ITALY

CHAMBER OF NATIONAL AND INTERNATIONAL ARBITRATION OF MILAN

Final award of 20 July 1992, no. 1491

Sole Arbitrator:	Prof. Riccardo Luzzatto (Italy)
Parties:	Claimant: Subcontractor (Italy) Defendant: Main Contractor (Italy)
Place of arbitration:	Milan, Italy
Published in:	Unpublished. Original in Italian.
Subject matters:	- Italian Iraq embargo legislation - mandatory character of EC Council Regulation (Iraq embargo) - allocation of risk between Main and Subcontractor - *factum principis*

Facts

By a contract concluded in 1989, Subcontractor agreed to supply Main Contractor with parts of a plant to be built in Iraq. Delivery of the first batch of products was to take place in November 1990.

A dispute resolution clause in the contract provided that: I) as far as disputes "involving Customer", i.e., an Iraqi Ministry, were concerned, Subcontractor was bound by the agreement reached on those disputes by Main Contractor and Customer, with the participation of Subcontractor or, should an amicable settlement not be reached, by an arbitral award made in arbitration

proceedings between the Customer and the Main Contractor; II) all disputes "which do not involve Customer and the documents issued by Customer" were referred to a Sole Arbitrator to be appointed according to the National Rules of the Milan Chamber of National and International Arbitration. The clause further called, in the latter case, for *arbitrato irrituale*, a decision according to the rules of law[1] and the application of Italian law.

On 8 August 1990, EC Council Regulation no. 2340, declaring an embargo against Iraq, was issued. On 27 August 1990, Main Contractor informed Subcontractor that the Subcontract was suspended.

On 17 October 1991, upon request by the Subcontractor, a Request for Arbitration was notified to Main Contractor. The parties did not reach an agreement on the Sole Arbitrator and, on 25 November 1991, the Arbitral Council of the Milan Chamber appointed Prof. Riccardo Luzzatto as Sole Arbitrator.[2]

The Sole Arbitrator found that the Subcontract had been suspended by the EC and Italian embargo legislation against Iraq as of 8 August 1990 and had been subsequently terminated. The Arbitrator also found that Subcontractor shared in the risk of the overall venture and that, therefore, nothing was due by Main Contractor to Subcontractor for the work done until 8 August 1990. The Arbitrator's reasoning is summarized herebelow.

Excerpt

I. JURISDICTION

[1] "First of all, the present arbitral proceedings is of an *irrituale* nature, since such is the intention of the parties as expressed in the arbitral clause.... The

1. The standard arbitral clause attached to the National Rules of the Milan Chamber suggests that the parties indicate whether they intend their dispute to be decided according to the rules of law or in equity.
2. Art. 18(3) of the National Rules of the Milan Chamber of Arbitration reads [Italian original]:

   "3. If a sole arbitrator is to be appointed, the Arbitral Council confirms the appointment of the person designated by the parties. In the absence of an agreement between the parties within thirty days from notification of the Request for Arbitration, or if the Arbitral Council does not confirm the appointment of the person designated by the parties, the Arbitral Council shall appoint the Sole Arbitrator."

clause provides that the Arbitrator decide the dispute according to the rules of the law, and specifically Italian law.

[2] "It must be noted, for the sake of completeness, that the wording of the clause is not totally coherent, since it utilizes terms (in casu, the Arbitrator's 'decision') that would fit better in *rituale* proceedings. However, the general wording of the clause does not leave any doubt as to the fact that the parties intended the proceedings and the award to have an *irrituale* character.

[3] "Main Contractor preliminarily objects to the Arbitrator's 'jurisdiction' to hear the dispute between Subcontractor and Main Contractor, on the basis of the particular wording of the arbitral clause, which distinguishes disputes between the parties – concerning the supply [of the product] – according to whether they involve Customer and the documents issued by Customer or not. The clause provides that Subcontractor is bound by the agreement reached on the former type of disputes by Main Contractor and Customer, in the negotiation of which Subcontractor has participated; if no amicable settlement can be reached, Subcontractor is bound by the outcome of the arbitral decision. Main Contractor undertakes to submit [in the arbitral proceedings] all elements supplied by Subcontractor. For the latter type of disputes, including disputes concerning the validity, interpretation, performance and termination of the contract, referral to a decision by a Sole Arbitrator under the National Rules of the Milan Chamber of National and International Arbitration is provided.

[4] "According to Main Contractor, the dispute brought before the Arbitrator by Subcontractor belongs to the first category, since it concerns the possibility to perform under the contract between Main Contractor and Subcontractor, notwithstanding the supervening Iraq embargo legislation. Hence, it necessarily involves the relation of the Subcontract to the contract between Main Contractor and the Iraqi Customer, as far as the impossibility to perform under the two contracts is concerned, that is, it involves the Iraqi Customer in the sense of the arbitral clause. According to the interpretation suggested by Main Contractor, in other words, all disputes on issues concerning the Main Contract – whichever these issues may be –, such as the dispute concerning the impact of the embargo legislation on the two contracts, are disputes involving the Iraqi Customer.

[5] "In the Arbitrator's opinion, such an interpretation of the clause cannot be accepted, since it is too broad. It is indeed true that the particular wording of the arbitral clause reflects the [parties'] intention – which is obvious, besides, when one considers the characteristics of the relationship between the contract [between the parties] and the overall operation – to avoid that disputes on the same issues, apparently only concerning Main Contractor and the Iraqi Customer, but in reality affecting the relationship with the Subcontractor as

well, in that they concern performances by Subcontractor, may be decided differently in different dispute resolution systems, that is, under the Main Contract and under the Subcontract. This intention, however, also indicates to what extent the parties wish one contract to influence the other. From this point of view, disputes on issues concerning the Subcontract and performance under the Subcontract involve Customer: that is, disputes concerning performance under the Subcontract, in that they play a role in the execution of the overall work entrusted to Main Contractor and, therefore, affect the relationship with Customer, its rights and obligations.

[6] "On the other hand, it does not seem possible to include in this category, as defined by the parties, any dispute concerning issues which may *in abstracto* play a part in both contractual relationships, but which do not concern performance under the Subcontract.

[7] "In the present dispute, such an issue would be that of the impact of the embargo legislation on performance under the Main Contract, since it is *in abstracto* possible (although it is very difficult to imagine it *in concreto*) that in an arbitration between Main Contractor and the Iraqi Customer a result may be reached, other than the result reached in the present proceedings. We must keep in mind, however, that in the present proceedings, the issue of the embargo legislation's effect on the contract between Main Contractor and the Iraqi Customer is only a preliminary issue, on which the Arbitrator may not render a direct decision, since the Iraqi party does not appear in the proceedings. On the contrary, in an arbitration between Main Contractor and the Iraqi Customer the issue of that legislation's effect on the Subcontract would be totally extraneous to the subject matter of the proceedings, and could not be decided. Thus, also from this point of view it appears that the dispute brought before the Arbitrator should not be decided together with the dispute between Main Contractor and Customer: the latter cannot be decided by the Arbitrator, and Subcontractor's waiver of court action through the arbitral clause for *arbitrato irrituale* would otherwise result in an absurd waiver of any form of protection.

[8] "For these reasons, the Arbitrator finds that the arbitral clause – and the appointment by the [Arbitral] Council of the Chamber of Arbitration – empower him to hear the claims filed by Subcontractor against Main Contractor."

II. THE MERITS

A. The Parties' Position

(....)

[9] Subcontractor maintained: "[T]he prohibition under the EC and national embargo legislation cannot affect the Subcontract: neither directly, since the legislation itself rules this possibility out, nor indirectly on the basis of a connection between the contracts (the Main Contract and the Subcontract as connected contracts), since there is no sufficient connection between the two. On the other hand, Subcontractor maintains that non-performance under the Main Contract does not in fact depend on a real impossibility to perform due to a *factum principis* – i.e., the legislative prohibition – but on the non-performance by the Iraqi party. By accepting the UN Resolutions, Iraq recognized that its behaviour had been unlawful, as implied in the Resolutions: hence, prohibition under the embargo legislation should be juridically evaluated, also from the point of view of the Iraqi legal system, as a consequence of a fact imputable to Iraq itself – a State of which the Iraqi Customer of Main Contractor is only a body.

[10] "Main Contractor replies to this allegation by maintaining, first of all, that performance was impossible under the embargo legislation which affected – initially in a temporary, and now in a definitive way – the Main Contract with the Iraqi Principal. According to Main Contractor, the impossibility to perform cannot but affect the Subcontract concluded between the parties, both because the prohibition affects the contracts also indirectly aiming at promoting, favouring or carrying out a supply of goods to Iraq, and because the connection between Main Contract and Subcontract is such, in any case, as to undoubtedly make the latter share in the former's fate, including the impossibility to perform. Nor is Subcontractor entitled to damages for the activities carried out before 8 August 1990, in the light, inter alia, of the provision of Art. 1672 CC,[3] that is, that the work done by Subcontractor until that date is not useful to Main Contractor, considering the impossibility – which has now become definitive – to perform under the Main Contract.

[11] "Hence, the issues to be decided by the Arbitrator concern the scope and effect of the EC Regulation and national laws concerning the embargo, their

3. Art. 1672 of the Italian Civil Code reads:

> "*Impossibility to perform.* If the [construction] contract is terminated because performance has become impossible due to causes which cannot be imputed to either party, the customer must pay for that part of the work which has been completed, to the extent that that work is useful to him, in proportion to the price agreed upon for the whole work."

impact on the juridical situation of Main Contractor as party to the Main Contract, and their effect in relation with the Subcontract between the parties to the present proceedings."

B. EC and National Embargo Legislation

[12] "For the aim of these proceedings, the relevant provisions are the EC Council Regulation no. 2340 of 8 August 1990 and [Italian] Decree 23 August 1990 no. 247, which has become Law 19 October 1990 no. 298.

[13] "According to Art. 1(2) of Regulation no. 2340, it is forbidden as of 7 August 1990 to export any product originated in or coming from the EC to Iraq and Kuwait. According to Art. 2(2) and (3), it is prohibited as of the said date in the EC territory, by means of vessels or aircrafts flying the flag of a EC Member State, and when carried out by any EC national, to sell or supply any product, wherever it originates or comes from, to any legal or natural person located in Iraq or Kuwait, or in any case for commercial activities carried out in or from those territories (para. 2). All activities are also forbidden, which have as their object or effect the promotion of such sales or supplies (para. 3).

[14] "According to Art. 1 of Decree no. 247 of 1990, Italian citizens – wherever they may be – and foreign citizens who have their residence, domicile or abode in Italy, are forbidden to carry out any activity aiming, also indirectly, at promoting, favouring or carrying out the sale, supply, export or transport of all kinds of goods to or from Kuwait and Iraq.

[15] "It is evident that the EC and national legislators used very broad expressions [in their provisions]. In particular, the use of the term 'indirectly' in the national provision, and of the expression 'activity having as its object or effect' the promotion of sales or supplies to Iraq, in the EC provision, must be stressed.

[16] "These provisions not only cannot be derogated from: they must be necessarily applied; that is, they are provisions which must be necessarily applied in the EC, whichever law applies to the contract, as it appears from their purpose and public law character.

[17] "In the light of the broad wording of the prohibition and of its mandatory character – which we have just stressed –, there is no doubt that, due to the prohibition, performance under the Main Contract between Main Contractor and the Iraqi Customer is impossible. Performance [in the face of the embargo legislation] would violate the prohibition and expose Main Contractor to the sanctions provided for in Decree no. 247 of 1990. This conclusion does not imply a judgment on [the Iraqi party's] behaviour, which would violate the Arbitrator's terms of reference (hence the impossibility to decide Subcontractor's claims

involving a judgment on the lawfulness of that behaviour): it only considers the embargo legislation's effect on the contractual position of the Italian party in the relationship at issue in the present dispute. Further, any evaluation of the contractual behaviour of the Iraqi party would be not only inadmissible but also totally irrelevant with regard to the decision which the Arbitrator is requested to render, since it is solely the position of Main Contractor in the Subcontract that he must determine.

[18] "Not even Subcontractor seems to doubt that it has become impossible to perform under the Main Contract between Main Contractor and the Iraqi Customer. Subcontractor only contests that the impossibility is a 'non-imputable fact' – and it has been said already that this aspect is irrelevant as far as the present dispute is concerned. The parties' position, on the contrary, totally differs on the issue as to whether the Subcontract is also affected by the prohibition (and, if so, why and how).

[19] "On this issue, the Arbitrator first considers that the very broad terms of the legislative provisions reveal a clear intention to preclude in the amplest possible way all activities which may lead to supply goods to Iraq or Iraqi bodies and individuals, or to execute works in their favour. This intention calls for a non-restrictive interpretation [of the provision], which may contribute towards attaining the goals set on the international level by the UN Security Council decisions and later on EC level. Thus, the wording of Regulation no. 2340 of 1990 – 'activities the object or effect of which is' the promotion of sales or supplies to Iraqi parties –, which echoes the formula of Art. 85 of the 'EEC' Treaty on agreements,[4] indicates that the [Regulation's] determining factor is not the parties' intention, but the activity's objective capability to lead to the prohibited result (in Art. 85 of the Treaty, the objective capability to restrict competition is the provision's determining factor).

[20] "Equally, the adverb 'indirectly' in Art. 1 of Decree no. 247 of 1990 leads us to hold that an activity, carried out between parties on the Italian territory and the final beneficiary of which is Iraq, necessarily falls within the scope of the prohibition (and if it were not so, the EC provision should prevail, according to generally accepted principles). It is true that the said adverb has been used, generally speaking, in order to avoid so-called triangulations.

4. Art. 85 of the EEC Treaty reads in relevant part:

> "The following shall be prohibited as incompatible with the common market: all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the common market...."

However, in the Arbitrator's opinion, a broader meaning must be given to the adverb, in the sense indicated above.

[21] "Further, if we correctly interpret the Regulation, no distinction can be made as to the prohibition's impact on activities to be carried out after the entry into force of the Regulation (that is, activities under new contracts) and activities under contracts already concluded and/or partially performed on that date. Subcontractor correctly observes that the text only mentions 'transactions which have already been concluded or partially carried out' in para. 1 of Art. 2 of the Regulation, in relation to the export of products from Iraq. However, the reason for this is clear: only here does the provision use the concept of 'activity or commercial transaction', a concept which can cover a range of successive operations and, therefore, necessarily requires that the regime for activities or transactions initiated before the entry into force of the Regulation be indicated. As far as operations towards Iraq are concerned, the provision uses the different concept of 'sale or supply', that is, a concept which can be referred to individual operations, with no need to indicate when the overall activity – of which the individual sales or supplies are part – started.

[22] "If this interpretation of the EC and national Iraq embargo provisions is correct, then, in the Arbitrator's opinion, the Subcontract between the parties to the present proceedings is subject to these provisions and, therefore, is also affected by the impossibility to perform, ensuing from the embargo legislation.

[23] "In fact, the Subcontract undoubtedly and univocally concerned the production of a (small) part of the works for the [plant] to be built under the Main Contract. It did not concern fungible, mass-produced goods which could be used in many ways. It concerned products specifically developed in view of the particular needs of the works, on the basis of tailor-made specifications. Nor can it be doubted that the final destination of the product was well known to and accepted by Subcontractor. The prohibition based on the EC Regulation and national legislation does not allow performance under the Subcontract, since the Subcontract univocally aimed at the execution of the Main Contract's works, that is, it had as its effect the promotion of supplies to Iraq.

[24] "Further, it seems to the Arbitrator that the impossibility to perform under contracts promoting forbidden activities towards Iraq, which originally could be considered temporary, must now – two years after – be considered definitive, taking into account that the *medio tempore* circumstances in the relationship with Iraqi parties have fundamentally changed, that it is still impossible to foresee if and when full normalization shall be reached in the relationship with the Iraqi State and that it shall be necessary, if normalization shall be reached in the near or far future, to renegotiate all contracts.

[25] "Further, even if Main Contractor might possibly in the future make use

of Subcontractor's products, Main Contractor cannot be compelled to accept Subcontractor's performance in view of that hypothetical utilization.

[26] "Hence, the impossibility to perform under Subcontract cannot be imputed to Main Contractor; it is an objective, absolute and definitive impossibility and it falls, therefore, under the scope of Art. 1463 CC,[5] on termination of contract."

C. *Connection Between the Contracts*

[27] "It would seem superfluous, in the light of the conclusions reached, to examine further other issues which have been given ample attention by the parties in the course of the proceedings such as, especially, the existence of a connection between the Main Contract and the Subcontract. The parties contended that a connection did or did not exist in relation to the effect on the latter of the impossibility to perform under the former.

[28] "If the Subcontract is terminated due to impossibility to perform under the embargo legislation, it is useless to ask oneself whether the same result may be reached by a different path. However, the Arbitrator deems it appropriate to give some thought to the matter of the connection between the two contracts. This perspective may shed some light on some aspects of the dispute and on the reasons for the Arbitrator's decision.

[29] "The existence of a juridically relevant connection between the two contracts has been maintained by Main Contractor, on the basis of the parties' explicit intention – as expressed in the particular wording of the dispute resolution clause – and of an alleged economic-juridical functional link, necessarily ensuing from the contracts' nature and mutual function.... Subcontractor maintains that there is no connection, because the parties expressed no intention to that effect, the nature of the contracts is not identical and there is no legislative source on which to base an *ex lege* connection.

[30] "On this issue, the Arbitrator holds that subcontracts have a typical configuration in international trade and especially in large construction works in developing countries: a subcontract cannot be seen as a contract derived from the main contract, but rather as a contract with a certain autonomy, although

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5. Art. 1463 of the Italian Civil Code reads:

> "*Total Impossibility*. In contracts providing for performance by both parties, the party released from his duty to perform by the impossibility to perform cannot request the other party to perform and must return what it has received, in accordance with the provisions on the *restitutio indebiti*."

connected to the original contract by an economic and functional link which normally, however, is not juridically relevant.

[31] "Of course, it is possible to connect contracts in a juridically relevant manner, producing the typical consequences as defined by case law. This, however, requires a specific, if tacit, intention of the parties, aiming at making the contracts 'teleologically dependent or interdependent in view of the realization of a certain interest',[6] so that which affects the one also affects the other. In casu, the Arbitrator considers that there has been no such intention. The contracts refer indeed to one another, but they do not do so in an univocal and clear manner allowing a conclusion in that sense. In particular, the reference in the dispute resolution clause aims at coordinating decisions, as correctly maintained by Main Contractor; it cannot jeopardize the mutual autonomy of the two contracts. The connection between the two contracts, therefore, is only economic and functional; it does not entail the mutual dependence and interdependence which is essential, according to case law, for the events concerning the one to concern the other as well.

[32] "There is no connection [between the contracts] such as to cause the events concerning one contract to concern the other as well. A connection, however, does exist, as mentioned above, on the economic and functional level. This fact is not devoid of significance in the present dispute: it justifies the conclusion reached on the impossibility to perform – in an ampler perspective than the mere interpretation of EC provisions – and lends further strength to this interpretation.

[33] "Undoubtedly, the said economic and functional connection between the two contracts is one of the paramount reasons for extending the EC prohibition beyond the scope of contracts between Iraqi parties and EC (in casu, Italian) final exporters. Subcontractor insists that the prohibition cannot affect relationships between Italian parties residing in Italy, having as their object products to be delivered to the final exporter on Italian territory. According to Subcontractor, there is no reason, even in equity, to shift the contractual risk from Main Contractor to Subcontractor. Subcontractor certainly did not intend to accept any risk concerning the final operation with Iraq, nor can Subcontractor be held subject to such risk.

[34] "On the contrary, in the Arbitrator's opinion, the said connection calls for this restrictive thesis to be overcome. When, as is the case here, Subcontractor negotiated with the Main Contractor, well knowing that the final destination of the supply was Iraq (and it is of little relevance, of course, that

6. The Arbitrator referred to the Supreme Court decisions of 4 May 1989, no. 2065, 25 July 1984, no. 4350 and 17 November 1983, no. 6864.

Subcontractor did not know the name of the Customer), accepting the specifications made by the final Customer, undertaking – when necessary – to carry out activities on the building site, then the situation well justifies that part, albeit a modest part of the contractual risk be borne by Subcontractor: Subcontractor participates in the whole operation and shares, though in a limited manner, in its risk. Hence, the 'transparent' nature of the economic and functional connection [between the two contracts] justifies that part of the risk be shifted onto the Subcontractor. A different solution would be reached in the case of a supplier of fungible and mass-produced goods, who is totally unaware of their specific utilization and final destination.

[35] "In the Arbitrator's opinion, these considerations justify, also in equity, the conclusion reached. (However, equity does not play a role in the Arbitrator's decision, since the parties agreed on arbitration according to law.) Further, they elucidate the purpose of the broad scope of the EC prohibition, i.e., to prevent a trick by Main Contractors, that is, that parts – also large parts – of supplies to Iraq be manufactured, notwithstanding the prohibition, under contracts having their effect only in the EC (or in Italy, or another EC State). This trick would allow less scrupulous Main Contractors to violate the prohibition easily. In this sense, [the broad scope of the prohibition] contributes toward guaranteeing that the sanctions against Iraq are observed.

[36] "For the afore-said reasons, this ratio does not violate equity, as alleged by Subcontractor, because the Subcontractor participates in the larger operation. The Subcontractor's participation – which does not imply a juridically relevant connection between contracts – justifies the assessment of the contractual risk, that is, extension to the Subcontractor of the objective circumstances preventing performance of the Main Contract; the reason [for this extension] is certainly not the possibility for the Main Contractor to shift the risk of the non-performance of the customer on the Subcontractor."

D. Conclusions

[37] "Due to the lack of a juridically relevant connection between the two contracts, as ascertained, Italian law is undoubtedly and exclusively applicable to the contract between Subcontractor and Main Contractor, as indeed agreed upon by the parties in the often-mentioned dispute resolution clause. In its turn, the impossibility to perform, based on the (EC and national) embargo legislation – an impossibility which, it is almost superfluous to say, affects the whole performance under the contract and not only the mere reception by Main Contractor of the performance – also implies that the contract at issue has been suspended and later terminated according to Art. 1463 CC, as of the date when

the Decree entered into force (the impossibility was initially a 'juridical' impossibility, of a temporary nature, and then a definitive impossibility).

[38] "According to the general principles, the above considerations imply that the Regulation applies retroactively. Hence, since performance was suspended on 8 August 1990, that is, before the date on which the first delivery was scheduled under the Subcontract, i.e.,... November 1990, Main Contractor does not owe Subcontractor compensation and it is unnecessary to decide on this issue.

[39] "For the reasons set out above, Subcontractor's claim for indemnification for developing and manufacturing the products which were ready by 8 August 1990, or for compensation for the damage suffered because of the suspension of the contract cannot be granted. The latter claim cannot be granted, since the damage does not ensue from a fact imputable to Main Contractor, but from the impossibility to perform. The former claim also cannot be granted: even if Art. 1672 CC, which provides for an exception to the normal regime of termination, were applicable to the case at issue – but in reality it is Subcontractor which maintained that the contract was not a construction contract but a sale of future goods: an issue which can be left unanswered – it does not seem that the part of the works already done by Subcontractor can be of any use to Main Contractor, nor has Main Contractor been unjustifiedly enriched."