

Sanctions Clauses - Safeguarding payment under Letters of Credit

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Publication Date: January 11, 2012

The documentary letter of credit ("**LC**") is a key payment method in international trade - not only does it satisfy both the seller's and the buyer's conflicting needs, but it also is considered to be relatively risk free. However, the recent surge in financial sanctions and embargoes, and the resulting "sanctions clauses" in LCs trying to meet the issue, is challenging the fundamental nature of an LC.

Sanctions against Iran, Libya, and Syria in particular have led to disputes over LC payments.

In this client alert, we highlight how sanctions legislation can have the effect of diluting the payment obligation under an LC (including a standby LC), and how the risk that a bank may not pay could be mitigated by traders.

The Payment Obligation

An LC creates a payment obligation that is independent of, and completely separate from, the underlying sale contract between the seller and the buyer. This principle is clearly set out in UCP 600, Article 4a:

"A credit by its nature is a separate transaction from the sale or other contract on which it may be based. Banks are in no way concerned or bound by such contract..."

The main concern of the seller is that he wants to ensure that, provided he has presented the documents required and the LC terms and conditions are satisfied, he will get paid by the bank. There should be no room for uncertainty as to how the terms and conditions of the LC will operate, in particular the undertaking to pay.

Sanctions

Sanctions are a way for governments to achieve political and economic results by using restrictions on trade as a tool for foreign policy. Sanctions can be imposed by the UN, EU Council or individual countries, and increasingly have an extra-territorial effect (in particular, U.S. sanctions seek to reach widely beyond U.S. borders). They are often imposed with no prior notice and with limited or no "savings" for pre-existing transactions, causing huge disruption for trade.

Sanctions Clauses

Sanctions clauses are common in sale contracts - either within Force Majeure clauses or separate "compliance" clauses. They seek to deal with the impact of sanctions on sales in particular when imposed after the sale contract. However, sellers are increasingly coming across LCs that also include "sanctions clauses". These clauses warn that legal sanctions may prohibit the issuing or confirming bank from dealing with certain countries, persons or assets. This may mean that, *despite a complying presentation under an LC*, there is a real chance that payment will not be made.

A significant range of such clauses, which banks are seeking to insert in LCs, are now in circulation. We summarise below the types of clauses that may be encountered and the difficulties that may arise.

1. ***The bank is subject to sanctions legislation***

This type of clause (which may be acceptable to the Seller/Beneficiary) does nothing more than state the position in which the bank finds itself - that is, if prohibited by law, the bank will be unable to pay the seller under the LC. This type of clause does not give the bank a discretion to decide whether or not it will pay. It simply highlights for a seller that there may be legal reasons why the bank cannot pay.

2. ***The bank and its internal policy not to pay***

Where the sanctions clause goes further and suggests the bank may not pay as a result of internal policies going beyond the legally applicable sanctions, this chips away at the bank's irrevocable undertaking to pay. The bank's internal policy may go beyond the relevant applicable sanctions legislation. For example, a bank may have a policy to always follow and comply with all U.S. sanctions, even for an LC payable in Europe in Euros. This kind of term should not be accepted by a seller when checking an incoming LC, as it introduces considerable uncertainty as to whether or not payment will be made under the LC.

3. ***The bank may not pay if it believes that payment may be in breach of sanctions legislation***

Similarly, where the bank has discretion under the LC in deciding whether there may be a breach of sanctions, and that in such circumstances it will not pay under the LC, this wording should also be rejected by a seller. This wording undermines the independent payment obligation under the LC, and the bank's discretion creates a risk that the seller as beneficiary will not be paid.

An LC payment undertaking vs. sanctions: Which wins?

The UCP 600 (which sets out contractual rules for banks to follow in LCs) says nothing about sanctions at all. However, each bank is also subject to laws affecting it, whether based on the place of business,

place of incorporation, nationality of staff, or place of performance of the particular LC. Which will take priority; UCP or applicable law?

Quite simply, the relevant applicable sanctions legislation will always bind the bank.

If sanctions regulations apply to a transaction involving an LC, the affected bank has no choice - it has to comply. Sanctions override the terms of the LC, including provisions of UCP 600, which may have been incorporated. The important issue, however, is exactly which laws are in fact applicable to the particular LC. Precisely because this important issue is often unclear, banks have increasingly introduced wide sanctions clauses to try to permit them both to follow a wide range of possible sanctions regimes, and to be cautious when faced with possible sanctions affecting payment.

How to mitigate the risk of non-payment

Some steps can be taken to help address the risk of non-payment under an LC because of the effect of a sanctions clause:

- Ensure that the LC does not contain: (a) any sanctions clause; or (b) any wide sanctions clause of the type described above. Prevention is always better than a cure. To achieve this:
- The underlying sale contract could include terms that expressly prohibit a sanctions clause from appearing in the LC; or
- The exact form of the required LC, without any sanctions clause, could be attached to the sale contract. This obliges the buyer to arrange for an LC to be opened in the form set out in the sale contract, and there can be no arguments as to whether the LC is contractual or not; or
- As beneficiary, consider objecting to any LC opened with a sanctions clause which seems to do anything more than mention that the bank is subject to relevant sanctions laws.
- If a beneficiary is forced to accept a sanctions clause:
- Ensure that it does not give the bank discretion vis-à-vis its payment obligation.
- Obtain local law advice in case of any non-payment/threatened non-payment. Lawyers in the jurisdictions where the relevant banks are located should be contacted to determine the extent of the application of sanctions.

Conclusion

Sanctions are here to stay and we are likely to see their number increase in the future with global political volatility. As a result, and despite an ICC Guidance paper (470/1129, March 2010) advising against the use of sanctions clauses by banks, sanctions clauses will continue to be seen in LCs used in trade transactions. When faced with an LC containing a sanctions clause, the beneficiary should carefully check the terms of the clause to ensure it remains a suitable mechanism for payment. Even better, traders should take care to put suitable terms in the sale contract to prevent a buyer from opening an LC with these wide sanctions clauses.

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