An expanding minefield

Lawyers are being tested by the impact of Russian sanctions on complex financial instruments. New clauses are helping bank syndicates navigate the changes

Since March, the topic of sanctions has dominated conversation about the Russian syndicated loan market. With tensions between the west and Russia over events in Ukraine escalating, the US and EU (as well as some other jurisdictions) have imposed several rounds of financial sanctions on selected Russian and Ukrainian individuals, companies and banks. The sanctions have, to date, been somewhat limited in scope. But both US and EU government officials have said more wide-ranging sanctions – potentially targeting entire sectors of the Russian economy – could be introduced, depending on political outcomes in Ukraine.

Russia appears to be the first country targeted by financial sanctions whose companies and banks are major participants in the international financial markets. These entities are parties to syndicated loans, eurobonds, derivatives and other financial instruments worth hundreds of billions of dollars. The legal structures around which these financial products are delivered into the country are complex – in certain cases, due to specific Russian regulatory requirements, these legal structures are more complex than in western Europe or the US. Other countries previously targeted by sanctions – such as Iran, Cuba and Sudan – did not have such large, sophisticated international financings in place when the measures against them were announced. This is, therefore, the first time that the international financial and legal community has had to consider how US and EU financial sanctions impact complex financial instruments.

These developments have generated the most debate in the syndicated loan markets. US and EU lenders are now seeking to include in their loan documentation with Russian borrowers additional clauses dealing with the potential impact of the sanctions. These so-called sanctions clauses have triggered a degree of confusion and frustration in the market – particularly among Russian borrowers, who are now being asked to sign up to new and lengthy provisions in their loan documentation that are driven purely by US and EU regulatory requirements. Russian borrowers are naturally asking why they should accept sanctions clauses that seem to concern only the relationship between a lender and its US or EU regulator.

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The loan market's thinking on these issues is still developing, and each institution will have its own additional concerns to be addressed. But looking back over the last four months, it seems that US and EU lenders' concerns can be broken down into four main areas.

1. A loan facility with a Russian borrower is signed but undrawn. The US or EU then sanctions the Russian borrower, who submits a drawdown request the following day

A lender that is bound by US sanctions must not advance a loan to an entity sanctioned by the US. Similarly, a lender that is bound by EU sanctions must not advance a loan to an entity sanctioned by the EU (in certain cases, disbursement may be made to a blocked account, although syndicated loan facilities do not generally provide for this mechanism).

Most loan facilities for Russian borrowers are committed. Under the terms of a typical loan agreement, for a lender to be relieved of its obligation to lend one of the drawstops in the document must be triggered. The market has consequently been looking closely at standard cancellation events, representations, undertakings and events of default to see which of them may provide an exit.

The best place to start is the clause that allows a lender to cancel its commitment on the grounds of illegality. The usual formulation of this lender illegality clause (LIC) allows a single lender to exit the transaction if it becomes unlawful for it to advance the loan. The clause is useful as it applies to illegality for the lender (not the borrower), and it allows a single lender to exit the facility, irrespective of the position of other syndicate members.

However, some LICs do not expressly cover every situation where a lender might want protection. Specifically, lenders are seeking further protections in their LICs in the following three scenarios.

Scenario 1: A global financial institution has entered into a voluntary agreement with the US in relation to sanctions

Some international banks have signed voluntary agreements with the US, pursuant to which they undertake to comply with all US sanctions on a group-wide basis. A non-US member of the bank's group would not wish to make a loan to a sanctioned Russian borrower, as to do so may place it (or one of its affiliates) in breach of this voluntary agreement.

Under a typical LIC, the cancellation right is triggered if it is 'illegal' or 'unlawful' for the lender to make the loan. However, it may be difficult for the non-US bank to demonstrate that the breach of what is essentially a private contract is 'illegal' or 'unlawful'.

Scenario 2: The US makes its Russian sanctions 'extraterritorial'

The US has previously extended certain of its sanctions programmes (such as those against Iran and Cuba) to entities outside the US by making them binding not only on US persons, but also on non-US subsidiaries of US persons. Up to now, the US's Russian sanctions are not expressly extraterritorial: they are binding on 'US persons', as defined in the OFAC [Office of Foreign Assets Control] regulations.

However, if the US extends its Russian sanctions so they become extraterritorial, it may be unlawful for a US-headquartered bank if one of its non-US subsidiaries makes a loan to a sanctioned Russian borrower. Many LICs do not expressly provide for a lender's cancellation rights if the illegality arises at the level of its holding company or other affiliate (the Loan Market Association's LIC has such a provision, but it is stated to be optional).

A related concern is that some non-US lenders of record are funded by their US affiliate, by way of an intra-group loan or guarantee. The non-US lender's primary obligation to lend to the sanctioned Russian borrower may not be illegal, but it may be illegal for its US affiliate to fund the non-US lender's loan. A similar concern exists in relation to the EU sanctions. Again, this situation is not usually expressly covered in a typical LIC.

Scenario 3: A global financial institution has a policy to ensure group-wide compliance with US and EU sanctions

In the prevailing environment, as a matter of policy and franchise protection, some global financial institutions are choosing to operate as if the US and EU sanctions regimes were applicable to all their affiliates in every jurisdiction. This is irrespective of that fact that some of those affiliates may technically not be subject to the US or EU sanctions. The LIC does not normally address this situation.

Take the example of a non-US subsidiary of a US bank (such as a UK bank) that is party to a loan facility with a Russian borrower. The Russian borrower is then sanctioned by the US. The UK bank, as a policy matter, may not wish to make the loan. But again, under the typical LIC, the question is whether it is 'illegal' for the UK bank to make the loan. It may be technically legal for the UK bank to make the loan if the borrower has not also been targeted by EU or UK sanctions, meaning the cancellation rights under the LIC would not be available.

To address these concerns, LICs in new transactions are expanding to expressly permit a lender to cancel its commitment if sanctions in any way affect it, its holding company and affiliates, or the transaction in question.

2. A loan facility with a Russian borrower is signed and fully drawn. The Russian borrower then becomes sanctioned by the US or EU

A fundamental policy objective of sanctions is preventing the movement of fresh funds to sanctioned entities. However, the US and EU sanctions are broad, and generally prevent banks from performing most activities under a loan facility without first receiving a licence from the relevant authority (such as OFAC in the US and HM Treasury in the UK). For example, the sanctions prevent a lender from receiving repayment of the loan without first having a licence. In theory, funds could be received into a blocked account. But the practical implications of a blocked account are unclear – for example, it is difficult to see how the borrower could successfully transfer funds through the international payment system, without them being frozen before they reach the lender's blocked account.

In many LICs, a lender must promptly notify the borrower (via the facility agent) of an illegality event, which begins a chain of events leading to repayment of the loan. This creates a tension between what lenders are obliged to do under the loan agreement (ie deliver a notice requiring repayment), and what the sanctions permit them to do only with a licence. One approach, in new transactions, could be to remove the requirement for the lender to promptly notify the occurrence of an illegality event, and instead give the lender discretion as to when it makes the notification. This would give a lender time to receive a licence and, only at that stage, notify the occurrence of the illegality event and require repayment.

Both the US and EU regimes have licensing procedures in place. While a licence to advance further funds to a sanctioned entity seems unlikely to be granted, a licence to take away funds from a sanctioned entity should in principle be easier to obtain. However, it may not be straightforward to obtain even licences that permit a repayment: if broader sector sanctions affecting numerous Russian borrowers are introduced, sanctions authorities will receive multiple requests for specific licences. In this scenario, it is unclear how the sanctions authorities could quickly process so many requests.

One solution could be for the sanctions authorities to grant a general wind-down licence. This would allow all banks that have already advanced loans to Russian borrowers to exit (including demanding and receiving repayments) all their existing Russian loan facilities. Some of our bank clients have expressed a willingness to work with other financial institutions and regulators in relation to obtaining general licences at the appropriate time. If the political situation in Ukraine deteriorates further and the relevant sanctions warrant it, we would encourage a dialogue between the major lenders in the Russian loan market and the regulators.

3. Facilitation risk: the Russian borrower is not sanctioned, but it is dealing with entities who are sanctioned

US sanctions prohibit a US person (such as a US bank) from 'facilitating' transactions between a non-US person (a Russian borrower) and a sanctioned entity, if the US person itself could not engage in such transaction. The EU uses a similar concept. The classic example of facilitation is where a bank finances a borrower that is not subject to sanctions; the borrower then on-lends the loan proceeds to an entity that is sanctioned, which may trigger sanctions liability for the bank.

This risk is not new – banks were concerned about facilitation risk even before the Ukrainian crisis. The historic concern was that a borrower might use loan proceeds to finance activities in sanctioned countries like Iran or Cuba.

> **Sanctions clauses have triggered a degree of confusion and frustration**

But in the Russian context, this risk could escalate quickly if entire sectors of the Russian economy are sanctioned, thereby affecting potentially hundreds of Russian companies. Perhaps a Russian borrower under a particular loan agreement would not be sanctioned, but its business and trade partners might be. In this case, banks will be very sensitive to the risk that their non-sanctioned Russian borrowers use the loan proceeds to finance sanctioned Russian companies.

Banks are therefore seeking specific representations and covenants in loan agreements, whereby the borrower expressly undertakes not to finance entities that are themselves subject to sanctions. Russian borrowers are understandably concerned with the scope of these representations and covenants – they ask how they can screen all of their counterparties and be sure that none of those counterparties is sanctioned. Ultimately, this is a question of risk allocation – the fines that could be imposed by sanctions authorities on banks are substantial, so banks are keen to demonstrate that they have done all they can to ensure their loan proceeds are not channelled to sanctioned entities.

> **Some global financial institutions are operating as if the US and EU sanctions applied to all their affiliates**

4. Reputational concern: the Russian borrower is not sanctioned, but one of its officers or directors is sanctioned

The Russian sanctions apply to persons on the US and EU lists, as well as entities that they 'own' or 'control' (which sanctions authorities determine by using various tests). But what about entities that are not owned or controlled by someone on the list, but are instead 'linked' to someone on the list? For example, what if an officer, director or other affiliate of a Russian company is added to the sanctions list, but the requisite tests for 'ownership' or 'control' are not met? In this case, the Russian company will not be considered sanctioned and, as a purely legal matter, a US or EU bank is free to lend to that Russian company.

But even if the Russian company is not itself sanctioned, as a reputational matter, a US or EU bank may not wish to enter into a loan facility with that company. This is why some sanctions clauses require the Russian borrower to represent that none of its officers, directors and affiliates are sanctioned. A breach of this representation entitles the lender to cancel its commitment and require repayment of the loan (though whether a lender would exercise this right is of course a different question).

This concern has proved the hardest to explain to Russian borrowers who, understandably, ask why their loan facilities should be capable of being terminated on the basis of sanctions, even if they themselves are not sanctioned. In these situations, we ask the Russian borrower to look at the situation from its own perspective: Russia has its own sanctions list that targets certain US persons (today, that list is comprised only of US government officials, though there is speculation that if the US ratchets up its sanctions, the Russian list could be expanded). Assume that Russia puts a senior officer of a US bank – but not the US bank itself – on its sanctions list. Would a Russian company have similar reputational concerns about entering into a transaction with that US bank, knowing that one of its senior officers was sanctioned by Russia, even if the US bank itself was not?

Pending an improvement in the international political climate, the market will continue to debate this and the other questions.

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