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Sanctions Update

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This is a two part sanctions update. In Part One we look at a Court of Appeal judgment delivered last week which has implications not only for the insurance market, but also for any industry which trades or transacts with a country or entity which becomes the target of sanctions including most recently Iran, Syria and Libya.

In particular, this decision provides all those involved with the trade or financing of commodities with guidance on risk assessment when deciding whether they can rely on contractual clauses to permit non-performance following the introduction of sanctions.

In Part Two we provide an overview of the new sanctions imposed in the last two weeks by both the European Union and the United States relating to Syria.

PART ONE: Guidance on Assessment of Risk Relating to Breach of Sanctions: Arash Shipping Enterprises Company Limited v Groupama Transport

The Court of Appeal has dismissed an appeal brought by the owner of the National Iranian Tanker Company ("NITC"), Arash Shipping Enterprises Company Limited ("Arash") on behalf of its co-assureds, against the lead underwriter on the policy Groupama Transport ("Groupama").

The claim related to Groupama's and other insurers' (the "Cancelling Insurers") decision to cancel a composite insurance policy, containing a twelve month automatic extension clause, covering the NITC fleet (the "Policy"). The Cancelling Insurers' decision was based on the risk of breach of EU sanctions regulations imposed against Iran, prohibiting renewals and extensions. Reed Smith acted for one of the following insurers, The Swedish Club, as Intervener in the proceedings.

Facts

In October of last year, the EU Council published EC Regulation No.961/2010 (the "Regulation") which sought to tighten sanctions against Iran with the main aim of impeding the country's nuclear program. Given Iran's energy based economy, the sanctions are specifically focussed on its oil and gas, transport, finance and insurance sectors. Article 26 prohibits the provision of insurance and reinsurance to Iranian persons, entities or bodies.

In particular, Article 26(4) of the Regulation provides that:

"This Article prohibits the extension or renewal of insurance and re-insurance agreements concluded before the entry into force of this Regulation, but, without prejudice to Article 16(3), it does not prohibit compliance with agreements concluded before that date".

The Regulation came into force five months after the inception of the Policy. The Policy was for an initial period of twelve months with an automatic twelve month extension subject to Arash complying with the agreed claims threshold (the "Review Clause"). Significantly, the Policy also contained a clause (the "Iran Sanctions Clause"), in various forms, one of which read:

"Insurers hereon may, on such notice in writing as the Insurer may decide, cancel the Insurer's participation under this Policy in circumstances where the Assured has exposed or may, in the opinion of the Insurer, expose the Insurer to the risk of being or becoming subject to any sanction, prohibition or adverse action in any form whatsoever against Iran by the State of the Ship(s) flag, or by the United Kingdom and/or the United States of America and/or the European Union and/or the United Nations".

The Policy was subject to the law and exclusive jurisdiction of England and Wales and without the automatic extension, was due to expire in early May 2011.

In view of the Regulation, the Swedish Club (and subsequently the other Cancelling Insurers) concluded that the automatic renewal of the Policy may place them at risk of breaching EU sanctions and therefore - reliant on the Iran Sanctions Clause - issued notices of cancellation to take effect at the end of the initial period.

In light of the impending expiry, Arash brought a claim against Groupama (on behalf of the other insurers) requiring them to renew the Policy for a further 12 months pursuant to the Review Clause and restraining them from cancellation. Arash's claim centred on two issues:

- **Issue 1**: Whether Article 26(4) of the Regulation prohibited the mandatory or automatic renewal of the Policy; and
- **Issue 2**: Whether the Insurers were entitled to cancel the Policy on the basis of the Iran Sanctions Clause.

Commercial Court Proceedings

At first instance Mr Justice Burton held that Article 26(4) of the Regulation amounted to a blanket ban on any kind of extension or renewal of pre-existing insurance agreements.

Importantly, Mr Justice Burton also found that the Iran Sanctions Clause gave a discretion to the Insurers as to whether there are circumstances which may "in the opinion of the Insurer expose the Insurer to the risk" of a breach of EU sanctions regulations. The boundary to the exercise of this discretion was that such a decision must not be unreasonable in the sense akin to what is known as "Wednesbury unreasonableness" i.e. the decision taken by the Insurers to cancel the Policy, based on the Iran Sanctions Clause, must not be irrational or perverse. Insurers considered that they had been exposed to risk of breach of the Regulation by virtue of the nationality of the Insured in combination with the Review Clause and Article 26(4) of the Regulation prohibiting extensions or renewals of insurance polices. It was not Wednesbury unreasonable of the Cancelling Insurers to have relied upon the Iran Sanctions Clause and to have believed that there was a risk of breach of Article 26(4).

Moving one step further, Burton J commented that it would not have been unreasonable for the Cancelling Insurers to have continued to believe that there was a risk even if he had concluded that the renewal was not prohibited by the Regulation. For example, it would not have been Wednesbury unreasonable for the Cancelling Insurers to have assessed that the risk of breach still existed in light of the opinion given by HM Treasury (who were not bound by the proceedings) that the purpose of the Regulation and of Article 26 was to prohibit the provision of Insurance, and that renewal or extension contradicted this objective and therefore an automatic renewal or extension would constitute a breach and/or on the basis that the relevant competent authorities in the UK (or in the case of the Swedish Club, the relevant competent authorities in Sweden) might not follow the Commercial Court's decision.

The Appeal

On appeal to the Court of Appeal, Arash relied on two grounds, namely that the clear interpretation of Article 26(4) was that this automatic renewal was not prohibited and, secondly, that on assessment of the risk, the notices of cancellation were premature. Arash argued that the risk to the Insurers must be real, not fanciful or de minimis.

The Respondent and Intervener pointed to Article 26(4) as an absolute prohibition on extension. In relation to cancellation, they relied on the Wednesbury unreasonableness point argued before the lower court and that the tendering of the notice of cancellation was an unqualified and unfettered right. The purpose of the Iran Sanctions Clause was to allow Insurers to withdraw from the Policy in circumstances where the Insurers believed that the actions they were being forced to take or refrain from taking may risk them being in breach of EU sanctions regulations.

The Court dismissed the appeal solely on the second ground relating to cancellation, endorsing the Commercial Court's decision that it was not unreasonable in the Wednesbury sense for the Cancelling Insurers to come to the conclusion that they were exposed to the risk of breach of sanctions and, accordingly, the notice of cancellation was valid. Having decided the second issue in that way, the Court did not consider it was necessary to decide the first issue as to whether the automatic extension of the Policy breached Article 26(4). Further permission to appeal was denied.

The approved judgment is still awaited.

It is important to note that both the Commercial Court and Court of Appeal recognised that neither they (nor indeed the Supreme Court) were the final arbiter of the question as to whether the automatic Review Clause offended Article 26(4), and concluded that even with a ruling from them in Arash's favour, the risk of breach would not have been eliminated as it would still be open to the European Court of Justice, and to the relevant competent authorities in England or indeed Sweden, to find the Cancelling Insurers in breach of the Regulation, should the extension of the Policy be effected.

Wider implications

- When assessing the risk of breaching sanctions regulations, although not opined on by the Court of Appeal, parties may consider the test adopted by Mr Justice Burton akin to Wednesbury unreasonableness i.e. when making a decision in reliance on the Iran Sanctions

Clause or any similar clause in an agreement, the exercise of that discretion by that party should not be irrational.

- To trigger the rights under such a clause it appears that the risk must be real but not necessarily substantial.
- A decision by an English Civil Court such as the Court of Appeal may not eliminate the risk of being held in breach of sanctions regulations. The ultimate decision will be for the European Court of Justice or the relevant competent authorities.
- Those parties whose business activities may result in them finding themselves subject to sanctions regulations should consider inserting appropriate wording into their agreements which expressly sets out that neither party is required to take or refrain from taking any action that may reasonably place it at risk of breach of specified sanctions regimes in order to excuse their non-performance and which better still, gives to each party a discretion itself to assess the risk of breach.

PART TWO: Syrian Sanctions

The EU

Sanctions imposed this week by the EU provide for an arms embargo, a ban on the supply of equipment which could be used for internal repression and for the freezing of funds and economic resources of individuals responsible for the repression of the civilian population in Syria.

Council Regulation (EU) No. 442/2011 came into force on 10 May 2011. The Regulation provides that all funds and economic resources belonging to, owned, held or controlled by the persons listed in Annex II of the Regulation shall be frozen. The Regulation further provides that no funds or economic resources shall be made available, directly or indirectly, to or for the benefit of the persons listed in Annex II. There are 13 individuals currently listed in Annex II, including the President's younger brother. A list of the targeted individuals can be accessed here.

Whilst the impact of the Regulation may not be as significant as recent sanctions imposed against Iran, Ivory Coast and Libya, it may well be that Annex II is expanded in the near future. A UN Security Council Resolution may also follow.

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The U.S.

On 29 April 2011, President Obama issued Executive Order 13572, Blocking Property of Certain Persons with Respect to Human Rights Abuses in Syria. These measures took effect immediately. The measures included the blocking of all assets of three individuals and two entities, namely Mahir Al-Asad, Ali Mamluk, Atif Najib, the Syrian General Intelligence Directorate and the Islamic Revolutionary Guard Corps - Qods Force. They join a list of 20 Syrian individuals already subject to U.S. asset blocking for ties to terrorism, corruption, or proliferation activities.

Compliance with the blocking requirements is required of all "U.S. persons." This includes U.S. citizens and resident aliens, entities organized under the laws of the United States or any jurisdiction within the United States (e.g. companies, non-profit groups, government agencies, and including foreign branches, wherever located), and any person within the U.S.

The latest U.S. action supplements sanctions already in effect including the Syria Accountability Act of 2004, which prohibits the export of most U.S.-origin goods to Syria, and the USA Patriot Act, which restricts correspondent banking with the Commercial Bank of Syria.