Dechert LLP

EU Sanctions: Commercial and Contract Risks

A review by Dechert's International Trade Practice

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Dechert LLP

Introduction

Sanctions programmes are established and developed as a political response to international relations developments; yet they impose significant obligations on commercial entities in terms of compliance. They may interfere with the performance of pre-existing contracts; and the broadly-framed and ambiguous nature of some sanctions restrictions is such that firms often struggle to place workable limits on their sanctions risks when entering into contracts. This article looks at the steps that firms can take from a contractual perspective to better manage their exposure to EU sanctions developments, and the protections that exist at law.

Sanctions Laws Can Be Ambiguous

Some sanctions restrictions are imprecise in scope. The consequent ambiguity may be unavoidable (in the EU, this is commonly due to different linguistic traditions across Member States, or a compromise wording chosen to reach EU-level agreement) but it can have benefits for policy-makers: open-ended wording makes it harder for sanctions targets to side-step a measure, and ambiguity may persuade risk-averse firms to take a cautious approach to potentially-prohibited activities. All of this helps policy-makers to achieve the political objectives of the sanctions, but passes considerable risk onto firms. Firms need to plan ahead to mitigate that risk.

The imprecise nature of some terms in the sanctions legislation against Russia is currently the subject of court proceedings. Although the High Court in London accepted that some of the provisions in the EU regulation are *"undeniably broad brush in their scope"*[1] and *"could have been more precise and clearer"*[2], it was sympathetic to the position of the EU in framing the legislation, and formed the provisional view that *"given the urgency with which the legislation was drafted...the drafting approach adopted by the [EU] Council was in the circumstances a proper one".*[3] The question of the legal certainty of these provisions has now been referred to the Court of Justice of the EU.

Regulators can offer non-binding clarifications even after sanctions have been framed. OFAC in the US publishes regular advisory notices, and the European Commission published an extensive Q&A on aspects of the Russia sanctions. The UK's new Office of Foreign Sanctions Implementation aims *to "provide a high quality service to the private sector"*. But such regulatory input will never fully eliminate the risks which sanctions pose for companies.

Managing Exposure to International Sanctions Developments

Faced with broadly framed restrictions and the risk of further developments at any time, how should a firm minimise its exposure in its commercial activities:

The types of sanctions risks which firms need to consider from a contractual perspective fall into three broad categories:

- Exposure to the risk of breaching sanctions, or being associated with an existing breach of sanctions by entering into a contract;

[1] *R (on the application of OJSC Rosneft Oil Co) v HM Treasury* [2015] EWHC 248 (Admin), Green LJ at para 47

[2] *R (on the application of OJSC Rosneft Oil Co) v HM Treasury [2014] EWHC 4002 (Admin), Beatson LJ at para 38*

[3] *R (on the application of OJSC Rosneft Oil Co) v HM Treasury [2015] EWHC 248 (Admin), Green LJ at para 53*

- the risk that sanctions may subsequently be imposed or extended, so as to interfere with parties' ability to perform existing contractual commitments;[4] and
- the risk that a change in the status or ownership of a counterparty brings sanctions restrictions into play which may have existed but did not apply to it when the contract was entered into.

There are a number of ways firms can protect themselves in terms of their contractual arrangements:

(i) Ensuring That Entering into a Contract Does Not Breach Sanctions Laws

- *Due diligence*: due diligence is more than mere screening against sanctions lists (although that is part of it). The object of a firm conducting due diligence is to get itself to the position where it can be comfortable that it has conducted all reasonable/proportionate enquiries, and has no reasonable cause to suspect that proceeding with the contract would infringe any applicable sanctions restrictions, including knowing the firm's counterparty, and who ultimately owns and controls it.
- *Prior authorisation*: where committing to perform an activity which requires a prior authorisation (including an export licence), the grant of the authorisation should be a condition precedent to the contract (or at least the obligation) becoming binding. Where the other party to a contract requires such a licence, the contract should anticipate what will happen if the authorisation is not given, or is unduly delayed.
- *Warranties and disclosures*: it is common to expect specific sanctions warranties to complement due diligence. These could give reassurance that a contractual counterparty is not engaged in any activity which might cause it (and indirectly you) to breach international sanctions or export controls; proposing such warranties may flush out factors which would prompt further due diligence;
- *Compliance commitments*: a firm may consider securing commitments from a counterparty that it will comply with export control and sanctions laws – for example a representation that it has and will maintain a sanctions compliance policy, that it will not deal with certain countries without notifying you first, or where exporting goods, that the counterparty is the ultimate end-user of the goods, and that such goods will only be used for a specified end use; and that it will apply for all necessary authorisations, licences etc. The types of commitment required will vary according to the nature of the contract. Termination and indemnification provisions may provide for the consequences of an actual or suspected failure to comply with such commitments.

(ii) Protecting Against the Risk of Sanctions Impacting on an Impending or Existing Contract

- *Force majeure provision*: this would permit either party to avoid performance of a contractual obligation without incurring liability for breach of contract following the occurrence of a specified event that prevents the party from performing that obligation. "Force majeure" does not have a specific meaning in English law – it needs to be defined in the contract. Therefore, if a firm wants sanctions developments to constitute an event of force majeure, the contract should provide for this expressly, and set out clearly the intended consequences.

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[4] See, for example, *Maud v The Libyan Investment Authority [2015]* in which the right to payments due under a guarantee contract was held to be unenforceable on the grounds that making such payments would breach the EU's sanctions regime relating to Libya

- *Express termination provisions*: additionally, a firm may want to provide for immediate termination in certain eventualities. Some of these may overlap with the force majeure provision, though this provision may go wider, allowing for termination where sanctions do not actually prevent the performance of any aspect of the contract, but simply makes it less attractive or disproportionately more burdensome or expensive.

- *Limitations on liability*: a firm may want such limitations in the event, for example, that a requirement to obtain a licence before proceeding with a transaction leads to potential delays.

Defences in Sanctions Laws

EU sanctions laws contain some limited but useful protections:

- The freezing of funds or the refusal to make funds available, done in the reasonable belief that such action is required by the sanctions, will not give rise to liability;

- a person will not be liable in relation to sanctions measures if they did not know and had no reasonable cause to suspect that their actions would infringe the provisions;

- sanctions laws usually have some limited carve-outs for pre-existing contracts;

- designated persons and others against whom a sanctions measure is directed may not make claims in relation to any contractual or other right affected by the sanctions; and

- in certain cases, the relevant national authority can issue a licence exempting a transaction from sanctions measures such as asset freezes. Authorities issue both general licences addressed openly to anyone who meets the criteria in the licence, and individual licences addressed to specifically named parties, permitting specified actions.

Frustration

The doctrine of frustration can also serve to bring a contract to an end where "*without default of either party a contractual obligation has become incapable of being performed because the circumstances in which performance is called for would render it a thing radically different from that which was undertaken by the contract*"[5]. Reliance on this doctrine, and in particular the principle of supervening illegality, may enable a party to avoid liability arising from breach of contract resulting from sanctions developments.

Supervening illegality occurs where a change in law disrupts the performance of contractual obligations due to the performance of the contract becoming illegal, and this disruption fundamentally changes the terms of the contract. For example, where the inability of a party to obtain a licence (having applied) means that a contractual obligation is incapable of being performed indefinitely, this is may constitute a supervening event that has significantly changed the nature of the contractual obligations. This may lead to be the contract being frustrated.

However, frustration has been argued in court a number of times in a sanctions context, and courts have rejected such arguments in a number of recent cases[6]. Given the challenges associated with relying on the doctrine of frustration, firms will generally prefer to include express provisions in the contract covering the possibility of international sanctions interfering with performance – thereby offering greater certainty and protection.

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[5] *Davis Contractors Ltd v Fareham U.D.C.* [1956] A.C. 696, Lord Radcliffe at 729

[6] For example *Libyan Arab Foreign Bank v Bankers Trust Co* [1989], or more recently *Melli Bank v Holbud Ltd* [2013]

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Insurance

It may be possible for firms to obtain insurance to guard against sanctions risks. Although this may be used as an alternative form of protection against the risks of breach of contract as provided by contractual provisions, firms may prefer to use this as a complement, rather than an alternative to including express provisions, given the uncertainty in making a successful claim and the likelihood of a fixed liability cap under the terms of the insurance policy.

The types of insurance which may be relevant include export credit insurance, political risk insurance and trade disruption insurance.

What Does This Mean For You and How Can Dechert Help?

Given the significant impact that international sanctions laws can have on a firm's obligations and contractual arrangements, firms should take steps to manage the risk of breach of contract by incorporating express provisions in their commercial agreements, and consider whether insurance can be obtained to further mitigate this risk. We can assist clients in ensuring suitable contractual protections across all types of contractual arrangement, in considering what other steps a client may take to ensure against sanctions risk, and in taking action to protect clients' positions in the event that either changes to sanctions laws, or a counterparty's failure to comply with existing sanctions requirements has left an entity potentially exposed.

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