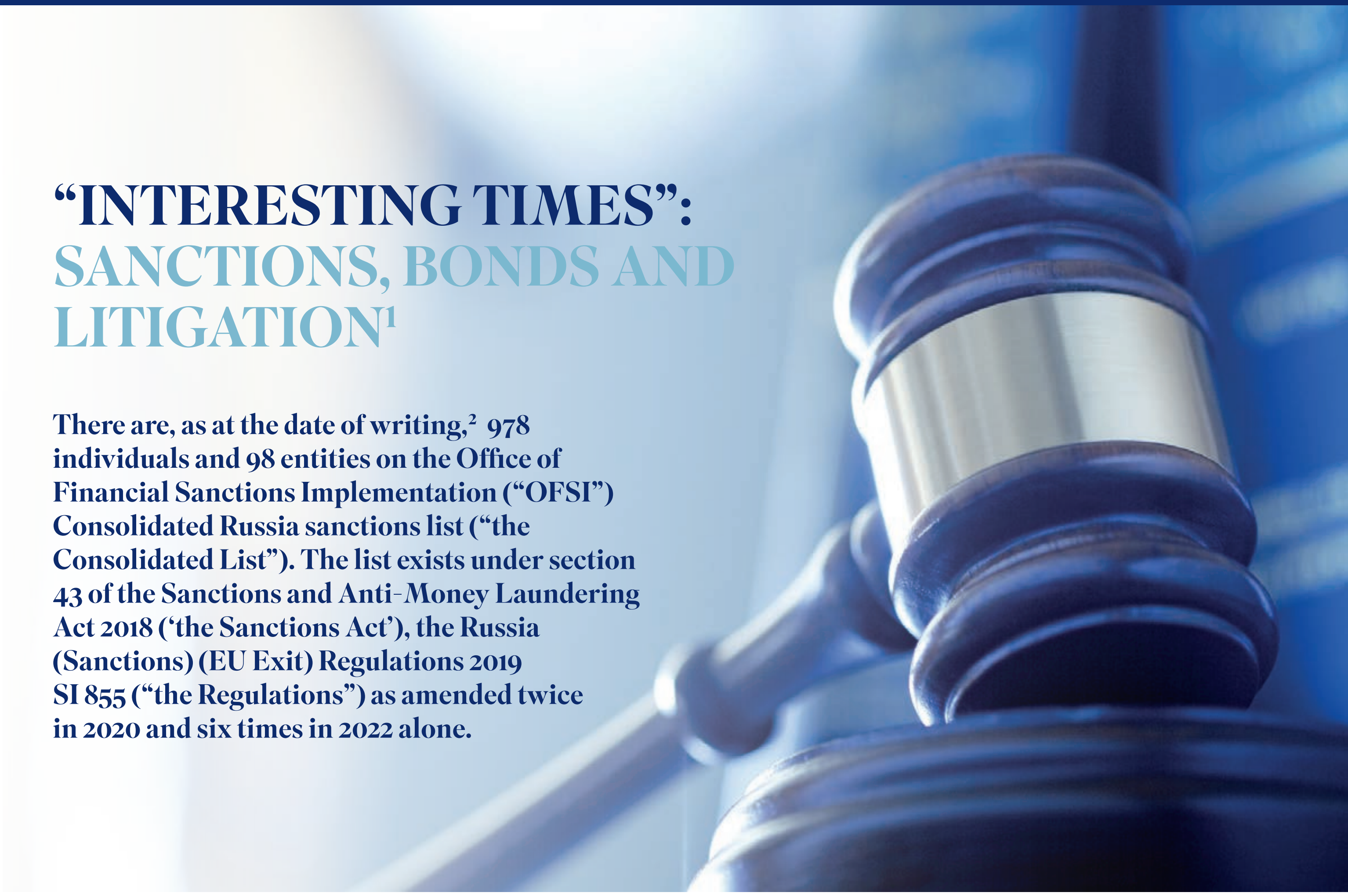

"INTERESTING TIMES": SANCTIONS, BONDS AND LITIGATION[1]

There are, as at the date of writing,[2] 978 individuals and 98 entities on the Office of Financial Sanctions Implementation ("OFSI") Consolidated Russia sanctions list ("the Consolidated List"). The list exists under section 43 of the Sanctions and Anti-Money Laundering Act 2018 ('the Sanctions Act'), the Russia (Sanctions) (EU Exit) Regulations 2019 SI 855 ("the Regulations") as amended twice in 2020 and six times in 2022 alone.

By Sean Wilken KC

In crude terms, the way in which the regime operates is that an individual is designated for sanctions purposes under Regulation 5 of the Regulations. On designation, sanctions are imposed limiting the designated person's ability to participate in transactions or receive various services.[3]

Then, Regulation 11 imposes an asset freeze. Regulations 12 – 15 then bite on the making available of funds, finance or economic benefit. Regulation 16 deals with money market securities. Regulation 17 bars loans and credit arrangements, whilst Regulation 17A deals with correspondent banking arrangements. All the Regulations are framed to catch indirect funds, economic benefits and loans and credit arrangements. Finally, all of Regulations 11 – 17A permit OFSI licensing of certain transactions and arrangements.

There are two sets of provisions[4] that are particularly relevant to commercial and construction litigators,[5] and then even more specifically, to the financing of large infrastructure or other property developments.

The first is Regulation 64, which permits a Treasury licence to be issued legitimating what would otherwise not be permitted under Regulations 11 – 17A. Part 1 of Schedule 5 to the Regulations permits Treasury license exemptions to the asset freeze and banking relationship controls for the "reasonable" legal fees incurred by the designated person.[6] It is this provision that lawyers acting for any designated person must fall within and they must apply for an OFSI licence to that effect. Given the length of the designated persons list and the breadth of its cover, applying for a licence may be cumbersome and there is little guidance as to how applications for licenses may be considered or, indeed, as to what are reasonable legal fees.

1 One issue that arose in February/March 2022 was whether sanctions questions were ones with which the Bar needed to concern itself. That issue was resolved by a BSB Circular dated 31 March 2022 unequivocally stating that the Bar had to ensure that it was compliant with all aspects of sanctions and OFSI licences.

2 26 – 31 March 2022

3 There is a procedure to challenge designation but the prospects of a successful challenge against the current Russian sanctions targets may be slim.

4 I do not deal in this short paper with the compliance issues associated with sanctions compliance for the legal profession. In terms of the Bar, the BSB circular would require, for example, checking of client lists as against the Consolidated List. Further complications are added as a result of the Economic Crime (Transparency and Enforcement) Act 2022.

5 As opposed to those working in financial markets or general financing arrangements.

6 See paras 3 and 9M of Schedule 5

The second turns on the definition of funds. As set out above, Regulations 12 – 15 bite on the making available of funds. Under section 60 of the Sanctions Act, funds is defined to mean:

In this Act "funds" means financial assets and benefits of every kind, including (but not limited to)—

- *(a) cash, cheques, claims on money, drafts, money orders and other payment instruments;*
- *(b) deposits, balances on accounts, debts and debt obligations;*
- *(c) publicly and privately traded securities and debt instruments, including stocks and shares, certificates representing securities, bonds, notes, warrants, debentures and derivative products;*
- *(d) interest, dividends and other income on or value accruing from or generated by assets;*
- *(e) credit, rights of set-off, guarantees, performance bonds and other financial commitments;*
- *(f) letters of credit, bills of lading and bills of sale;*
- *(g) documents providing evidence of an interest in funds or financial resources;*
- *(h) any other instrument of export financing.*

Thus, under the regime, both performance bonds and letters of credit are caught. This raises two particular issues for both; both issues flowing from the nature of performance bonds and letters of credit as supposedly autonomous instruments. As these instruments facilitate international trade and infrastructure and property developments, the fact these instruments now fall within the sanctions regime may have unexpected consequences.

As Donaldson MR put it in *Bolivinter Oil SA v Chase Manhattan Bank NA* [1984] 1 WLR 392:

> *"The unique value of such a letter, bond or guarantee is that the beneficiary can be completely satisfied that whatever disputes may thereafter arise between him and the bank's customer in relation to the performance or indeed existence of the underlying contract, the bank is personally undertaking to pay him provided that the specified conditions are met. In requesting his bank to issue such a letter, bond or guarantee, the customer is seeking to take advantage of this unique characteristic. If, save in the most exceptional cases, he is to be allowed to derogate from the bank's personal and irrevocable undertaking, given be it again noted at his request, by obtaining an injunction restraining the bank from honouring that undertaking, he will undermine what is the bank's greatest asset, however large and rich it may be, namely its reputation for financial and contractual probity. Furthermore, if this happens at all frequently, the value of all irrevocable letters of credit and performance bonds and guarantees will be undermined."*[7]

Thus, letters of credit and performance bonds (and in particular on demand performance bonds) are autonomous instruments – existing separate and distinct from the underlying transaction. Thus, the instruments can supposedly be relied on irrespective of the merits of the underlying transaction.

Standardly, the extent and application of the autonomy principle only raises its head where the Beneficiary of the instrument (that is the one receiving some form of credit arrangement or the benefit of an assisted trade transaction) seeks to restrain

7 See also *Tetronics (International) Ltd v HSBC Bank Plc* [2018] EWHC 201 (TCC) at [26]

payment by the Bank/Guarantor to the creditor or Obligor.[8] As the instrument is autonomous, anyone seeking to restrain the Bank/Guarantor will need both to have an independent cause of action and grounds for impugning payment under the instrument as against the Bank/Guarantor. This is usually expressed as a fraud exception.[9] Yet even with the fraud exception, where the Bank/Guarantor is not the Beneficiary's own bank,[10] it is difficult to see what the cause of action the Beneficiary has against the Bank/Guarantor is.[11] Allied to that is a further principle, however, which perhaps is even less appreciated. At least where one is dealing with an on-demand bond or letter of credit, absent fraud or potentially a demand in breach of the underlying contract,[12] there can be no injunction to restrain the Obligor from calling on the instrument – for that would violate the autonomy principle.[13]

Thus, the autonomy principle gives the Obligor the right to demand payment irrespective of an underlying dispute. Similarly, as the letter of credit/on demand performance bond are "equivalent to cash" they can be negotiated – that is transferred or signed over as further security for separate and independent credit and thus potentially "traded".

The current sanctions regime, however, disturbs the autonomy principle, and therefore letters of credit and bonds, in two very critical ways. The sanctions regime requires one to know whom is directly or indirectly benefitting from the letter of credit or performance bond. Is a designated person in some way receiving funds or economic benefits or credit from the letter of credit or performance bond? Similarly, enquiries have to be made as to which entities are in the banking chain and are any of those sanctioned entities. If so, unless there is a Treasury licence, then the receipt of that benefit is blocked by sanctions and the payment of that benefit would be an offence and therefore potentially illegal.[14] Further, it would be arguable that an instrument which did not directly breach sanctions, but sought to evade them, would be similarly unenforceable.[15] Thus, a sanctions related issue would provide a potential defence to a call on a letter of credit or performance bond.

This position may be compounded if, as and when a letter of credit or performance bond were negotiated. An obvious result of the letter of credit or performance bond being used as further collateral is that the number of entities involved in the transaction would increase. In certain cases that would inevitably raise issues as to the identity of those entities, their sanctions status and intended or inadvertent sanctions busting.

In normal circumstances, the risks of sanctions law impacting on letters of credit and bonds might be regarded as slim. Indeed, there are doubts expressed as to whether either the regulatory framework or the political will are sufficiently robust for sanctions properly to bite. That said, these are not normal circumstances, and the wording of the sanctions will need to be given effect. Before sanctions were imposed, it was well known that a considerable volume of monies ex the former Soviet Union/Russian Federation were being deployed in global markets in many and various types of transactions – often via the use of several monetary instruments and various holding companies in differing jurisdictions.[16] The length of the sanctions list and the breadth of its targets must, it would seem, give one further pause as to whether particular transactions or instruments were involved in such flows of money from Russia and whether, therefore, the sanctions regime is now in play. If so, further thought would have to be given as to whether there was now an illegality defence to any call on the letter of credit or bond.

8 In the following discussion, I refer to the party that issued the instrument and will pay against it as the Bank/Guarantor; the party making the claim as the Beneficiary and the party in default triggering the claim against the instrument as the Obligor.

9 Recently reiterated in Alternative Power Solution Ltd v Central Electricity Board [2014] UKPC 31 at [56 ff] but a long standing principle in English law.

10 Where the Obligor can rely on the bank mandate between it and the Bank/Guarantor.

11 As the Court of Appeal recognised in United Trading Corp v Allied Arab Bank [1985] 2 Lloyd's Rep 554 at 561

12 Sirius International Insurance Co v. FAI General Insurance Ltd [2003] EWCA (Civ) 470 at [26 – 7]; MW High Tech Projects UK Ltd v Biffa Waste Services Ltd [2015] EWHC 949 (TCC) at [28 – 34]

13 Group Josi Re v Wallbrook [1996] 1 Lloyd's Rep 35 casting significant doubt on Themehelp Ltd v West [1996] QB 84

14 As to the complexities which can ensue – see Libya Arab Foreign Bank v Bankers Trust Co [1989] QB 728. As sanctions are suspensory, sanctions could not frustrate the contract in Bankers Trust – see 772 B – E.

15 See Regazzoni v KC Sethia (1944) Ltd [1956] 2 QB 490

16 There is extensive (and controversial) literature on the subject but for present purposes see purely by way of example "The London laundromat: will Britain wean itself off Russian money?" FT 4/3/22