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Expecting the unexpected – lessons on sanctions and addressing legal uncertainties

With the decision by the United States and the European Union to impose sanctions on Russia came a raft of new challenges not ordinarily contemplated even by the most seasoned sanctions experts. Commercial and financial transactions have been heavily impacted by the imposition of constraints on dealings with a major trading power of the West, and the nature of the restrictions is itself unprecedented. Here, Clifford Chance experts explore some of the contractual clauses and other mechanisms being used in the market, and look at the legal uncertainties that remain unresolved.

In recent years, against the backdrop of ever more intrusive enforcement activity, major corporations and financial institutions around the world have developed sophisticated compliance policies and procedures to deal with sanctions. But the decision taken in March by the US and EU to impose sanctions on Russia is beyond anything that organisations have dealt with before, and brings many challenges.

Rae Lindsay, a Clifford Chance international law partner, says: "The usual problems associated with sanctions regimes have been exacerbated by the fact that Russia is a major trading partner of the West. The sanctions have huge repercussions for existing and pending deals, and also for the market as a whole."

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Further complicating the issue is the way in which the sanctions have targeted lists of individuals and firms, and have tightened incrementally to target whole sectors of the Russian economy, by denying Russian state-owned banks access to Western capital markets, for example, and restricting the export of high-tech oil production machinery.

US sectoral sanctions relating to Russia

In the US, sanctions targets have been designated by the Office of Foreign Assets Control (OFAC), and whilst similar in scope to the entities, individuals and sectors targeted by the EU, the lists are not identical. The so-called SSI List, or Sectoral Sanctions Identification list, published by OFAC, initially named just Gazprombank, VEB, Novatek and Rosneft, but has since added Bank of Moscow, Russian Agricultural Bank, VTB Bank and Sberbank and a multiplicity of energy companies, with sanctions also applying to subsidiaries where they own more than 50%.

George Kleinfeld, a partner in Clifford Chance's Washington office, says: "These directives were unique in the annals of OFAC sanctions. Never before have we

seen sanctions designations under a country sanctions program that do not impose a complete blocking but only impose limited sanctions on the designated persons. There is also no particular reputational taint involved in continuing the business not covered by the sanctions, in that companies on the SSI list have not done anything inconsistent with the US notion of global peace and security. They are purely collateral damage that the US government, in partnership with the EU, have imposed to obtain leverage and attempt to influence conduct in the Kremlin."

The restrictions are detailed in four directives, three of which relate to preventing US involvement in capital raising by the entities named, and a fourth that seeks to deprive Russian oil companies of the ability to involve US partners in projects. These are accompanied by export controls administered by the Bureau of Industry and Security, which seek to prevent Russian oil and gas companies accessing US goods and services.

George says: "These rules have thrown up a host of very complex issues, because there are very important global economic players on these lists. These entities remain active globally, US parties remain interested in doing business with them, and the sanctions are limited to new debt or equity."

Key US issues therefore include the extent to which non-US deals that involve US persons or US dollars are within the scope of the regime; the exact meaning of the "new debt" or "equity" when applied to complex financing structures and arrangements; and the application to rollovers of pre-existing facilities, because many of the SSI companies are the beneficiaries of facilities where rollovers may or may not be deemed to be new contractual commitments.

EU sectoral sanctions relating to Russia

The EU sectoral sanctions against Russia came into effect on 1 August and were amended on 12 September. They have given rise to a host of complex issues, and while the policy considerations are very similar to those in the US, the legislation, and therefore the implementation, has been somewhat different. There remains considerable ambiguity about the scope of the capital markets and lending restrictions and how they ought to be interpreted.

Michael Lyons, a Clifford Chance senior associate in London, says: "Since these sanctions came into effect, a range of difficult issues of interpretation has arisen. The sanctions are broad and novel in their approach, and there is no formal guidance yet available."

Issues of interpretation relate to the scope of the entities to which the restrictions relate as well as the intended ambit of the sanctions themselves. For instance, it is unclear what it means to deal with instruments that are not themselves 'transferable securities or money market instruments' but which have 'transferable securities', such as derivatives with the listed banks, collective investment schemes and GDRs.

The lending restrictions have created some of the biggest challenges. While the sanctions prohibit new loans or credit being made available to sanctioned entities, there is a lack of clarity as to what amounts to a new loan for these purposes. Uncertainty relates to whether funds can be advanced under loan agreements entered into before the sanctions came into effect. There is also no grandfathering clause in the legislation, to exempt entities wishing to perform obligations arising from agreements entered into before the sanctions took effect, in contrast with the EU's approach in other contexts.

It is also not clear how revolving credit facilities should be treated in all cases, or what is meant by the prohibition on being 'part of any arrangement' to make a loan, for example.

Rae says: "Banks are well used to dealing with restrictions on lending arising from standard asset freeze regulations. Here we are dealing with a similar situation affecting making funds available, but in the specific context of defined lending restrictions that appear to be trying to mirror the types of sanctions imposed by the US, but do not come with the benefit of guidance that has been published by OFAC in the US. There are a huge number of interpretational issues that arise."

There has been no guidance published at EU level, limited and sometimes inconsistent direction given at state level, resulting in the possibility that institutions operating in different jurisdictions across Europe may find themselves confronted with different interpretations of the rules.

Issues in lending transactions

With the loan markets so heavily impacted by uncertainty as a result of the sanctions regimes, the use of sanctions clauses in transactions is becoming ever more prevalent. Clauses developed prior to the new sanctions aimed at the situation in Ukraine may no longer seem fit for purpose in light of the new issues raised by those sanctions.

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Likewise there is an issue with repeating representations and warranties in existing transaction documents, where it can be important to ensure the opportunity to declare a breach after the imposition of sanctions. Use of proceeds undertakings that include reference to compliance by the borrower with 'applicable sanctions' may not provide sufficient comfort to lenders, where the sanctions "applicable" to the borrower do not include EU or US sanctions. On the other hand, listing out all the conduct that is prohibited for a non-EU or non-US borrower is also impractical. For instance, where the borrower undertakes not to use proceeds in a manner that would expose the lenders to risk, a commercial issue may arise as the borrower may not know all the circumstances in which that risk would arise.

Michael says: "Trying to define the conduct that the borrower can and cannot engage in is probably not useful given the constantly changing situation. In drafting an appropriate sanctions clause it is essential to have regard both to the sanctions risks presented and the commercial position in terms of who takes the risk of what the sanctions prohibit."

Reliance on illegality clauses may not be sufficient, and requires a look at each particular transaction's documents. Whether or not clauses and other triggers in a contract offer remedies and entitlements in the event of the imposition of sanctions, and whether those developments give rise to an illegality, will depend on who the parties are, the governing law and the place of performance. There are uncertainties around establishing when it becomes unlawful to perform obligations under finance documents, with the possibility of licenses or other authorisations to permit performance to take place. There are obligations on lenders and other involved parties to mitigate, for example.

As a rule, we see the market acting cautiously in the face of uncertainty. But Rae says: "All these interpretational issues could lead to unprecedented levels of litigation, because people have to take very difficult decisions in the face of persisting interpretational uncertainties. Whether or not they get it right may well be fought out in the courts in due course."

Commercial and legal responses

There are a number of trends that we have observed in recent months as to emerging market practice in response to these conditions. With respect to loans, the inclusion of sanctions wording is now the rule on Russian deals, and sanctions analysis by external counsel has become standard practice. Sanctions wording has become more refined, with specific drafting to take account of sectoral sanctions and currency toggles often seen.

Logan Wright, a Clifford Chance partner based in Moscow, says: "The due diligence aspect is obviously a lot greater and external counsel is being asked to give sanctions advice to lenders, and sometimes also for borrowers. International banks are quite sensitive to any sanctions risk where Russian banks are lending in the deal, even though the restrictions do not impact where Russian banks are making the loans."

On capital markets transactions, we are witnessing extended discussions between lead managers and issuers with respect to sanctions-related risk factors. International exchanges including the UK Listing Authority are calling for the confirmation of non-applicability of sanctions to particular issuers, from the issuer and their counsel, plus an insistence on detailed sanctions-related disclosure in the prospectus.

Finally, in M&A and other commercial deals, there are signs of an increased and renewed focus on know-your-customer checks on borrowers, acquisition targets and guarantors, to ensure visibility as to ownership, control and operation. There are changes to transaction structures to avoid falling foul of sanctions restrictions, while the need to avoid circumvention activities remains in the forefront of minds, particularly when parties are considering the possible restructuring of existing deals. Companies are having to develop insulation policies, to ensure they are not involving US or European personnel in sanctioned matters. Finally, some are turning away from European venues as the seat of possible arbitration to consider disputes arising from contracts that may be affected by sanctions.

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Logan Wright, Partner, Clifford Chance (Moscow)

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