Between a Rock and a Hard Place: the Unexpected Risks of Taking a Conservative View of Sanctions

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The Commercial Court of England and Wales recently issued two decisions that clarify certain elements of UK sanctions law and how U.S. sanctions can interact with UK sanctions. These decisions emphasise that English courts are unlikely to look favourably on parties attempting to use very broad interpretations of UK sanctions or U.S. sanctions to avoid payment obligations.

The first decision was handed down on 23 March 2023 (*Celestial Aviation Services Ltd v Unicredit Bank SA* [2023] EWHC 663 (Comm)); and the second one was handed down on 5 May 2023 (*Celestial Aviation Services Ltd v Unicredit Bank SA* [2023] EWHC 1071 (Comm)). Both judgments concern letters of credit that were issued by a Russian designated entity, Sberbank, and confirmed by the defendant, Unicredit, in the context of lease agreements between certain Irish aircraft lessors and Russian airlines. The Irish lessors (the claimants) were the beneficiaries of those letters of credit and the key issue in the case was whether payment by Unicredit to the Irish lessors under the letters would breach UK or U.S. sanctions regulations.

First Judgment

It was common ground that the claimants had made valid demands under the letters of credit, and that the defendant was liable to pay the claimants subject to the sanctions issue. The defendant argued that it was prohibited from making payment under Regulation 28 of the Russia (Sanctions) (EU Exit) Regulations 2019 No. 855 (the "UK Regulations"). In other words, the defendant argued that compliance with its contractual obligations would involve the commission of a criminal offence. The key sanctions issue concerned the interpretation and application of Regulation 28(3), which prohibits the provision of financial services or funds in pursuance of or in connection with an arrangement whose object or effect is the export of restricted goods to, or for use in, Russia, or to a Russian person.

Importantly, Unicredit had applied to the UK sanctions regulators—the Office of Financial Sanctions Implementation (OFSI) and the Export Control Joint Unit (ECJU)—for licences under Regulations 11, 13 and 28 of the UK Regulations in order to make payment under the letters of credit. OFSI and ECJU granted those licences and Unicredit made payment to the claimants shortly thereafter. However, the

claimants argued that (i) there had been no need of? a licence for Unicredit to make payment to them under the letters of credit, and (ii) the licence applications were misleading in that they suggested that the grant of the licence to make payment to the lessors should be dependent on the grant of a licence for payment by Sberbank to Unicredit. Notwithstanding the fact that payment had been made under the letters of credit (pursuant to the licences), the Court went on to determine the issue of the proper interpretation of the relevant prohibitions, including because it remained relevant to questions of interest and costs, and because it was likely "*to be of more general assistance to market participants and practitioners*."

The Court confirmed the importance of considering the purpose of the sanctions in question when interpreting sanctions legislation, as well as the importance of arriving at an interpretation that, consistent with the purpose of the sanctions, would avoid a disproportionate or intrusive effect. The Court rejected the submission that the provisions in question should be read broadly on the basis that the broad application of the prohibitions could be assuaged under the licensing system.

The Court broke down Regulation 28(3) into three constituent elements: (i) a person provides financial services or funds; (ii) in pursuance of or in connection with; (iii) an arrangement whose object or effect is the supply of restricted goods to, or for use in, Russia, or to a Russian person. As for (i) and (iii), the Court accepted that the relevant transaction (payment under the letters of credit) involved the provision of funds, and that each of the leases (to which the letters of credit related) was an arrangement whose object or effect was the supply of restricted goods (aircraft) to, or for use in, Russia, or to a Russian person (Russian airline). The "*critical dispute*" centred on (ii): whether payment under the letters of credit would be "*in pursuance of or in connection with*" the supply of aircraft under the leases. The Court adopted a narrow interpretation and concluded that payment would not be made in pursuance of or in connection with the relevant arrangement, and was therefore not prohibited by Regulation 28(3).

In so finding, the Court observed that the legislative intent behind Regulation 28(3) was to ensure that financial assistance would not be provided to Russian parties (Russian airlines) in relation to the supply of aircraft, and that the Regulation operated only prospectively. As a result, it did not apply to the letters of credit in this case, which were issued by Sberbank upon an application by the Russian airline (with the Irish lessors as beneficiaries) and confirmed before the relevant prohibitions came into force. The only outstanding action after the prohibitions came into force was to fulfil the payment obligation in favour of the claimants (the Irish lessor). The Court ruled that the autonomy principle meant that the claim on the letters of credit (against Unicredit) was "*wholly independent*" from any other elements of the overall transaction. Considering the matter in the round, the Court ruled that the payment in question was by the London branch of a German bank (Unicredit) to Irish companies, and could not be said to be intended to benefit

Russian entities that happened to have been involved in other elements of the transaction.

The Court also considered Regulation 11 of the UK Regulations, which provides that a person must not deal with funds or economic resources owned, held or controlled by a designated person. The Court found that, since Sberbank's designation did not come into force until after the obligation to pay matured, the sanctions could not have impacted the relevant contractual obligation. Further, the Court found that the satisfaction of Unicredit's obligations was entirely independent of (and therefore did not constitute dealing with) Sberbank's property. The Court found that the same reasoning applied in respect of Regulation 13, which prohibits the making available of funds to designated persons.

Separately, the Court dealt with an argument regarding the impact of U.S. sanctions on Unicredit's payment obligations. Unicredit argued that, by making the payment, it would commit an offence under U.S. law. The payment obligation was in U.S. Dollars, and the unchallenged evidence was that the payment could only be made via a correspondent bank in the United States, thereby implicating U.S. jurisdiction. The Court considered the judgment of Mr Justice Staughton in *Libyan Arab Foreign Bank v Bankers Trust Co* [1989] 1 QB 728, and concluded that it was authority for the proposition that, if a U.S. Dollar payment is required under the contract, the customer is entitled to demand such payment in cash to avoid any violation of U.S. law: "[w]*here the fundamental obligation is to make payment, and where it is possible to make such payment, then the bank must do so*." On that basis, the Court held that the payment obligation did not necessarily give rise to a breach of U.S. sanctions law.

Second Judgment

The main issue at the consequentials hearing concerned the interpretation and application of section 44 of the Sanctions and Anti-Money Laundering Act 2018. Section 44 provides that a person is not civilly liable in respect of any act or omission taken in the reasonable belief that it was done to comply with sanctions regulations. Unicredit argued that it could rely on the section 44 defence because it had refused to make payment under the letters of credit based on a reasonable belief that Regulation 28 of the UK Regulations prohibited it from doing so.

It was common ground that the application of section 44 involved a two-stage test: (i) whether Unicredit believed that it was prohibited from making payment under the letters of credit; and (ii) whether that belief was reasonable.

In relation to the first issue, Unicredit adduced a number of witness statements, including from its Head of Financial Crime Compliance, showing that the bank believed that payment would contravene the provisions of Regulation 28. The

relevant OFSI licence applications were also adduced in evidence. The Judge noted that the question of subjective belief "*might have been approached and answered much more clearly by a simple statement on the part of a Unicredit witness that they held this belief*". However, the evidence adduced by the bank was held to be sufficient to establish the subjective belief.

As for the second issue, whether the belief was reasonable, Unicredit pointed to the breadth of the prohibitions under Regulation 28, the fact that licences were issued by the OFSI and the ECJU, and the fact that as soon as Unicredit received the licences it made arrangements for the relevant payments to be made. Notwithstanding these submissions, the Court found that Unicredit's belief was not reasonable. The Judge reiterated that the obligation to pay the claimants was "*wholly independent*" from the receipt of funds from Sberbank. The Judge also noted that Unicredit's licence applications had sought to obfuscate the "*difference between receiving money from Sberbank with which to satisfy Sberbank's obligations to the beneficiaries, on the one hand, and satisfying UniCredit's own, separate obligations, owed to the beneficiaries, which they could do from their own funds*." According to the Judge, the relevant payments were therefore unaffected by Regulation 28. On that basis, the Court held that Unicredit could not rely on the section 44 defence.

Key Takeaways

These decisions follow a consistent trend of English courts taking a critical approach to defendants' attempts to avoid payment obligations based on broad interpretations of UK or other sanctions regimes. These decisions suggest that English courts will continue to interpret UK sanctions in a way that focuses on their perceived purpose and avoids an arguably disproportionate or intrusive effect. Further, the Judge's decision on section 44 suggests that this defence cannot be used as a shield to justify overly conservative assessments of sanctions risk and that it may apply only in relatively narrow circumstances. Overall, the case shows the challenges faced by compliance departments in striking the right balance when it comes to taking a position on the interpretation of sanctions provisions. In particular, the case confirms that the English courts will not necessarily defer to OFSI when interpreting sanctions prohibitions, thus following the approach taken by the High Court earlier in the year on the much-debated question of "ownership and control" in *PJSC National Bank Trust and another v Mints and others* [2023] EWHC 118 (Comm). [Note: *see* Debevoise update dated 21 February 2023]

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