

ANALYSIS

Russia Is Using Lawsuits to Fight the West's Sanctions

Ukraine is currently on the losing side of the new legal front in the West's economic war.

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Oleg Nefedov, a judge of Russia's Supreme Court, reads a decision in Moscow on Nov. 30, 2023. NATALIA KOLESNIKOVA / AFP

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The imposition of the largest sanctions program since the Second World War in response to Russia's full-scale invasion of Ukraine remains a key tool for limiting the

Kremlin's war machine. But it has inadvertently also had substantial secondary and tertiary effects, from the rewiring of European energy networks to myriad lawsuits over what insurers should have to pay for the Kremlin's seizure of over 400 Western aircraft.

These unintended consequences have garnered far less attention than the intended ones, but the former are still multiplying and there are tens of billions of dollars already at stake in them. While sanctions rightfully continue to be tweaked to maximize their impact, policymakers have not paid due attention to the legal spats and sanctions challenges that have already arisen in their wake. Their outcome will greatly determine the effectiveness of the sanctions and the extent to which the Kremlin or the West will bear their cost.

This is not the first time the West has had to deal with such issues. At the outbreak of the war with Japan in 1941, the U.S. seized assets and businesses owned by Japanese nationals on its soil, acting under the Trading with the Enemy Act. These actions, while directed primarily at the war-time adversary, inevitably wrought a lot of collateral damage, as investors in Japanese enterprises, their creditors, or depositors in Japanese-owned banks, were often the American public.

It took years to untangle the resulting mess. And yet, when all was said and done, the U.S. Supreme Court and Congress acted to protect the interests of these investors, and ensure both the orderly liquidation and the equitable distribution of proceeds to those affected. Thus, the depositors of Yokohama Specie Bank, had their claims on the "yen certificates" preserved in a decision by the U.S. Supreme Court in 1967, allowing the certificate holders to recover at least some economic value from proceeds of the bank's liquidation.

In short, there is a blueprint for handling the legal spats that result from waging economic war. That blueprint, in broad terms, is to act forcefully against the economic interests of the enemy, yet make full use of the institutions of law and justice for the interests of affected parties at home.

Today, as Russia and the West remain engaged in a full-scale economic war, this blueprint seems largely ignored. What we see instead, is perhaps the opposite: The adversary ruthlessly subverting the toolkit of the “rules-based international order” for its benefit with lawsuits that seem to lead Western institutions down the path of treading softly where Russian interests are concerned, while Western investors and, of course, Ukraine take the brunt of the costs and receive little or no protection.

Consider the June G-7 summit, where member states united on a plan for using the returns earned by Russia’s \$300 billion in frozen sovereign assets to aid Ukraine, of which \$200 billion are held as cash and securities at the Belgian financial company Euroclear. Leaders of the G7 have agreed to effectively monetize the future income flow on the frozen assets, and turn it into an immediate \$50 billion in loans to Ukraine. This is as stark an acknowledgement as possible that Russia’s assets will not be returned to it any time soon, even if outright seizure is off the table for now following a chorus of complaints that doing so would not be compatible with international law.

Nevertheless, Brussels has insisted Kyiv will not receive any of the five billion euros that the frozen assets have generated thus far and continues to tread softly against Russia and its proxies. The reason: Euroclear itself is worried about lawsuits brought by Russia over this action and its freezing of other securities affected by the Western sanctions regime.

According to Euroclear, it is facing “a significant number of legal proceedings...almost exclusively in Russian courts,” where “the probability of unfavourable rulings is high since Russia does not recognize the international sanctions.”

This reveals a fundamental flaw in the arguments made by proponents of the so-called “rules-based international order.” Russia can appeal to its structures too—and, slowly but surely, make sanctions even less effective than they already are. Meanwhile in the West, the powers that be continue to dither, and ignore the blueprints for economic confrontation from the past.

Russia's efforts here are already advancing: thus the suits against Euroclear, and the efforts of Mikhail Fridman—the sanctioned Russian oligarch—to return the nearly \$16 billion of his former assets through an arbitration claim under the Soviet-Belgium-Luxembourg Bilateral Investment Treaty. As its name gives away, the pact actually even predates Russia's establishment as an independent state and was inherited from the Soviet Union. It has not been updated since, but cannot be so easily unwound—its final clause notes that it applies to investments made before its hypothetical abrogation for 15 years thereafter.

It is also this treaty that Russia would ultimately use to try and have its domestic court rulings against Euroclear and other Western institutions enforced. We can be sure that there is more to come: Russia has already promised “endless legal challenges” if its assets or the income on these assets are seized. One of the largest such clashes is likely imminent, and will require politicians decide how to proceed. On 7 June the Permanent Court of Arbitration awarded Uniper, which was taken over after being bailed out by the German state, €13 billion in damages from Gazprom over Putin's decision to toggle Europe's gas taps in 2022, which forced Germany to bail out Uniper. A Russian arbitration court, on the other hand, has awarded Gazprom €14 billion from Uniper in the dispute. Berlin aims to re-IPO Uniper but will hardly be able to do so with such an albatross hanging above it.

It is therefore all the more remarkable that Western policymakers have not yet addressed how they intend to overcome such risks, nor why Russia remains permitted to take advantage of Western legal system under circumstances of a full-scale economic warfare.

Potential vulnerability to legal action by Russia and its proxies, and a lack of credible or coherent response by the West appears to have led Euroclear to take a number of actions that are clearly not in the Western interest and are often inconsistent with its past practices.

The clearing house has, for example, refused to label a number of securities as being in default in cases where the underlying entity has *chosen* to default rather than being forced into default by sanctions. This has not just affected Russian corporate borrowers but even the debts of the government of neighboring Belarus. Belarus' sovereign Eurobonds that were due to be repaid in early 2023 and are still unpaid, and thus in “default”; but Euroclear has instead designated these as “matured”. This semantic choice has significant implications, blocking the clearing and settlement of these bonds and thus impacting Western creditors – while Belarus, a key ally to Russia in its war, remains (intentionally or not) shielded from the full consequences of its default.

Good explanations for these actions are lacking, but it does appear that Euroclear has, in effect, accepted Belarus' purported excuse: that sanctions prevent it from paying. But not all sanctions are a barrier to payment—certainly not those that have been imposed on Belarus. Notably, the Development Bank of Belarus, which faces a similar sanctions regime as the sovereign government, successfully made its coupon payment in November 2022, which was, albeit with delay, passed on to the bondholders by Euroclear. Suspension of payments, then, is simply a policy choice, and indeed, the Development Bank ultimately followed the sovereign and suspended payments as well, and this year failed to repay its Eurobonds at maturity. Euroclear took the same action with respect to the Development Bank's bonds: they are marked as “matured” instead of “in default”.

This sort of leniency, and, seemingly, a fear of calling a “default” on a Russian ally, is without precedent, and completely at odds with the approaches by rating agencies, investors, the World Bank, the ISDA Determinations Committee (as it relates to Russia) and Euroclear's own actions as to other sovereigns. In the recent past, the defaulted bonds of Sri Lanka, Lebanon, Zambia are all correctly marked by Euroclear as “in default” and continue to settle.

For Western creditors of Belarus, its Development Bank and the similarly placed Russian corporate borrowers, the block on trading and settlement by Euroclear is

clearly harmful. For Russia and its ally, the lack of a “default” label by a key player in the Western financial infrastructure looks oddly protective. It also makes a mockery of the fact that sanctions are meant to constrain the *inflow* of funds to Russia and its allies instead of limiting their outflow and reducing the resources available to Russia and its allies to pursue an unjust war.

How should Western policymakers respond to these challenges? Firstly, by looking at the existing playbook for economic war, and treating as many claims as standard defaults and bankruptcies as possible. Secondly, by recognizing that the “international rules-based order” is in fact largely a set of established norms, particularly when it comes to creditor disputes, and that Russia has spent at least the last decade seeking to undermine these—beginning with its attempt to muck up Ukraine’s restructuring in 2014, something that continues to wind its way through the English courts.

That is the least that can be done to protect Western interests, free up more funds for Ukraine, and defang the Kremlin’s attempts to weaponize international law and institutions.

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