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Russian loan documentation and sanctions: the current state of play

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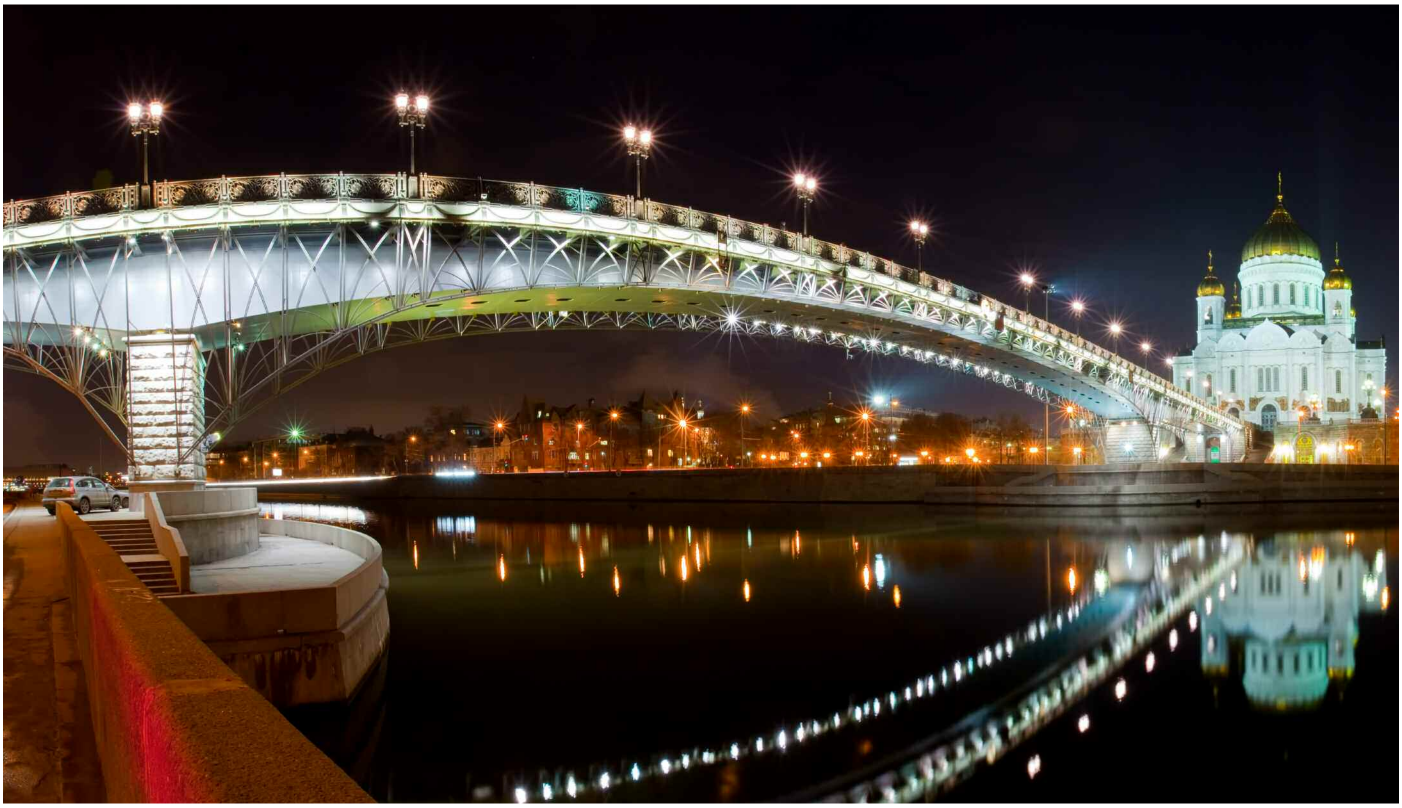


The introduction of the sanctions imposed by the US and the EU in connection with the situation in Ukraine (respectively, the "**US Sanctions**" and the "**EU Sanctions**" and, collectively, the "**Ukraine Related Sanctions**") in March 2014 was followed by a period of uncertainty in the Russian loan market. Never before had the US or the EU targeted a major world economy with such strong links to the international financial and energy markets. Many difficult questions arose as to the impact of the Ukraine Related Sanctions on new or pending loan transactions, as well as with respect to the implications under existing loan documentation. This uncertainty was exacerbated by developments in the summer of 2014 when the US and the EU unveiled the so called 'sectoral' sanctions; a type of sanctions regime that had never before been implemented by the US or the EU. These unique aspects of the Ukraine Related Sanctions, coupled with a rapidly evolving geopolitical situation and escalation of the Ukraine Related Sanctions throughout 2014, quickly led to sanctions becoming one of the most hotly negotiated issues on loan transactions in Russia; a trend that is expected to continue throughout 2015 and beyond.

There are many different ways to address sanctions risks in loan documentation and the approach followed on any particular deal largely depends on the parties involved and the law firms advising them. In the Russian market, a sufficient consensus has not yet been developed for there to be a 'market standard'. However, certain trends are clear, including a move away from the initial 'belts and braces' approach, which was common in the first half of 2014, in favour of a more refined approach. This note provides an overview of these trends and the types of issues that commonly arise in loan negotiations.

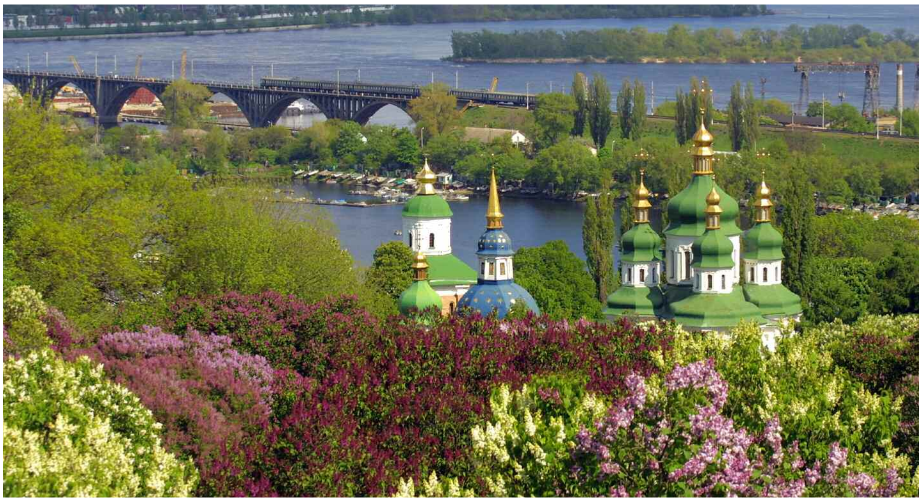
The problem with 'illegality'

Before looking at recent developments in the documentation, it is useful to briefly consider the position that existed under most syndicated loans at the time the Ukraine Related Sanctions were first introduced, and why the Russian market is now moving away from that position. Prior to the introduction of the Ukraine

Related Sanctions in March 2014, syndicated loan documentation in the Russian market generally did not pay a great deal of attention to sanctions, at least not expressly so. Russia was not regarded as a high risk jurisdiction for sanctions and so, for sanctions protections, banks tended to rely primarily on LMA-standard illegality mandatory prepayment provisions (which, essentially, enable lending banks to exit loans if it becomes 'unlawful' for them or any of their affiliates to fund or maintain those loans), rather than tailored sanctions provisions.

The intense scrutiny applied to the LMA-standard illegality mandatory prepayment provisions in the immediate aftermath of the introduction of the Ukraine Related Sanctions highlighted a number of areas of potential concern for banks in the context of the Ukraine Related Sanctions. One of the key concerns identified was that, even in cases where the Ukraine Related Sanctions directly affected the loan in question, it was not always clear what constituted 'unlawfulness' for the purpose of triggering the banks' right to exit. Consider for example a transaction involving a syndicate of European banks lending to a Russian borrower who, after signing the loan agreement but before funding, is designated (i.e. specifically named as a target) under the EU Sanctions. In this case, the advancing of the loan would seemingly directly contradict the prohibition in the EU Sanctions with respect to 'making funds or economic resources' available to those targeted by the EU Sanctions, thereby making it 'unlawful' for the banks to fund. However, the analysis is not that straightforward. The EU Sanctions contain various exemptions which, depending on the circumstances, may come into play (such as an exemption which allows payments to be lawfully made into a frozen account), as well as a licensing regime for authorising payments that would otherwise be prohibited. These factors, when considered in conjunction with the provisions in syndicated loan agreements which typically require banks to take steps to 'mitigate' the effects of illegality events, give rise to some difficult questions – for example: Are the banks obliged, contractually, to advance the loan into a frozen account? Are the banks required to apply for a licence before invoking the illegality mandatory prepayment provisions and exiting the deal?

The answers to these questions will ultimately depend on the facts, the parties and the terms of the loan agreement, specific to each case. So as to avoid being drawn into complex legal analysis and lengthy negotiations on these issues, banks and their lawyers have developed new provisions which are tailored to the Ukraine Related Sanctions and which seek to remove the uncertainty described above.



Prepayment vs event of default

Banks invariably require the right to exit loan transactions which violate any sanctions with which they are required to comply. The two primary ways of achieving this exit are mandatory prepayment events and events of default. There seems to be an emerging consensus in the Russian market that sanctions-related issues, which are for the most part not fault-based, are more appropriately treated as mandatory prepayment events, rather than events of default. This is generally regarded as being in all parties' interests; from the banks' perspective, it allows each bank to exit the deal unilaterally (ie without the need for a majority lender vote, as is typically required in the case of events of default) and, from the borrower's perspective, it potentially mitigates concerns with respect to cross defaults. Accordingly, sanctions-related issues are commonly addressed through a 'fortified' illegality mandatory prepayment clause.

Fortified illegality clause

For most Russian loans, the illegality mandatory prepayment provision remains the primary contractual protection for banks in the context of sanctions. So as to overcome the uncertainties described above with respect to 'unlawfulness', it is now common practice for various 'enhancements' to be agreed to the LMA-standard form for the purpose of dealing specifically with sanctions. The content and scope of these

enhancements continue to vary from deal to deal but, in most cases, they will involve a right for the banks to insist on early repayment in some or all of the following circumstances:

(i) upon the 'designation' or targeting (directly or indirectly) of the borrower by a relevant sanctions authority. The primary benefit of such approach, as far as banks are concerned, is that it eliminates the uncertainties described above with respect to 'unlawfulness'. In most (although not necessarily in all) cases, it is a relatively simple process to check whether a borrower has been designated under any applicable sanctions regime. Another reason that banks favour a right to exit in these circumstances is that, even absent any unlawfulness, becoming a sanctions target can often lead to a subsequent deterioration in the creditworthiness of the borrower by virtue of the harmful effects the sanctions may have on its business. On transactions where this mechanism is agreed, borrowers will commonly insist that a distinction is drawn between the sectoral sanctions (which generally target new financings, as distinct from existing financings) and other types of sanctions (which may target both);

(ii) if the banks determine that they have become exposed to restrictions or penalties relating to sanctions. The subjective nature of this trigger, based on the banks' determination, is sometimes a cause of concern for borrowers; and

(iii) upon a breach of any of the sanctions-related representations or undertakings set out in the loan agreement. There is no settled market practice as to the scope of these representations and undertakings but, as a minimum, they typically include a representation by the borrower that it is not a sanctions target and provisions regulating the use of the loan proceeds and the source of funds used to service the loan.

Sanctions definitions – less is more

Perhaps the most convoluted aspect of loan documentation in the immediate aftermath of the introduction of the Ukraine Related Sanctions was the exceedingly lengthy and detailed sanctions-related definitions. Initially, there was a tendency to simply replicate sanctions definitions that had been crafted with other sanctions regimes in mind (such as the stricter sanctions regimes targeting, for example, Iran) and, in some cases, the definitions alone ran for several pages, describing every conceivable sanctions list and authority. Some borrowers regarded this approach as clumsy; not only because of the unnecessary complexity, but also because, in some cases, the definitions went beyond what was actually required under the applicable sanctions regimes. For example, during the first half of 2014 it was not uncommon to see definitions which, for the purposes of the loan agreement, purported to treat companies 'resident, or incorporated, in a jurisdiction targeted by sanctions' as being sanctions targets, even though the Ukraine Related Sanctions did not necessarily regard them as such.

More recently, sanctions definitions have become more refined and concise. It has become increasingly common to define a 'Sanctioned Person' simply along the lines of 'any person who is a designated target of Sanctions or is otherwise a subject of Sanctions'. The benefit of this approach, aside from its simplicity, is that it automatically covers all targeted persons without regard to whether they are designated or otherwise targeted directly or indirectly; whether by virtue of ownership, control or any other relevant criteria.

The key issue to be agreed between the banks and the borrower in this context is which sanctions regimes (eg EU, US and/or others) should be included for the purpose of the definition of 'Sanctions' (see further below with respect to 'Policy banks'). It may also be necessary to consider whether a distinction should be drawn as between the so called 'sectoral' sanctions (which impose a fairly limited set of restrictions) and sanctions involving assets freeze (in the EU) or blocking (in the US) requirements (which typically involve more comprehensive restrictions).

Policy banks

One of the most controversial issues that arises in negotiations is with respect to the treatment of those non-US banks which, although generally not required to comply with US sanctions, choose not to undertake business that would be prohibited to US banks, as a matter of internal policy. The rationale for doing so generally stems from a desire to ensure that their (often sizeable) US businesses are not jeopardised, the compliance costs that can be involved in navigating US sanctions risks as well as unease associated with potentially massive fines and the perceived aggressive enforcement policy of the Office of Foreign Assets Control of the US Department of the Treasury ("**OFAC**"). Such 'policy banks' typically insist that they have a right to exit the loan in case the borrower is targeted under the US Sanctions. Borrowers often resist, particularly when the loan is not denominated in US dollars, on the basis that there are no legal impediments to the bank remaining in the deal.

This issue remains highly contentious in the Russian loan market. It can be very difficult for policy banks to commit to transactions that are not in line with their internal policies and so this risk is often pushed onto the borrower. In such cases, borrowers will often seek to water down the banks' right to exit; for example, by insisting that, in circumstances where the right to exit arises by virtue of a bank's policy requirements (as distinct from a legal requirement), the borrower has a longer period in which to prepay the affected bank.

Constraints on the borrower's business

Some of the most hotly contested sanctions provisions in the Russian loan market are those that seek to limit borrowers' business activities. In this context, it is not uncommon to see provisions in loan agreements which seek to prevent borrowers from engaging in any and all business dealings with persons or companies that are subject to sanctions. The rationale, from the banks' perspective, is to mitigate potential legal and reputational risks associated with indirectly financing sanctioned business dealings; however, in the context of the Ukraine Related Sanctions, this creates practical hurdles. By way of example, any borrower that has a banking relationship with one of the large state owned Russian banks (likely, the vast majority of Russian borrowers) would potentially fall foul of such provisions, notwithstanding the fact that such banking relationships may be entirely lawful under the US Sanctions and the EU Sanctions. Similarly, it is not uncommon to see provisions requiring Russian borrowers to comply with EU and US sanctions. Most Russian borrowers object to this on the basis that neither the US Sanctions nor the EU Sanctions require this (because, generally speaking, non-US persons and non-EU persons have compliance obligations under the US Sanctions and the EU Sanctions (respectively) only in certain limited circumstances) and it unnecessarily deprives them of the right to conduct otherwise legitimate business activity.

Due to the more limited nature of the Ukraine Related Sanctions (in comparison with other comprehensive sanctions regimes), these issues are now commonly addressed through more targeted undertakings, such as with respect to the use of the loan proceeds, the source of the funds used to service the loan and other activities that could reasonably be expected to expose the lending banks to potential liability, rather than blanket prohibitions.

Directors, officers, employees

Another commonly negotiated issue relates to the treatment of directors, officers and employees of the borrower. It is not uncommon for the scope of sanctions-related representations and undertakings to be expanded so that they cover not only the borrower itself, but also its directors, officers and employees. For example, a common representation might state that neither the borrower nor any of its directors, officers or employees is a sanctioned person, or engaged in any activity which is in violation of sanctions.

Borrowers often object to such provisions on the basis that, generally speaking, the mere designation of a director, officer or employee of a company under the Ukraine Related Sanctions does not necessarily implicate the company itself. Banks tend to be sympathetic to this objection and are thus willing to negotiate this provision, provided there are additional risk mitigants. In particular, caution needs to be exercised in any dealings with a designated director or officer of the company, even if he or she is acting on behalf of the company.

Currency toggles

A novel development with respect to sanctions has been the introduction of so called 'currency toggles'. Currency toggles are provisions in loan agreements which seek to mitigate the impact of the US Sanctions (in particular, with respect to the clearing of payments through the US financial system) on deals that do not involve any US persons and whose only nexus to the US is the currency of the loan (ie US dollars). More specifically, these provisions seek to provide a means for payments under US dollar loans to be settled without exposing the parties to the risk of OFAC enforcement action for involving US persons or the US financial system.

There is no standard form for currency toggles but they typically involve a right for the banks and/or the borrower to elect to have payments under US dollar denominated loans settled in an alternative currency (usually selected from a pre-agreed list) if payments relate to potentially OFAC-prohibited activities. The loan itself remains denominated in US dollars, and only the currency of settlement changes.

The initial concerns that existed with respect to currency toggles and possible sanctions circumvention risks have largely subsided and currency toggles are now widely used in the Russian loan market. Such provisions are generally regarded as being mutually beneficial for banks and borrowers; from the banks' perspective, they provide a means of being repaid in circumstances where the payment may otherwise not be cleared through the US financial system and, from the borrower's perspective, such provisions can mitigate the risk that they will be asked to repay the loan early.

Indemnities

Banks typically seek (and obtain) from their borrowers indemnities with respect to misrepresentations and breaches of undertakings (eg undertakings with respect to the use of the loan proceeds), as well as with respect to any steps taken by the banks to mitigate the effects of sanctions and other illegality events.

Such indemnities are, for the most part, not regarded as being particularly controversial. However, since the introduction of the Ukraine Related Sanctions, it has become increasingly common for banks to seek additional indemnities covering, among other things, any and all liabilities which may be incurred in connection with sanctions. Notably, this would potentially include fines imposed on the banks as a result of their non-compliance with applicable sanctions; fines which can potentially run into the billions of dollars.

Not surprisingly, such indemnities tend to be fiercely resisted by borrowers. Borrowers argue that the banks' compliance with any sanctions laws applicable to them is a matter for the banks alone and that, so long as the borrower has complied with any undertakings given by it in the loan documentation, it should not be liable for any penalties imposed on the banks as a result of their own non-compliance. There is currently no settled market practice on this issue and the enforceability of any such indemnities should be considered on a case-by-case basis.

Delayed payments

A practical issue arising out of the Ukraine Related Sanctions has been that, in loan transactions involving companies targeted under the sectoral sanctions (including when such companies are participating as lenders), payments between the borrower and the banks are sometimes delayed due to enhanced due diligence being applied to those payments by the processing and clearing banks. As a result, payments are sometimes received by the banks several days after their due date, which inevitably leads to discussions as to whether a non-payment default has occurred and whether default interest is payable. To date, relatively few borrowers have sought to include provisions in their loan documentation for the purpose of regulating this issue, but that will likely change if these delays persist.

Conclusion

The issues described above are by no means exhaustive. Sanctions will undoubtedly continue to be one of the mostly hotly negotiated issues on Russian loan transactions and the trends described above will continue to evolve. As we enter 2015, participants in the Russian loan market are, due to experience gained throughout 2014, generally much better placed to consider and address sanctions-related issues that may arise on loan transactions.

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