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Loan documentation and sanctions

Russia: developments at the forefront

2018

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Introduction

Banks and borrowers active in the Russian loan market have been remarkably adept in dealing with the challenges posed by sanctions and, having been at the forefront of the only major world economy subject to U.S. and EU sanctions, in developing sophisticated contractual protections with respect to sanctions. Indeed, many of the contractual protections developed in the Russian loan market are now commonly cited as best practice and rolled out on loan transactions in others parts of the world.

Contractual sanctions protections evolved rapidly in the Russian loan market in the immediate aftermath of the first wave of Ukraine-related sanctions in 2014. Not content with the contractual uncertainty that had ensued following the first wave of sanctions, banks mobilised quickly to develop comprehensive sanctions provisions. These provisions served several purposes but above all else they were designed with a single overriding objective in mind: to ensure that banks would have a clear and unambiguous contractual right to call in their loans if their borrowers were targeted or otherwise affected by sanctions. Market practice with respect to these provisions has since been in an almost constant state of evolution and refinement in pursuit of striking a delicate balance between, on the one hand, banks' inviolable need to protect themselves from potential sanctions violations and, on the other, borrowers' equally inviolable need to be able to operate their businesses without undue constraint and disruption.

Recent events have once again brought these provisions into sharp focus and, in some cases, called into question whether an appropriate balance has been struck. On 6 April 2018 the United States' Office of Foreign Assets Control ("**OFAC**") deployed one of the most powerful weapons in its sanctions arsenal against prominent Russian oligarchs and the companies owned or controlled by them. For the first time, OFAC exercised its powers under Executive Order 13662 to designate specially designated nationals ("**SDNs**") and impose strict blocking sanctions, rather than the more limited sectoral sanctions. Among those targeted were globally-significant commodity producers and companies that had borrowed billions of U.S. dollars in the international debt capital markets and who were now at risk of being cut off from the U.S. financial system. This escalation, coupled with conflicting messages out of Washington as to whether further escalations would follow, sent shock waves through global commodities markets.

The fallout from these events has prompted the single most significant reassessment of contractual sanctions protections since they were first introduced in the Russian loan market in 2014. That reassessment is now leading to further evolutions in market practice and, although it is too soon for there to be a settled market practice, some common themes are already starting to emerge. This article provides an overview of some of those themes and negotiation points that are being raised on new deals. Although the issues discussed in this article relate specifically to the sanctions targeting Russia and market practice in the Russian loan market, many of the principles will apply equally to loan transactions in other jurisdictions.

Sanctions mandatory prepayment provisions – the devil in the detail

A familiar problem

The most fundamental documentation issue being discussed on new Russian deals is the mandatory prepayment trigger linked to sanctions, otherwise known as the 'sanctions mandatory prepayment provision'. Sanctions mandatory prepayment provisions were first introduced in the Russian market in response to concerns identified in the immediate aftermath of the first wave of sanctions in 2014. The key concern identified was that the concept of 'unlawfulness' in the traditional LMA-style illegality mandatory prepayment provisions, upon which banks had at the time tended to rely as their primary contractual protection with respect to sanctions, was not always a clear cut concept in the context of modern-day sanctions regimes.

The intricacies of the U.S. and EU sanctions regimes, coupled with (in some cases) a lack of precision in their drafting, as well as the potential extra-territorial application of U.S. sanctions, gave rise to many questions that often required detailed and complex legal analysis and that analysis did not always arrive at a robust conclusion. Is it unlawful for non-U.S. persons (such as European or Asian banks), who are generally not bound by U.S. sanctions in the same way as U.S. persons, to continue to deal with an SDN? Is it unlawful for a non-U.S. person to receive U.S. dollar payments from SDNs? What if the funds are paid into a blocked or frozen account as required by the applicable sanctions? What if the U.S. correspondent bank fails to block the payment? Can an SDN repay its U.S. dollar loans in a different currency? What is the impact of any temporary general licenses issued by OFAC and how does that affect the lenders' rights to call in their loans? At what specific moment does the banks' right to call in their loans crystallise?

These complexities gave rise to uncertainty and the possibility of there being a 'gap' between a loan being affected by sanctions, including instances where payments may be required to be blocked, and the triggering of the banks' rights to call in the affected loans. Banks regarded this as unsatisfactory; if their borrower became an SDN, banks expected to have a clear and unambiguous right to call in their loans and sever dealings with the affected borrower.

This led to a move away from sole reliance on the concept of unlawfulness. The key 'fix' that quickly emerged in the spring of 2014 was a new sanctions mandatory prepayment provision based on the concept of 'mere designation'. It became increasingly common for the LMA-style illegality mandatory prepayment provisions to be supplemented by an additional provision that allowed lenders to call in their loans and exit the deal if their borrower became a target of applicable sanctions (subject, in some cases, to appropriate carve outs for the more limited sectoral sanctions). The appeal of this approach for banks lay in its simplicity; mere designation, in and of itself and, importantly, irrespective of any unlawfulness, was sufficient to avail the banks of their rights and the complex legal analysis and uncertainties associated with unlawfulness were eliminated. These provisions quickly became banks' primary contractual protection for sanctions-related issues.

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Prepayment provisions come full circle

Market practice with respect to these provisions subsequently began to diverge and, in some cases, the concept of mere designation later morphed into a 'hybrid' approach linked to unlawfulness. In order to avail themselves of the contractual protections under this hybrid approach, banks had to be able to demonstrate not only that their borrower had been designated as a sanctions target, but also, in addition, that such designation gave rise to unlawfulness or a violation of applicable sanctions.

It is this hybrid approach that is now coming under intense scrutiny and being heavily negotiated on new deals. Recognising that such approach and, in particular, its reliance on the concept of unlawfulness gives rise to many of the same questions and uncertainties faced following the first wave of sanctions in 2014, banks are now seeking to 'disentangle' the concepts of unlawfulness and mere designation.

A new 'fix'

One of the ways this is now being addressed by banks on new U.S. dollar denominated deals, with a view also to not departing too far from the 'hybrid' standard to which certain borrowers have become accustomed, is to replace the concept of unlawfulness with a trigger point that is more closely tied to the direct legal and practical consequences of designation; namely, the impact on payments. Such a 'modified hybrid' provision might provide that the banks need demonstrate only that (i) their borrower has become a sanctions target and (ii) such designation results (or will result) in a requirement that any party to the loan (or any clearing or correspondent bank) being obliged to transfer funds remitted under or in connection with the loan into a blocked or frozen account. Both limbs of this test (the designation as a sanctions target and the requirement to block payments) are relatively clear and legally determinable trigger points which do not give rise to the same uncertainties associated with unlawfulness. Importantly, this formulation also mitigates the risk described above as regards a potential 'gap' between loan payments being blocked and the triggering of the banks' right to call in their loans.

When it comes to sanctions mandatory prepayment provisions the devil really is very much in the detail and the appropriateness of any particular formulation should always be carefully considered on a case by case basis having regard to the specifics of each transaction. In particular, while the provision described above might be appropriate for a U.S. dollar loan, it might not be so for a loan in a different currency. For example, in the context of a euro loan made available by European banks, the designation of the borrower as an SDN under U.S. sanctions would be unlikely to trigger such provision (as the processing of euro payments does not necessitate the involvement of the U.S. financial system and therefore will not necessarily lead to a blocking requirement), but this may not necessarily reflect the banks' intention. Aside from the legal and regulatory implications, designation as an SDN can also have a devastating impact on the creditworthiness and future prospects of a borrower and as such banks may expect a right to call in their loans to an SDN borrower, irrespective of any blocking requirement. In addition, it is not uncommon for European and Asian banks to comply with U.S. sanctions, as a matter of their internal policies,

even though the U.S. sanctions themselves do not generally require this. For those banks, the 'modified hybrid' provision described above (which triggers a right for the banks to call in their loans only if a blocking requirement arises but not for policy reasons) would be unlikely to be appropriate in the context of a non-U.S. dollar loan.

From banks' perspective, the 'mere designation' test that originated in the summer of 2014 also remains, subject to appropriate carve outs for sectoral sanctions, a viable and effective contractual protection for loans of all currencies. However, some stronger borrowers argue that such provisions do not account for the possibility that the U.S. may again introduce new types of more limited sanctions (as they did with the sectoral sanctions) and that such provisions are therefore too strict.

As market practice with respect to sanctions mandatory prepayment provisions continues to evolve, we may well see a convergence of the 'mere designation' concept and the 'modified hybrid' approach described above, such that the mere designation concept is retained for the more serious or stricter types of sanctions and the modified hybrid approach is retained for other types of sanctions. Such a provision might provide that the banks will be able to invoke their right to call in their loans if (a) their borrower becomes an SDN or the EU equivalent, or (b) their borrower has become a sanctions target in respect of any other types of sanctions and such designation results (or will result) in (i) a requirement that any party to the loan (or any clearing or correspondent bank) being obliged to transfer funds remitted under or in connection with the loan into a blocked or frozen account, or (ii) unlawfulness or a violation of sanctions.

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General licences and grace periods

Another area of increased scrutiny is the impact of the general licences that may be issued by OFAC. From time to time OFAC issues general licences, the effect of which is to permit certain dealings with SDNs (such as dealings required to wind down transactions that pre-dated the sanctions) that would otherwise be prohibited. This gives rise to a couple of potential timing issues. First, banks will expect that, if a sanctions problem arises, they will be able to invoke their contractual rights immediately and not only after the expiry of any relevant general licences. Careful drafting is needed to achieve this.

Secondly, more traditional illegality and sanctions mandatory prepayment provisions typically allow banks to call in their loans on the earlier of the last day of the then current interest period or such earlier date as may be specified by the bank, provided such earlier date is not earlier than the last day of any applicable grace period permitted by law. There is a clear logic to this; if the borrower is required to prepay its loans early due to sanctions or a change in law, it should be afforded the benefit of any grace period that is available under the relevant sanctions or law. However, such arrangements can be problematic in practice. In circumstances where an SDN is attempting to make payments through the U.S. financial system pursuant to a general licence, the correspondent banks will typically apply enhanced due diligence to those payments for the purpose of ensuring that they fall within the parameters of the relevant general licence. In practice, this often leads to delays in the processing of the payment and, if a payment is being made on the last day of the period allowed under a general licence, it runs the risk of being delayed beyond the last day of that period and thereafter being blocked indefinitely pending receipt of a specific licence from OFAC.

This practical consideration has prompted discussion on new deals as to whether linking the timing for the prepayment to the last day of the grace period is prudent or whether banks should be given greater flexibility to dictate the timing for the prepayment.

Currency toggles and alternative payment mechanisms

A novel development following the first round of sanctions against Russia in 2014 was the introduction of contractual provisions, commonly referred to as 'currency toggles' or 'alternative currency mechanisms', which seek to mitigate the extra-territorial effects of U.S. sanctions. Although 'primary' U.S. sanctions do not generally impose compliance obligations on non-U.S. persons, they do impose such obligations to the extent that the non-U.S. persons' dealings involve 'U.S. elements' (including dealings involving the U.S. financial system or which otherwise cause a U.S. person to violate U.S. sanctions). Accordingly, U.S. sanctions have the potential to directly impact any U.S. dollar loan transaction, and result in the blocking of payments thereunder, anywhere in the world, even if none of the parties to the underlying transaction are U.S. persons.

Currency toggles seek to provide a contractual framework pursuant to which non-U.S. banks and their borrowers can extricate potentially problematic U.S. elements from their dealings. Although the specifics of these provisions tend to vary, they typically involve a right for the banks and/or the borrower to switch the currency of settlement of the loan from U.S. dollars to another currency selected from a pre-agreed list of alternative currencies. The loan itself generally remains denominated in U.S. dollars, but all payments are settled in another currency, thereby removing the need to involve the U.S. financial system.

Although currency toggles have been a sporadic feature of Russian loans since 2014, they have recently re-emerged as a hot topic. Notably, such provisions were included in the recent sovereign debt issuances by the Russian government and they are increasingly sought by Russian banks and borrowers on loan transactions. However, the approach of international banks to these provisions has been more mixed. Some international banks view these provisions as a useful means of receiving payments from their borrower in circumstances when those payments might otherwise be blocked, and insist on their inclusion for new deals. Other banks have expressed concerns that such provisions might be viewed by the U.S. authorities as an attempt to circumvent U.S. sanctions or otherwise trigger the risk of 'secondary' sanctions.

These risks should always be carefully considered on a case-by-case basis in the context of the specific transaction as the analysis can be highly dependent on the facts, the drafting of the currency toggle provisions and the context in which the currency toggle is invoked. Accordingly, our observations as regards these risks are limited to general guidance only. As a general principle, the use of an appropriately drafted currency toggle in a loan agreement between non-U.S. persons, in and of itself, will not necessarily give rise to a material circumvention risk. As noted above, primary U.S. sanctions typically impose compliance obligations on non-U.S. persons only to the extent that they involve U.S. elements in their dealings and a currency toggle is potentially a means of ensuring that they do not do so. However, specific legal advice should always be sought on a case-by-case basis.

The analysis with respect to 'secondary' sanctions is more nuanced. Unlike other types of U.S. sanctions, secondary sanctions expose non-U.S. persons to the risk of themselves being designated as a sanctions target. More specifically, section 228 of the Countering America's Adversaries Through Sanctions Act ("**CAATSA**") authorises OFAC to impose secondary sanctions on non-U.S. persons if they engage in 'significant transactions' with certain sanctioned persons and section 226 of CAATSA authorises OFAC to designate any non-U.S. financial institution that knowingly facilitates a "significant financial transaction" on behalf of a sanctioned person (even if such transactions occur entirely outside the U.S.).

The broad authority conferred on OFAC to impose secondary sanctions means that it is inherently difficult to provide general guidance in the abstract. Factors that are likely to be relevant to the analysis will include (a) whether the currency toggle provisions were agreed prior to, or after, the sanctions designation, and (b) the purpose for which the currency toggle is invoked (in particular, whether the currency toggle is being invoked with a view to calling in the loans owed by the sanctioned person (and thereby depriving that sanctioned person of credit) or with a view to providing a benefit to the sanctioned person (for example, to provide additional credit, extend payment terms or 'cure' an event which otherwise

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would have required the loans to be prepaid)). A currency toggle that seeks only to provide a mechanism for the banks to call in their loans early following a sanctions designation can help facilitate the early repayment of the loans, which in turn has the effect of depriving the sanctioned person of credit (which is consistent with the stated objectives of the U.S. sanctions). When used in this narrow context, an appropriately drafted currency toggle should be unlikely to give rise to a material secondary sanctions risk.

A negotiation point that is emerging in this context on new deals is whether the ability to invoke a currency toggle, and thereby remove any U.S.-nexus from the deal, should 'override' the banks' right to call in their loans early on the basis of a U.S. sanctions designation. Borrowers argue that, if U.S. sanctions are imposed but the loan can continue to be serviced in an alternative currency in line with the original repayment profile, the banks should lose their right to call in their loans early. For various reasons, including the potentially devastating effects that being designated as an SDN can have on a borrower's creditworthiness (which might in any case trigger a material adverse effect event of default) as well as the perceived risk of secondary sanctions, banks tend to have little sympathy for this argument.

Finally, it should be noted that any subsequent conversion into U.S. dollars of an alternative currency received from an SDN borrower pursuant to a currency toggle will likely involve the U.S. financial system and could therefore potentially trigger a blocking requirement. Legal advice should always be sought before seeking to convert any such amounts.

Currency toggles seek to provide a contractual framework pursuant to which non-U.S. banks and their borrowers can extricate potentially problematic U.S. elements from their dealings.

Delayed payments

As noted above, it is not unusual for U.S. dollar payments which have a potential sanctions 'connection' to be delayed while the U.S. correspondent banks apply enhanced due diligence to those payments. This possibility of delay has prompted discussion as to whether borrowers should be given a short grace period before this delay results in a non-payment event of default in respect of their loan.

In practice, such delays are likely to occur only in limited circumstances, such as where the borrower has become a sanctions target (in which case the point becomes moot, unless the sanctions are the more limited sectoral sanctions), where one of the lenders in the syndicate is a Russian bank that is subject to sectoral sanctions or where the borrower directs that the payment be made through its account with a Russian bank that is subject to sectoral sanctions.

Representations and undertakings

A discussion with respect to contractual sanctions protections would not be complete without addressing sanctions-related representations and undertakings. These provisions, which complement the sanctions mandatory prepayment provisions and form a key component of banks' contractual risk mitigation, have evolved substantially over the last several years. Recognising that the realities of doing business in an economy in which the major banks and other major companies are subject to U.S. and EU sanctions necessitated a high degree of precision and a degree of pragmatism, banks and borrowers have developed tailored sanctions-related representations and undertakings which seek to provide the requisite level of protection for the banks, while at the same time not unnecessarily constraining borrowers' normal business activities.

Although certain limited aspects of these provisions remain controversial, and are regularly negotiated, the key pillars (being limitations with respect to the use of the loan proceeds, the source of funds used to service the loan and other activities which could reasonably be expected to expose the banks to a sanctions-violation) are now relatively well established in the Russian market. Recent events have not, so far, resulted in any material change in market practice in this respect.

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Conclusion

Contractual sanctions protections, such as those discussed above, will only ever be one piece of the puzzle for banks when dealing with a borrower that has become a sanctions target. Other factors, such as overriding legal requirements, reputational issues and practical considerations (not least of all, whether the borrower has the financial resources to repay all of its loans early) will inevitably come into play and in some cases take precedence over precise contractual arrangements. Contractual protections are, however, a critical component of banks' risk mitigation with respect to sanctions and an important tool for ensuring they can take swift and appropriate action in the aftermath of a sanctions designation.

Recent events have highlighted the importance of careful drafting and identified areas of potential concern, for both banks and borrowers, in recent market practice. In response, market practice for new deals is already evolving and, while this is not expected to lead to a fundamental change in the principles underlying the general risk allocation between banks and borrowers, it is expected to lead to important improvements in loan documentation, both in Russia and beyond.

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