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Insights

Litigation & Arbitration Group

Russian Invasion of Ukraine: Legal Issues Surrounding Russia's Contemplated Nationalization of Companies

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In response to the Russian army's invasion of Ukraine, many nations have implemented economic sanctions on Russia and certain Russian entities and individuals. In addition, hundreds of companies, foreign to Russia, voluntarily are suspending or terminating operations in Russia.

In turn, the Russian Federation has taken certain measures against foreign stakeholders, including, among other things, preventing foreign investors from selling Russian assets[1] and authorizing Russian companies to pay foreign-held debt in rubles where the creditor hails from an "unfriendly" country.[2] Russia also has authorized Russian businesses to use foreign intellectual property without compensating owners of such intellectual property from "unfriendly" countries.[3] The United States, the United Kingdom, and the countries of the European Union are among the many such "unfriendly" countries.

In addition, with several hundred international business announcing that they will cease operations in Russia, Russian President Vladimir Putin threatened to nationalize foreign businesses that suspend operations within the country.[4] In March 2022, Russia announced a draft law that would apply to companies in Russia that are controlled or at least 25% owned, directly or indirectly, by investors from an "unfriendly" state. If such company ceases operations or its management or shareholders act in a manner that indicates the company will cease operations in Russia, a board member or select Russian governmental authorities can request appointment of an external manager for the company. The appointed external manager, a Russian state agency, would take control of the company. The company's assets would be transferred out of the company into a new Russian company, the original company

[1] https://www.reuters.com/business/russia-impose-temporary-curbs-foreigners-seeking-exit-assets-2022-03-01/.
[2] https://www.business-standard.com/article/international/russian-president-putin-allows-firms-to-pay-foreign-creditors-in-ruble-122030700043_1.html.
[3] https://asiatimes.com/2022/03/russia-using-intellectual-property-as-a-war-tactic/.
[4] https://www.nytimes.com/2022/03/10/world/europe/russia-economy-ukraine.html.

would be liquidated, without any compensation to its original shareholders, and the original shareholders would not be permitted to purchase shares in the new company.

On April 8, 2022, Russia announced a similar, broader, draft law that would allow Russia to nationalize the property of any person associated with "unfriendly" countries, including foreign citizens, legal entities, their beneficiaries, affiliates, and persons under their control. The proposed law directs that no compensation will be provided to owners of the nationalized assets and the right of ownership would be terminated retroactively to February 24, 2022.

This alert provides a broad overview of the potential legal implications of Russia's contemplated nationalization efforts. The analysis of any legal issue, however, is necessarily fact-specific and will depend on, among other things, the residence or domicile of the company at issue, its corporate structure and ownership, the governing or applicable laws, the existence and language of an applicable treaty and the conduct of the parties in each instance. As the situation continues to develop, the legal landscape likewise will continue to change.

Outside of the US: Investor-State Arbitration

Investor-state arbitration is a dispute resolution mechanism pursuant to which a nation-state gives advance consent to adjudicate disputes with foreign investors through binding arbitration. The jurisdiction of the arbitral tribunal can come from an arbitration clause in a contract between the state and a foreign investor or, more typically, from bilateral investment treaties ("BITs") or multilateral investment treaties ("MITs"), signed by the governments of the host state and the investor's home state. BITs and MITs have been described as "a nation state's standing offer to arbitrate with an amorphous class of private investors." *BG Group PLC v Argentina*, 572 U.S. 25, 46 (2014) (Sotomayor, J. concurring in part).

Virtually all BITs and MITs provide protection to investors against unlawful expropriation. Most treaties provide that, to be legal, expropriation must: (1) serve a public purpose; (2) not be arbitrary and discriminatory; (3) follow the principles of due process; and (4) be accompanied by prompt, adequate, and effective compensation. Unless each of these elements is satisfied, the expropriation likely is an unlawful taking in violation of the BIT or MIT, as well as international law. Expropriation may occur with one grand act or through a series of acts that collectively are tantamount to a 'creeping' expropriation.

Russia is party to over 70 BITs, including with G20 countries such as Canada, Germany, France, the United Kingdom, Spain, Italy, Korea, and Japan, among others.[5] Russia is also a party to a MIT with the European Union, referred to as the EC-Russia Partnership and Cooperation Agreement. It provides for certain investor protections against expropriation [6] and encourages, but does not mandate, settlement of disputes by arbitration.[7] ***There is no BIT or MIT in effect between Russia and the United States***.

The US: The Foreign Sovereign Immunities

Generally, foreign sovereigns are immune from US federal and state court jurisdiction pursuant to the Foreign Sovereign Immunities Act ("FSIA"). FSIA, however, provides certain statutory exceptions that permit plaintiffs to pursue claims against a foreign state. Two such exceptions to foreign sovereign immunity that plaintiffs may turn to in suits against the Russian government are the commercial activity exception and the expropriation exception, though each presents significant challenges.

A. Commercial Activity Exception

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[5] https://investmentpolicy.unctad.org/international-investment-agreements/countries/175/russian-federation. In particular, Russia's BIT with the UK has been in force since July 3, 1991.

[6] Art. 52(2) of EC-Russia PCA provides that ". . . compensation payments arising from measures such as expropriation, nationalization or measures of equivalent effect, and of any profit stemming therefrom shall be ensured."

[7] Art. 98(2) of the EC-Russia PCA.

The commercial activity exception provides, as may be relevant here, that a foreign sovereign is not immune from legal action in the U.S. where "the action is based . . . upon an act outside the territory of the United States in connection with a commercial activity of the foreign state elsewhere and that act causes a direct effect in the United States."[8]

Courts examine whether the plaintiff's claim is "based upon" commercial activity or upon an act performed in connection with that activity by examining only "particular conduct that constitutes the ***gravamen of the suit***."[9] FSIA defines commercial activity as a "regular course of commercial conduct or a particular transaction or act."[10] To determine whether an activity is commercial, the court examines "the nature of the course of conduct or particular transaction or act, rather than . . . its purpose."[11] Courts have held that when a foreign sovereign acts "not as a regulator of a market, but in the manner of a private player within that market," its acts are "commercial" under the FSIA.[12]

As may be relevant in the current circumstances, nationalization is typically a sovereign act; it is not commercial activity. [13] A few cases, however, have held that where the plaintiff's claims are sufficiently based upon the foreign sovereign's operation of the expropriated company, the commercial activity exception may apply.[14] Thus, in examining whether a company has a claim and in articulating it in a complaint, it is particularly important to focus on conduct that would satisfy the immunity exception.

The plaintiff also must show that the act in connection with commercial activity causes a direct effect in the United States. To be direct, an effect need not be substantial or foreseeable, but it must follow as an "immediate consequence" of the defendant's activity.[15] As a general matter, "mere financial loss" suffered by a U.S. person is not sufficient to constitute a direct effect.[16] But, in cases where a plaintiff is contractually entitled to receive certain payments in the United States—for example, dividends at a shareholder's place of residence in the U.S.—the direct effect prong may be satisfied.[17]

B. The Expropriation Exception

The expropriation exception permits claims against a sovereign "in which rights in property taken in violation of international law are in issue and . . . that property . . . is owned or operated by an agency or instrumentality of the foreign state and that agency or instrumentality is engaged in commercial activity in the United States." 28 U.S.C. § 1605(a)(3). Claims of unlawful nationalization are claims regarding "rights in property taken in violation of international law."[18] As presently contemplated, Russia's draft law would nationalize foreign property without compensation in a discriminatory manner against companies owned by citizens of unfriendly countries, in violation of international law.

Where the property at issue is located outside the United States, a plaintiff must establish that an agency or instrumentality of the foreign sovereign ***is engaged in commercial activity in the United States***, such as soliciting, marketing, and making sales to US customers, receiving exports from US companies, or even accepting payment with US credit cards.[19]

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[8] 28 U.S.C. § 1605(a)(2) (2012).

[9] *OBB Personenvrekehr AG v. Sachs*, 136 S. Ct. 390, 396 (2015) (emphasis added) (internal quotations omitted).

[10] 28 U.S.C. § 1603(d) (2012).

[11] *Id*.

[12] *Luxexpress 2016 Corp. v. Government of Ukraine*, Civil Action No. 18-cv-812(TSC), 2020 WL 1308357 (D.D.C. March 19, 2020) (internal quotes omitted).

[13] *See, e.g.*, *Barnet as Trustee of 2012 Saretta Barnet Revocable Trust v. Ministry of Culture and Sports of the Hellenic Republic*, 961 F.3d 193, 201 (2d Cir. 2020) ("nationalization of property is a distinctly sovereign act"); *Garb v. Republic of Poland*, 440 F.3d 579, 586-87 (2d Cir. 2006) (holding that expropriations of plaintiffs' property following WWI did not fall within the commercial activity exception of the FSIA); *Rong v. Liaoning Province Gov't*, 452 F.3d 883, 890 (D.C. Cir. 2006) (holding that a Chinese political subdivision's unilateral declaration of a nongovernmental organization's assets to be state assets was a sovereign act, and thus did not qualify as a "commercial activity" under the FSIA).

[14] *See e.g., Siderman de Blake v. Republic of Argentina*, 965 F.2d 699, 712 (9th Cir. 1992).

[15] *Republic of Argentina v. Weltover, Inc.*, 504 U.S. 607, 617–18 (1992).

[16] *Siderman*, 965 F.2d at 710; *America West Airlines, Inc. v. GPA Group, Ltd.*, 877 F.2d 793, 799 (9th Cir. 1989) ("Mere financial loss incurred by a U.S. corporation does not, in itself, constitute a 'direct effect' for purposes of section 1605(a)(2).").

[17] *See Siderman*, 965 F.2d at 711.

[18] H.R. REP. NO. 94-1487, at 19 (1976).

[19] *See id*; *Siderman de Blake v. Republic of Argentina*, 965 F.2d 699, 712 (9th Cir. 1992) (finding that "Argentina's solicitation and entertainment of American guests" at an expropriated hotel and "the hotel's acceptance of American credit cards and travelers' checks" were sufficient to show that

C. Execution of Judgement

A sovereign's property is generally immune from attachment and execution of judgment, but FSIA sets forth certain exceptions that permit attachment or execution of judgment against a sovereign's assets in the United States. For instance, a plaintiff may be able to attach or execute on property in the U.S. where: (1) the property is or has been used for the commercial activity on which the claim is based; (2) the judgment involves property expropriated in violation of international law; or (3) the judgment is based on an order confirming an arbitral award rendered against the sovereign.[20] Notwithstanding those exceptions, property of a sovereign's central bank remains immune from attachment and execution.

The UK: The State Immunity Act

As is the case in the US, as a general rule, states[21] are immune from UK court jurisdiction pursuant to the State Immunity Act 1978 ("SIA") subject to a limited number of exceptions. These exceptions have some similarities with, but also important differences from, those in the US.

Under section 3 of the SIA, states are not immune as regards proceedings relating to (i) commercial transactions entered into by the state; or (ii) an obligation of the state which by virtue of a contract (whether a commercial transaction or not) is to be performed wholly or partly in the UK. The term "commercial transaction" is defined in the SIA as "any contract for the supply of goods or services; any loan or other transaction for the provision of finance and any guarantee or indemnity in respect of any such transaction or of any other financial obligation; and any other transaction or activity (whether of a commercial, industrial, financial, professional or other similar character) into which a state enters or in which it engages otherwise than in the exercise of sovereign authority."

Whether an expropriation will fall within this exception will invariably be fact specific. Case law in the UK in relation to this has been relatively limited, although, by way of example, in *Playa Larga (Owners of Cargo lately laden on board) v I Congreso del Partido (Owners)* [1983] 1 AC 244, 267, Lord Wilberforce held that its application depended on "whether the relevant act(s) upon which the claim is based, should, in that context, be considered as fairly within an area of activity, trading or commercial, or otherwise of a private law character, in which the state has chosen to engage, or whether the relevant act(s) should be considered as having been done outside that area, and within the sphere of governmental or sovereign activity."

Unlike FSIA, the SIA does not contain a specific expropriation exception to state immunity. Historically, English courts have been hesitant to question acts of foreign states (expropriations and/or nationalizations of property being potential such acts). In *Uganda Co. (Holdings) Ltd. v the Government of Uganda* [1979] 1 Lloyds Law Reports 481, for example, the Court's view was that the restrictive concept of sovereign immunity in the UK did not generally permit the questioning of a foreign sovereign's legislation. More recently, the Supreme Court confirmed the rule that acts of a foreign executive generally cannot be questioned by English Courts (subject to certain exceptions).[22]

In such circumstances, parties may need to consider whether the relevant nationalization and/or expropriation would be considered a 'commercial transaction' or a sovereign act under the SIA exception

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Argentina engaged in a commercial activity); *Schubarth v. Federal Republic of Germany*, 891 F.3d 392, 399 (D.C. Cir. 2018) (holding that German state-owned corporation's sales and marketing of expropriated land in the U.S. was a commercial activity under the expropriation exception).

[20] 28 U.S.C. § 1610(a)(2) (2012).

[21] Under section 14(1) of the SIA, a 'state' means "any foreign or commonwealth State other than the United Kingdom", including the sovereign or other head of state in his public capacity; the government of that state; and any department of that government, but not any entity which is distinct from the executive organs of the government of the State and capable of suing or being sued (subject to limited exceptions).

[22] See *Maduro Board of the Central Bank of Venezuela v Guaidó Board of the Central Bank of Venezuela* [2021] UKSC 57 and *Belhaj v Straw Rahmatullah v Ministry of Defence* [2017] UKSC 3. See also *Yukos Capital SARL v OJSC Rosneft Oil Co (No 2)* [2014] QB 458, which outlined exceptions to this, such as that "[T]he doctrine will not apply to foreign acts of state which are in breach of clearly established rules of international law, or are contrary to English principles of public policy, as well as where there is a grave infringement of human rights." (Citing *Oppenheimer V Cattermole* [1976] AC 249, 277–278, per Lord Cross; *Kuwait Airways Corpn v Iraqi Airways Co (Nos 4 and 5)* [2002] 2 AC 883).

mentioned above, and/or whether any international law and/or domestic public policy grounds may be of assistance.[23]

Finally, even if a state potentially loses its immunity from suit in the UK, it does not mean it will lose its immunity from enforcement/execution. The applicable test in relation to losing immunity from enforcement/execution is whether: (i) a state has given consent to such enforcement against its property or (ii) in respect of judgments or arbitral awards, the "property [which] is for the time being in use or intended for use for commercial purposes."[24] Parties may face difficulties in seeking to prove that state property is used for 'commercial purposes', for example in circumstances where a state bank account is being used for both state and commercial purposes.[25] Similar to the position under FSIA, and consistent with international law, property of central banks remains absolutely immune from enforcement/execution in the UK under section 14(4) of the SIA.[26]

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[23] *Ibid.*; *Re Helbert Wagg* [1956] 1 Ch. 323.

[24] Subject to these exceptions, relief cannot be given against a state by way of injunction or order for specific performance or for the recovery of land or other property; and the property of a state cannot be subject to any process for the enforcement of a judgment or arbitration award or, in an action in rem, for its arrest, detention or sale (see section 13 SIA).

[25] *See Alcom v Colombia* [1984] A.C. 580, where the (then) House of Lords held that the bank account of the Colombian embassy (which was used to pay commercial debts but was also mixed with non-commercial purposes) could not be attached for the purposes of enforcement. The Court held that the SIA specifically required such accounts to be 'solely' used for commercial purposes in order for them to be able to be attached. See also *SerVaas Inc v Rafidain Bank* [2012] UKSC 40, where the Court held that it was the use at the time of execution that was relevant for the determination of the purpose of a bank account, and not the original source of funds.

[26] *See AIG Capital Partners Inc. v Kazakhstan* [2005] EWHC 2239 (Comm), where the Court held that this related to any "asset [which] is allocated to or held in the name of a central bank, irrespective of the capacity in which the central bank holds it, or the purpose for which the property is held," finding that a number of assets against which the claimants were seeking to enforce were immune (even though the relevant ICSID arbitration award had noted that the actions the subject of the award "amounted to expropriation, were arbitrary, in willful disregard of the due process of law and "were shocking to 'all sense of juridical propriety'").