international commercial arbitral tribunal to make a mistake, or even supposing it does not acknowledge such right, it leaves the committed mistakes without legal consequences, [and thus] 'amnesties' the arbitral tribunal."[33]

The control over compliance of the arbitral award with public policy, including Russian civil-law principles, by no means permits its review on the merits.[34] Thus, the courts consistently refuse to allow a public policy defense where the arbitral tribunal misapplied some special rules of the Russian civil

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[31] HCC Presidium ruling of Feb. 3, 2009, No. 10680/08. *See* note 9 and accompanying text.

[32] Moscow Circuit FCC Ruling of June 10, 2003, No. КГ-А40/3039-03.

[33] Aleksandr I. Muranov, *Razlichia mejdu gosudarstvennymi arbitrajnymi sudami i mejdunarodnym kommercheskim arbitrajem v svete poniatia "zakonnost"* [*Differences between state commercial courts and international commercial arbitration in the light of the concept of "lawfulness"*], 5 ADVOKAT [ATTORNEY] 14 (2009).

[34] HCC Presidium ruling of Oct. 24, 2000, No. 9083/99 (In that case the courts of the first instance and cassation refused to enforce the monetary award from the Arbitration Court at the Russian Lawyers League rendered in favor of a Cyprus company against a Russian debtor on the ground that it contravened currency control regulations. The HCC Presidium reversed those judgments and held that review of the award on the merits is not allowed under Russian law); HCC Presidium ruling of Sept. 12, 2006, No. 4485/06 (The court of the first instance granted enforcement of the ICAC award in favor of Irish and Dutch companies against a Russian debtor upon a dispute which arose from a loan agreement. The cassation court reversed its judgment on the ground that the actual lending had not been proven and thus the legality principle was infringed upon by the arbitral tribunal. The HCC refuted this conclusion and held that this approach amounted to a reappraisal of the facts established by the arbitral tribunal); Moscow Circuit FCC ruling of Feb. 14, 2006, No. КГ-А40/247-06, *supra* note 26.

law.[35] For example, the courts dismissed the parties' claim of a public policy violation through misapplication by the arbitral tribunal of the Russian civil-law rules on set-off,[36] on onerous provision of services (Chapter 39 of the CC),[37] on recovery of damages,[38] on calculation of the penalty amount,[39] and on examining a foreign entity's legal standing.[40]

Thus, the Russian courts presently apply the public policy exception when the arbitral tribunal has violated one of its principal general rules that are considered fundamental to the protection of the rights and lawful interests of private parties, rather than mere "ordinary" rules of civil law.

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[35] HCC decision of Dec. 6, 2007, No. 13452/07 upon case No. A40-694/07-68-7, *supra* note 21; Moscow Circuit FCC ruling of Jan. 4, 2003, No. КГ-А40/8640-02 (the Russian debtor invoked misapplication by the ICAC of the CC rules relating to freedom of contract and the exercise of rights, presumption of good faith in the exercising of rights, due performance of obligations. The court found these defenses inadmissible under Russian law); Moscow Circuit FCC ruling of Feb. 14, 2006, No. КГ-А40/247-06, *supra* note 26; Moscow Circuit FCC ruling of April 3, 2003, No. КГ-А40/1672 (Russian debtor unsuccessfully sought to set aside ICAC award on the ground that the tribunal misapplied the CC rules on the conclusion of contracts and on the liability for failure to fulfill obligations); Moscow Circuit FCC ruling of Sept. 29, 2004, No. КГ-А40/7948-04 (the court rejected the Russian debtor's claim of the failure by the ICAC to correctly apply the freedom of contract principle); Moscow Circuit FCC ruling of April 17, 2003, No. КГ-А40/1964-03, *supra* note 22; Russian High Court decision of July 14, 2000, No. 5-Г00-70 (the court rejected claim by the Russian defendant of misapplication by the ICAC of the CC and held that legal rules formulated in the CC cannot be deemed to constitute part of Russian public policy).

[36] Moscow Circuit FCC ruling of Nov. 5, 2003, No. КГ-А40/8453-03 (the ICAC award loser unsuccessfully sought to challenge the arbitrators' refusal to set-off where no counterclaim was filed); Russian High Court decision of Dec. 3, 2001, No. 16-Г01-16 (The court rejected the ICAC award respondent's claim based on the refusal by the tribunal to consider his counterclaims arising from the same contract).

[37] Povolzhski Circuit FCC ruling of Feb. 19, 2004, No. А06-1779У-4/03, *supra* note 27.

[38] Russian High Court decision of Feb. 18, 2002, No. 78-Г02-1: A Russian bank unsuccessfully tried to oppose recognition and enforcement of a monetary award rendered by the Arbitration court at the Geneva Commerce and Industry Chamber in favor of a Turkish company. In particular, the debtor argued that the tribunal awarded lost profit which might have not occurred (speculative damages). Both the courts of the first instance and cassation found that the debtor's references to unlawful recovery of damages amount to a review of the case on the merits. On the recovery of punitive damages, see below.

[39] North-Western Circuit FCC ruling of Mar. 20, 2003, No. А56-34456/02. The Russian defendant argued that the ICAC awarded disproportionately high damages against him. The court of the first instance refused to enforce the award, in particular, on the ground that the damages amount was incorrectly calculated. The cassation court set aside its judgment and held that, unlike with punitive damages, mere incorrect calculation of the penalty amount cannot be considered as violating basic principles of Russian law.

[40] *Id.*

B. *Principles Established in Article 1 of the CC*

1. *Freedom of Contract*

As we mentioned above, several Russian judgments confirm that the provisions specified in Article 1 of the CC, constitute Russian civil-law principles and thus fall within Russian public policy.[41] One of such principles is the freedom of contract.[42]

In this regard, it is worth mentioning a ruling of the Moscow Circuit FCC which found no violation of the freedom of contract principle where the arbitral tribunal had applied provisions of an intergovernmental agreement instead of the contract agreed upon by the parties.[43] The court concluded that "no intervention by the arbitral tribunal in contractual relations has taken place." This approach contradicts the freedom of contract definition given in the same judgment: "the right of individuals and legal entities to freely establish their rights by means of an agreement and determine any terms which do not contradict the law." Thus the arbitral tribunal did intervene in the parties' contractual relations. The facts of the case specified in the judgment are not sufficient to judge whether this intrusion was justified or not, or, in other words, whether the public policy violation had taken place. The court did not consider the issue whether these intergovernmental agreement provisions are fundamental to Russian law.

It should be pointed out that freedom of contract extends to the choice of applicable law. The agreement on the applicable law is an essential element of the contract and determines the parties' rights and obligations by reference to the rules of the chosen law. Notably, there is a case in which the Irkutsk Region Commercial Court[44] characterized the non-application by the arbitral tribunal of the agreed substantive law as a violation of the lawfulness principle and, consequently, of Russian public policy.[45]

2. *The Parties' Equality*

The courts have also applied the public policy exception with regard to a violation by the arbitral tribunal of the principle of party equality, established in

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[41] It follows from the rationale of the *Povolzhski* Circuit FCC ruling of Feb. 19, 2004, No. A06-1779У-4/03, *supra* note 27, that the court attributes only these civil-law rules to Russian public policy.

[42] HCC decision of Dec. 6, 2007, No. 13452/07 ("The freedom of contract principle is a fundamental Russian civil-law principle and operates between the parties from the beginning to the end of the negotiations. The court may interfere in the contractual relations of the parties in order to control compliance with the said principle operation criteria and the limits of its application.") *See also* the Moscow Circuit FCC ruling of April 3, 2003, No. КГ-А40/1672, *supra* note 35.

[43] Moscow Circuit FCC ruling of Sept. 30, 2005, No. КГ-А40/9552-05.

[44] The Irkutsk Region Commercial Court decision of May 4, 2008, No. А19-2579/08-31-10. *See* note 7 and related text.

[45] *See* Sec. 3.A *supra*.

Article 1 of the CC. For instance, the Moscow Circuit FCC[46] held that charging only one party with adverse pecuniary consequences of commercial risks contravenes the principle of party equality and, therefore, Russian public policy. The parties entered into an agreement on the assignment of a claim. The claimant sought the amount agreed to for making such assignment to the respondent. The ICAC found that the agreement was not duly concluded and distributed the claimant's resulting losses in proportion 50:50. The court of the first instance enforced the award, but the cassation court held that charging the respondent with the consequences of the claimant's business risks violated the principle of party equality.

In another case the Moscow Circuit FCC set aside an arbitral award compelling the defendant to enter into a contract on substantially nonmarket and disadvantageous terms.[47] In the court's opinion, this arbitral award was contrary to the principle of party equality. The court also found it inadmissible to compel a commercial company to conclude an agreement contrary to the purpose of commercial activity, i.e. profit-making.

Both of these cases show a certain paternalism characteristic of the Russian courts when deciding on the enforcement or setting aside of arbitral awards. It seems that the courts try to protect the party which in their view suffered from the arbitral tribunal's injustice. Therefore, the courts sometimes tend to interpret broadly the public policy exception. In the former case the court neglected the fact that the allocation of the consequences of commercial risks clearly relates to the merits of the case and falls within the arbitrators' competence. In the latter case the court did not pay attention to the parties' agreement to prolong their contract on the set terms and to submit the dispute to arbitration, with the arbitration agreement never being held void or unenforceable. Striving to restore the balance between the parties, the court neglected the freedom of contract principle which implies not only the parties' right to establish the regulatory framework for their relations, but also their duty to comply with the agreement reached by them.[48]

C. *Interpretation of Part One of the Civil Code by the Courts*

1. *Abuse of Rights*

The Russian courts include within public policy the provisions of Article 10(1) of the CC on "Limits of the civil rights exercise."[49]

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[46] Moscow Circuit FCC ruling of Aug. 15, 2003, No. КГ-А40/5470-03П.

[47] Moscow Circuit FCC ruling of Oct. 13, 2008, No. КГ-А40/9254-08, *supra* note 27.

[48] LADO CHANTURIA, SVOBODA I OTVETSTVENNOST. PRAVO I PRAVOSUDIE POSTSOVETSKOY EPOKHI [FREEDOM AND RESPONSIBILITY: POST-SOVIET PERIOD LAW AND JUSTICE] 64 (2004).

[49] "Not permissible shall be actions by citizens and legal entities, performed with the express purpose of inflicting damage to another person, as well as the abuse of the civil

For example, the HCC Presidium held that "an arbitral award granting damages is unenforceable if bad faith (abuse of right) on the part of the claimant alleging damages is discovered."[50] A foreign purchaser in an arbitration before the ICAC claimed $1,752,986 in damages, including lost profit, from a Russian seller due to breach of a contract for the sale of a vessel. The court found that to establish the allegedly lost profits, the claimant submitted to the arbitral tribunal a time charter entered into with a U.S. company. After the arbitral award was rendered the defendant obtained documents proving that the U.S. company had no legal capacity (was not on the books) when the time charter was entered into. The HCC held that such facts may evidence bad faith (abuse of right) by the claimant and hence enforcement of the award was contrary to Russian public policy.

There was also a case in which a cassation court held an arbitral award contrary to Russian public policy because, after it was rendered, a competent court in a criminal case found that the facts underlying the defendant's liability in the case resolved by the arbitration court constituted the *corpus delicti* in a criminal case against the claimant's employees.[51] The ICAC rendered its award in a dispute between a Cyprus company and the Ukrainian Cultural Centre in Moscow which arose out of a building maintenance contract. Subsequently a state Ukrainian court rendered a sentence in a criminal case establishing, in particular, that the monetary debt in the ICAC case had arisen due to criminal actions on the part of the claimant's employees, which consisted of creating double repair documents on the work performed under the contract in question.

In another case the claimant alleged that the breach of contract by the respondent resulted in the claimant's owing a duty to pay a penalty to a third party. The claimant satisfied the claim of such third party just before the arbitration hearing with the respondent. The ICAC awarded the amount to be compensated by the respondent. The respondent applied to a Russian state court to set aside the award, allegeing that the claimant had abused his rights and acted with the express purpose of causing damage to the debtor, in particular, by claiming from him the penalty paid to the third party just a few days before the arbitration hearing. The court of the first instance[52] and the cassation court[53] found that the debtor was in fact trying to have the award reviewed on the merits. The court rejected the respondent's argument that the arbitral tribunal should have applied the principle of abuse of rights.

A comparison of these judgments leads to the conclusion that the Russian courts are likely to consider an abuse of rights argument if it was not considered by the arbitral tribunal and substantial bad faith on the part of a party has been

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rights in other forms. Neither shall the use of civil rights for the purpose of restricting competition be permissible, nor the abuse of a dominant position in the market."

[50] HCC Presidium ruling of Oct. 26, 2004, No. 3351/04.

[51] Moscow Circuit FCC ruling of Jan. 8, 2004, No. КГ-А40/10552-03-П.

[52] Moscow City Commercial Court decision of March 21, 2005, No. A40-5317/05-25-11.

[53] Moscow Circuit FCC ruling of June 15, 2005, No. КГ-А40/4342-05.

demonstrated. Yet if the facts evidencing the party's bad faith were known at the time of the arbitration, then in accordance with the general prohibition against reviewing the arbitral award on the merits, the claim of bad faith by the party is unlikely to be considered unless a particularly grave act of bad faith has taken place.

We support such an approach. The refusal to allow an abuse of rights defense is not only established in the CC but also flows from Article 17(3) of the Russian Constitution.[54]

The efficient protection of civil rights requires the possibility of banning the enforcement of the arbitral awards obtained resulting from the bad faith of a party. Yet the prohibition against a review on the merits requires limiting such a ban to exceptional cases.[55] One of the advantages of arbitration is rapid dispute

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[54] "Exercising human rights and liberties shall not infringe rights and liberties of other persons."

[55] German case law found the following solution: The Federal Court (*Bundesgerichtshof*) held that the public policy exception bans recognition and enforcement of the arbitral award where there is at least one ground that under § 580 of the German Civil Procedure Code entitles a party to claim review of the case upon newly established facts ("action for restitution") and that the party lacked the opportunity to invoke these facts at the arbitration through no fault of its own (BGH, Order of Nov. 2, 2000, No. III ZB 55/99, published in 2001(5) NEUE JURISTISCHE WOCHENSCHRIFT (NJW) 373; MÜNCHENER KOMMENTAR ZUR ZIVILPROZESSORDNUNG (3d ed. 2008). ZPO/UNU (Commentary to New York Convention) Art. V Rn. 77). § 580 of German Civil Procedure Code:

An action for restitution arises:

1) In the event that the opponent, by confirming on oath a statement on which the judgment is based, is guilty of intentionally or recklessly violating his or her oath;
2) In the event that a document on which the judgment is based was falsely drawn up or falsified;
3) In the event that, in case of a testimony or expert opinion on which the judgment is based, the witness or the expert is guilty of a punishable violation of the duty of speaking the truth;
4) In the event that the judgment is secured by the representative of the party or of the opposing party by a criminal offense committed relating to the lawsuit;
5) In the event that a judge who, with respect to the action, is guilty of a punishable violation of his or her official duties vis-à-vis a party participated in making the judgment;
6) In the event that the judgment of a regular court, an earlier special court or of an administrative court, on which the judgment is based, shall have been set aside by another final judgment;
7) In the event that the party discovers:
   a) a prior final judgment given in the same matter; or
   b) another document, the use of which would place him or her in a position to bring about a decision more beneficial for him;
8) In the event that the European Court of Human Rights established a violation of the European Convention on Human Rights and Fundamental Freedoms or its Protocol and the judgment is based on such violation.

resolution resulting in an arbitral award generally immune from challenge or annulment. Such legal certainty precludes bringing new claims. Yet such protection should not be granted to a party that knowingly acted in bad faith. At the same time it is necessary to avoid a dispute on the good or bad faith of the party, which in fact is tantamount to a review of the arbitral award on the merits.

2. *Invalidity of the Transaction Underlying the Arbitral Award*

There is not a uniform judicial position on whether an award based on a transaction held null and void is contrary to Russian public policy.

The Moscow Circuit FCC[56] has several times invoked the invalidity of the transaction on the grounds provided in Article 169 of the CC as an example of a public policy violation.[57] The court meant that the arbitral tribunal may not compel a party to execute a transaction knowingly made with a purpose contrary to the foundations of the legal order and morality, or to be held liable for the failure to execute such a transaction.[58] However, neither Article 169 nor any other Russian legislative provision defines the term "foundations of the legal order and morality," hence recourse to this term *per se* is not of much help in distinguishing those cases when an arbitral award is contrary to Russian public policy.

It should, however, be kept in mind that a transaction that is contrary to law is a separate ground of its invalidity (Article 168 of the CC[59]), which has a much wider scope than a transaction that is contrary to the foundations of the legal order and morality. The invalidity of the transaction on this ground was found by the HCC Presidium to be insufficient to trigger the application of the public policy exception.[60] Furthermore, the Russian High Court has held that reference to the invalidity of a transaction amounts to review of the arbitral award on the merits

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English text (except paragraph 8) taken from GERMAN COMMERCIAL CODE & CODE OF CIVIL PROCEDURE 334 (Charles E. Stewart trans. 2001) (translation of paragraph 8 by the authors).

[56] Moscow Circuit FCC rulings of Sep. 29, 2004, No. КГ-А40/7948-04 and Feb. 14, 2006, No. КГ-А40/247-06, *supra* note 26.

[57] "Article 169. Invalidity of the Deal, Made for a Purpose Contradicting the Foundations of the Law and Order, and of Morality

The deal, which has been aimed at the goal, flagrantly contrary to the foundations of the law and order, or of morality, shall be regarded as without legal force."

[58] Moscow Circuit FCC ruling of Feb. 14, 2006, No. КГ-А40/247-06, *supra* note 26.

[59] "Article 168, Invalidity of the Deal Not Corresponding to the Law or to Other Legal Acts

A transaction not complying with the requirements of the statute or of other legal instruments is void, unless a statute establishes that such a transaction is voidable or provides other consequences for the violation."

[60] HCC Presidium ruling of Feb. 3, 2009, No. 10680/08: "the first instance court exceeded its powers by considering and reviewing facts of the case relating to nullification of the sale agreement made between the parties." *See supra* note 9 and related text.

and thus is inadmissible.[61] In that case, the Arbitration Institute of the Stockholm Chamber of Commerce awarded $757,187 in damages to a foreign corporation from a Russian local authority resulting from a unilateral cancelation of the contract, and $40,533 in arbitration expenses. The corporation sought to enforce the award in Russia. The debtor alleged that the contract was null as surpassing his authority, but the High Court found this objection invalid as amounting to a review of the case on the merits. However, it is necessary to mention a Moscow Circuit FCC ruling on enforcement of a foreign judgment based on a bank guarantee subsequently annulled by a Russian state judgment. The court found that the enforcement of such judgment would contravene Russian public policy.[62] Yet, it was not the bank guarantee's invalidity per se which was crucial, but rather the fact that it was recognized as such by a Russian court, which provoked a conflict between the Russian and foreign judgments.

In the case of enforcement of arbitral awards, such conflict is resolved by the Russian courts through recourse to the public policy provision as well. Thus, the courts have held that recognition and enforcement of arbitral awards inconsistent with the holdings of Russian judgments violates Russian public policy, which contains the principle of obligatory force of judgments.[63]

In our opinion, the public policy provision should be applied only if the transaction underlying the arbitral award is void on the ground that it is contrary to the foundations of the legal order and morality, and not on other grounds. Otherwise the award will in fact be reviewed on the merits, as the issue of the transaction's validity falls within the competence of the arbitral tribunal.

It is, however, a controversial issue whether the invalidity of the transaction makes the award unenforceable where the transaction was held void by the court as was in the case heard by the Ural Circuit FCC.[64] In such a situation it is

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[61] Russian High Court decision of March 4, 2002, No. 34-Г02-2.

[62] Moscow Circuit FCC ruling of April 13, 2004, No. КГ-А-40/2399-04-П.

[63] Ural Circuit FCC ruling of Oct. 12, 2005, No. Ф09-2110/05-С6. The Netherlands Arbitration Institute awarded damages resulting from a breach of sale and marketing as well as partnership contracts from a Russian company in favor of a Cyprus company. Subsequently these contracts were deemed void by a Russian state court on the ground that their conclusion required a special procedure for making interested party transactions which was not complied with. On this ground the courts of the first instance and cassation refused to enforce the award, on the ground of public policy. *See also* North-Caucasian Circuit FCC ruling of Dec. 19, 2006, No. Ф08-4572/06. An arbitration court in Russia, upon a claim by a Russian company, compelled another Russian company with foreign investments to transfer the property title to a wool-washing factory by virtue of a contract of assignment. A Russian state court of the first instance refused to enforce this award on the ground that another Russian state court judgment (which was rendered before the award) had found that the assignor was not an owner of this factory. The cassation court set aside the ruling on other grounds, but confirmed that the enforcement of an arbitral award which contradicts findings of a Russian judgment is contrary to Russian public policy.

[64] Ural Circuit FCC ruling of Oct. 12, 2005, No. Ф09-2110/05-С6, *supra* note 63.

necessary to take into account that a Russian judgment is obligatory "for the state and municipal authorities, non-governmental organizations, officials and individuals" (Art. 13 of the Civil Procedure Code/Art. 16 of the Commercial Procedure Code). Thus, Russian law endows judgments with an extensive legal force. Hence where an arbitral award contradicts a state court judgment it appears sound to grant priority to the latter. Yet the parties are bound by the arbitration agreement. Even if an agreement does not provide for submission of the issue of the validity of the contract to arbitration, the arbitrator still must consider this issue before deciding on the parties' rights and duties under the contract in question. Thus the issue of the validity of the contract falls within the competence of the arbitral tribunal.

Therefore, if a party to a contract to which the arbitration agreement extends files a claim in a court, after the tribunal has decided on the validity of the contract, he disregards the arbitration agreement and thus acts in bad faith. Therefore, such party's reference to public policy should be rejected. If such claim was filed by a non-party to the arbitration agreement, he is not bound by the latter,[65] and he may challenge the contract's validity in court.

There is a doctrinal view that the validity of voidable transactions established by a court (such as a major transaction or an interested party transaction which was not duly approved) will not trigger the public policy exception[66] unlike void transactions. The premise for this conclusion is the assumption that void transactions have a greater inherent flaw than voidable ones.[67] We cannot support this view as it fails to consider that the regulation of voidable transactions has been designed to protect the set of persons expressly specified by law. As was mentioned above, the protection of private interests is part of public policy. Thus, it would be incorrect to use the categorizing of transactions into "void" or "voidable" as a criterion for the application of the public policy exception.

3. *Failure to Conclude the Transaction Underlying the Arbitral Award*

The courts have considered whether the public policy exception is applicable where the transaction underlying the arbitral award was concluded by a legal entity which at that time had no legal capacity. Under Russian law such a transaction is deemed void *ab initio*, which means without legal force.

Both the courts of the first instance[68] and cassation,[69] as well as the HCC judicial collegium [70] have found that recognition and enforcement of an arbitral

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[65] *See* V.V. Yarkov, *Arbitrazhnoe soglashenie i trebovania tretiih lits o priznanii nedeystvitelnym dogovora, ohvachennogo arbitrazhnym soglasheniem* [*Arbitration agreement and third parties claims on nullifying the contract provided in the arbitration agreement*], 1 TRETEYSKI SUD [ARBITRATION] 50 (2005).

[66] *Id.* at 66.

[67] *Id.* at 55.

[68] Republic of Kalmykia Commercial Court decision of Aug. 9, 2006, No. A22-826/2006/14-112. The court refused to enforce an arbitral award rendered in Russia on the

award based on a contract having no legal effect due to a party's lack of legal capacity (it had no state registration at the time of the contract's conclusion) is contrary to Russian public policy.

We believe that generally the issues of whether the parties had legal capacity and whether the contract was concluded or not fall within the arbitral tribunal's competence and cannot form the basis of the application of the public policy exception. Only in the case where a party was aware of its own lack of legal capacity while concluding a contract, may such incapacity serve as grounds for disallowing enforcement of an arbitral award that was rendered in its favor under the public policy exception.

D. *Principles not Embodied in Legal Rules*

1. *Remedies Proportional to the Consequences of the Breach of Obligation*

The public policy exception is applied fairly frequently in Russian case law where the arbitral tribunal awards an excessive penalty, in particular, a "punitive penalty" (similar to punitive damages in common law). When considering this issue the courts have formulated a notion which is not expressly provided for in the law: "the principle of remedies proportional to the consequences of the misdeed, considering fault"[71] as part of Russian public policy.

Russian law expressly recognizes penalty. Under Article 394(1) of the CC, if a contract provides for a penalty for a breach of obligation, then damages shall be recovered in the amount not covered by the penalty. The HCC has held that the Russian civil law admits "punitive penalty" as a possible remedy for breach of contractual obligations.[72] Thus, penalty forms part of the Russian legal system and its recovery may not *per se* contravene Russian public policy. Therefore, the key criterion for compliance with public policy is the proportionality of the remedy awarded by the arbitral tribunal to the consequences of the breach of contract.[73]

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payment of a debt arising out of assignment agreements. The court invoked another court's judgment which found that the agreements had not been duly entered into because the assignors at the time of their conclusion had not been entered in the public register of legal entities and thus had no legal capacity.

[69] North-Caucasian Circuit FCC ruling of Nov. 30, 2006, No. Ф08-6115/2006. The court upheld the judgment of the court of first instance.

[70] HCC decision of April 18, 2007, No. 2745/07. The court upheld the judgments of the court of first instance and the cassation court.

[71] Point 29 of the HCC Presidium Information letter of Dec. 22, 2005, No. 96, entitled "Commercial courts case law review re: recognition and enforcement of foreign judgments, challenging arbitral awards and writs of execution issuance to enforce arbitral awards."

[72] HCC Presidium ruling of Sep. 19, 2006, No. 5243/06, *supra* note 27.

[73] *See* Volgo-Viatski Circuit FCC ruling of May 25, 2006, No. A82-10555/2005-2-2. The arbitration court at the Chamber of Economy and Agriculture of the Czech Republic required a Russian company to pay a foreign company a penalty in the amount of

The penalty awarded by the arbitral tribunal may even exceed the amount of the principal debt. There was a case where the courts of both the first instance[74] and cassation,[75] as well as the HCC Presidium allowed recovery of a penalty exceeding six times the principal debt owed.[76] The courts took into account that the arbitral tribunal had reduced the penalty tenfold compared to the penalty requested by the claimant. The HCC found that a punitive remedy for breach of contract awarded by the arbitral tribunal was admissible in that the latter took into account the manifest disproportion of the penalty to the consequences of the breach and to the principal debt amount and reduced it accordingly.

There are also prior judgments where the very punitive nature of the penalty was found to contravene public policy.[77]

The Volgo-Viatski Circuit FCC has even found that awarding higher interest than is possible under Russian law constitutes a punitive remedy contrary to public policy. The court held that if the parties agreed that the tribunal must

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$21,530,003 for failure to transfer the title to shares under a contract. The court refused to enforce the award, in particular, on the ground that the penalty amount was substantially higher than the price of the shares specified in the contract. The court held that the principle of proportionality, fundamental to Russian law, disallows such compensation.

See also Volgo-Viatski Circuit FCC ruling of Feb. 17, 2003, No. A43-10716/02-27-10исп, *supra* note 8. The arbitral tribunal awarded greater interest than would be possible under Russian law. The amount of interest exceeded the amount of the principal debt. The court held that such award is contrary to the proportionality principle which forms part of Russian public policy.

[74] Moscow Commercial Court decision of Aug. 9, 2006, No. A40-40275/06-8-275. A Russian company applied at the ICAC to recover from a British Virgin Islands company the fees for agency services under a contract of agency in the amount of $9,302.44 and a penalty for failure to timely pay such fees in the amount of $591,256.94. The ICAC partly satisfied the claim and awarded the principal debt and a penalty in the amount of $60,000.

[75] Moscow Circuit FCC ruling of Oct. 13, 2006, No. КГ-А40/9858-06.

[76] HCC Presidium ruling of March 20, 2007, No. 15421/06.

[77] Volgo-Viatski Circuit FCC ruling of May 25, 2006, No. A82-10555/2005-2-2, *supra* note 74; Moscow Circuit FCC ruling of April 17, 2003, No. КГ-А40/1964-03, *supra* note 22; HCC decision of Sept. 19, 2006, No. 5243/06, *supra* note 27; North-Western Circuit FCC ruling of March 20, 2003, No. A56-34456/02, *supra* note 39; Volgo-Viatski Circuit FCC ruling of Feb. 17, 2003, No. A43-10716/02-27-10исп, *supra* note 8; Moscow Circuit FCC ruling of March 21, 2006, No. КГ-А40/922-06. In the last case a foreign company sought to enforce in Russia an *ad hoc* international arbitration award rendered in Stockholm against a Russian company requiring it to pay a penalty for a breach of contract in the amount of $28,041,975 plus interest. The courts of the first instance and cassation found that the penalty was not compensatory in its nature and its recovery would be contrary to Russian public policy. The HCC set aside their judgments and enforced the award, finding that lack of proportionality between the awarded remedies and the consequences of the breach of contract was not proved by the debtor. HCC ruling of Sept. 19, 2006, No. 5243/06.

resolve the dispute on the basis of the fairness principle, then awarding a higher liability than is stipulated by the *lex fori* is inadmissible.[78]

The HCC judicial collegium has indicated the court's duty to substantiate its judgment as follows: "In refusing to recognize and enforce an arbitral award, the commercial court must specify the punitive nature of the penalty applied by the tribunal, the adverse effect on the debtor, and how and in what amount the creditor's right confirmed by the award should be implemented in case of a refusal to recognize and enforce the award."[79]

However, there are rulings of the North-Western Circuit FCC which refused to apply the public policy exception where the arbitral tribunal awarded the penalty contrary to established Russian practice as "these reasons in fact amount to a review of the merits." In particular, the court confirmed enforcement of the Arbitration Institute of the Stockholm Chamber of Commerce award recovering from a Russian company 2,262,921.00 DKK of principal debt and 1,124,644.36 DKK of interest for the specified period, as well as additional interest in the amount of two percent of the principal debt per month until receipt of the said amount by the creditor, along with arbitration costs and legal fees.[80]

Therefore, this issue has not been resolved by the courts in a uniform way.

In deciding whether awarding punitive damages can trigger the public policy exception, a differentiated approach should be followed. On the one hand, the continental (civil) law system to which the Russian law belongs does not provide for the debtor's punishment by civil-law remedies. It is criminal law which fulfils the punishment function under this legal system. Establishing and applying punitive measures is the state's prerogative.

On the other hand, as mentioned above, Russian law acknowledges a penalty which, under Article 394(1) of the CC, may be recovered in addition to damages. In our opinion, from the aforesaid it follows that the functions of this kind of penalty are far from punitive. Its primary goal is the compensation of a creditor for its inconvenience, even when such cannot be characterized as damages under Russian law. This view is confirmed by Article 333 of the CC, which provides that the court is entitled to reduce the amount of the penalty if it is manifestly disproportionate to the consequences of the breach of the obligation.

In addition, allowing a contractual penalty fulfills one more important function, namely, to make the breach unprofitable for the debtor. For instance, a party may refuse to perform the contract, as it managed to enter into another contract on the same matter on more advantageous terms. Since at the time of the contract's conclusion the creditor cannot foresee what penalty is sufficient to

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[78] Volgo-Viatski Circuit FCC ruling of Feb. 17, 2003, No. A43-10716/02-27-10исп, *supra* note 8.

[79] HCC decision of Sept. 19, 2006, No. 5243/06, *supra* notes 27 and 77.

[80] North-Western Circuit FCC ruling of Dec. 9, 2004, No. A42-4747/04-13. *See also* North-Western Circuit FCC ruling of March 20, 2003, No. A56-34456/02, *supra* note 39.

fulfill this function,[81] he will (in some cases quite justifiably and in other cases merely taking advantage of the economic weakness and dependence of the other party) try to set the highest possible penalty. Article 333 of the CC empowers the court to reduce the penalty in such cases as well.

Thus, in such cases the recognition and enforcement of the punitive penalty in the arbitral award would contravene public policy, as it would allow a punishment that violates criminal procedure principles established by the Russian Constitution. Therefore, the public policy exception may be applied when the debtor proves manifest lack of proportionality of such penalty to the consequences of his breach. In our opinion, the public policy exception in such case should not result in refusal to enforce the entire award, but rather in the recognition and enforcement in that part of the award which complies with Russian public policy, by analogy with Article 333 of the CC. The provisions of Article 333 do not permit the total invalidation of the parties' agreement on account of the amount of the penalty specified, but allows a reduction in the amount of such penalty instead.

2. *Civil Liability Based on Fault*

The Russian High Court has adhered to the principle of the dependence of civil liability on fault. Generally, under Article 401(1) of the CC,[82] liability for breach of an obligation is subject to fault. For example, the Russian High Court refused to enforce an arbitral award on the recovery of damages and expenses by the defendant for breach of contract, finding that the breach in question was not through his fault.[83]

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[81] *See* Paul G. Mahoney, *Contract Remedies: General*, *in* ENCYCLOPEDIA OF LAW AND ECONOMICS, Vol. I, THE HISTORY AND METHODOLOGY OF LAW AND ECONOMICS (Boudewijn Bouckaert & Gerrit De Geest eds., 2000), *available at* http://encyclo.findlaw.com/4600book.pdf ("The preferred measure of contract damages is the amount of money that will make the promisee indifferent between performance and damages").

[82] "Article 401. The Grounds of Responsibility for the Violation of the Obligation

1. A person, who has not discharged the obligation or who has discharged it in an improper way, shall bear responsibility for this, if it has happened through his fault (an ill intention or carelessness on his part), with the exception of the cases, when the other grounds of the responsibility have been stipulated by the law or by the contract.…"

[83] Russian High Court decision of Dec. 1, 2000, No. 5-Г00-122. The Arbitration Court at the Federation of Oils, Seeds and Fats Association ("FOSFA") London required a Russian company to pay damages to a foreign company, which arose out of breach of contract in the amount of $522,107.82 plus interest. The first instance court found that enforcement of this award would be contrary to public policy as the debtor failed to fulfill the contract through no fault of his own. The Supreme Court confirmed that enforcing an award of damages without fault on the debtor's part is against public policy, but in the case at hand the debtor's lack of fault was not established. *See also* Russian High Court decisions of May 26, 2000, No. 5-Г00-59, *supra* note 13, and related text, and Dec. 4, 1998, No. 5-Впр98-363. In the latter case the Maritime Arbitration Commission of the

However, Article 401(3) of the CC provides for liability for a breach of obligation while engaging in business activity, regardless of fault. The entrepreneur may be exempt from liability only if the proper performance of contract was impossible due to *force majeure*. Also, by virtue of Article 1064(2) of the CC, the right to recover damages inflicted without fault may be stipulated by law. Hence, such approach of the Russian High Court may hardly be considered correct.[84] It results in a review of the arbitral award on the merits, a denial of the competence of the arbitral tribunal and the unjustified restriction of its discretion when resolving disputes submitted to it by the parties.

The stance of the commercial courts is currently opposed to that of the Russian High Court. The HCC judicial collegium approved the finding of the lower court which held that finding liability for the breach of obligation caused without the debtor's fault does not violate Russian public policy.[85] A Turkmenistan state authority applied for recognition and enforcement of a Turkmenistan state court judgment rendered in its favor against a Russian company obliging it to pay damages in the amount of $221,730.40, a penalty in the amount of $32,262, as well as transportation expenses for goods and compensation for legal costs. The debtor alleged that imposing liability for breach of obligation on an entity that was not at fault was contrary to Russian civil-law principles.

In another case the claimant alleged that the arbitral tribunal violated the principles of "fault and inevitability of liability for breach of obligation and of the infringed rights recovery." The claimant alleged the unjustified refusal by the tribunal to award a penalty for a breach that was the debtor's fault. The Moscow Circuit FCC rejected this argument as amounting to a review of the arbitral award on the merits.[86]

Russian Chamber of Commerce and Industry required a Russian company to pay a Latvian company freight for transporting cargo in the amount of $1,676,720. The contract for the carriage of goods by sea was entered into by two state-owned legal entities of the same state — the USSR. Then, upon the declaration of sovereignty by Latvia, the carrier became a foreign entity. Subsequently, the charterer became a private Russian company. The court found that under such new conditions it was not possible for the charterer to apply the mechanism established for debt settlement between Soviet entities, and thus failure to pay the "Soviet" debt by the charterer was not through his own fault. Hence the court refused to grant enforcement of the award.

[84] This is mentioned in S.V. KROKHALEV, KATEGORIA PUBLICHNOGO PORIADKA V MEZHDUNARODNOM GRAZHDANSKOM PROTESSE [PUBLIC POLICY CATEGORY IN INTERNATIONAL CIVIL PROCEDURE] 414 (2006).

[85] HCC ruling of Feb. 7, 2008, No. 575/08, No. A06-6957-2/2006.

[86] Moscow Circuit FCC ruling of Feb. 14, 2006, No. КГ-А40/247-06, *supra* note 26.

3. *"Payment for Work Depending on its Result"*

Unlike commercial courts, the courts of general jurisdiction resorted to this principle, which in fact they formulated. They had no uniform position. In 2000, the Russian High Court held that an arbitral award granting the payment of a bonus to the contractor who failed to fulfill the proper work may not be enforced on public policy grounds.[87] The Arbitration Institute of the Stockholm Chamber of Commerce in two awards required a Russian company to pay a foreign company in total amount some $3,000,000 plus interest, arising out of contracting agreements. The courts of first instance and cassation had refused to recognize and enforce these awards on public policy grounds. The High Court held that the contracts provided for applicable Russian law, whereas the arbitral tribunal applied, "in particular, customs in the international construction industry, corporate practice in this industry, the opinions of Western lawyers, as well as reasonableness. As a result, the monetary sums…were arbitrarily determined with reference to their reasonableness." The court also specified that "according to general principles, a bonus is paid based on the quality and duration of the work. Yet the arbitral tribunal granted a bonus in favor of the company, though it failed to fulfill the appropriate volume of work."

Two months later the High Court held that "one of the general principles of the Russian law is payment for work depending on its actual result," thus an award compelling payment for an unfulfilled portion of work is contrary to Russian public policy.[88] The ICAC obliged a Russian company to pay a Lebanese company $2,436,938 for work completed plus legal expenses. The debtor presented a statement from an expert showing that the contractor actually fulfilled only 21.45% of the work specified in the contract. The debtor alleged that the arbitration tribunal, contrary to the law on international commercial arbitration, failed to consider this statement. The debtor said that he had paid for this part of the work and thus the arbitral tribunal obliged him to pay for the same work twice. The court of first instance granted enforcement of the award, but the High Court set aside its ruling on the ground that payment for work depending on the actual result is a fundamental principle of Russian public policy.

In our opinion, the court here manifestly encroached upon the arbitral tribunal's competence and exceeded its judicial supervisory powers. Notably, the Russian High Court Presidium hearing this case in exercise of its supervisory power quite correctly held that recovery of debt under the contracting agreement without proper (in the debtor's view) determination of the actual volume of work and its actual value may not contravene Russian public policy. The High Court Presidium held that in fact such considerations amount to the review of the arbitral award on the merits, which goes beyond the judicial control powers.[89]

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[87] Russian High Court decision of May 30, 2000, No. 5-Г00-63.

[88] Russian High Court decision of Aug. 10, 2001, No. 5-Г01-92.

[89] Russian High Court Presidium ruling of June 19, 2002, No. 60пв-02.

IV. CONCLUSIONS

Summing up, the Russian courts have come to the understanding that the public policy exception may be applied only as *ultima ratio*, namely, where the fundamental rules of Russian law would be violated by enforcement of the arbitral award. Yet the uniform criteria specifying which Russian rules of law should be considered fundamental are still in a state of flux in Russian case law and doctrine.

Nevertheless, there are judgments which more or less broadly construe the public policy exception. Their existence may result from a lack of trust of arbitration and from certain paternalistic attitudes peculiar to the Russian courts. The latter are justified to some extent by the limited experience of most Russian businesses in international trade, which amounts to less than twenty years. Yet, as mentioned above, the freedom granted to businesses implies a responsibility, which will only develop provided the paternalistic care is lifted.