US Secondary Sanctions Recognized as "Mandatory Provision of Law" in UK Contract

October 3, 2019

Lamesa Investments LTD v Cynergy Bank LTD [2019] EWHC 1877 (Comm). The English Commercial Court has interpreted a loan agreement governed by English law as allowing a borrower to withhold payment of interest on the grounds that such repayments could give rise to U.S. secondary sanctions risks. Specifically, the court held that a fairly common contractual clause allowing payment to be withheld "*in order to comply with any mandatory provision of law, regulation or order of any court of competent jurisdiction*" applied not only to sanctions directly applicable to the contract parties, but also to the risk of U.S. secondary sanctions, which are extraterritorial in nature and can be applied at the discretion of the U.S. government against parties with no jurisdictional nexus to the United States. It is not yet clear whether this interpretation will be applied beyond the specific facts of this case. If so, it could impact any companies outside the United States that transact in jurisdictions targeted by U.S. secondary sanctions, including Russia, Iran, North Korea and Venezuela. Companies may wish to assess whether this decision may affect their rights and obligations under existing contracts and whether they need to amend or modify their agreements going forward.

Background. In December 2017, Cynergy Bank Limited, a UK-incorporated retail bank, borrowed £30 million from Lamesa Investments Limited , a Cyprus-incorporated entity ultimately owned by Viktor Vekselberg, under a facility agreement governed by English law. The facility agreement provided that Cynergy would be in default if it did not pay interest instalments within 14 days of each due date, except if such sums were not paid "*in order to comply with any mandatory provision of law, regulation or order of any court of competent jurisdiction*".

In April 2018, Mr. Vekselberg was named a specially designated national ("SDN") by the U.S. Treasury Department's Office of Foreign Assets Control ("OFAC"), which meant that U.S. persons were no longer permitted to deal with Mr. Vekselberg. Lamesa, as an entity more than 50% indirectly owned by Mr. Vekselberg, became subject to the same sanctions as Mr. Vekselberg by operation of OFAC's "50% rule". Due to the U.S. secondary sanctions introduced by Ukraine Freedom Support Act in 2014 and further expanded in the Countering America's Adversaries Through Sanctions Act in 2017, any non-U.S. person anywhere in the world could be subject to a number of secondary sanctions if they engage in certain activities, including, with respect to a non-U.S. financial institution, knowingly facilitating a "significant financial transaction" on behalf of any person included on the SDN list or otherwise blocked pursuant to U.S. sanctions against Russia.[1] The secondary sanctions that could be imposed on the financial institution for engaging in prohibited financial transactions include prohibitions on opening and restrictions on maintenance of correspondent and payable-through accounts with U.S. financial institutions.

Cynergy ceased paying interest due to Lamesa under the facility agreement. In response to the claim brought by Lamesa, Cynergy argued that the "mandatory provision of law" clause in the facility agreement allowed it to withhold payments because the transaction arguably constituted a significant financial transaction with Lamesa. As such, Cynergy argued, there would be a realistic risk to it of becoming subject to secondary sanctions if it continued making the interest payments. In response, Lamesa argued that the "mandatory provision of law" clause required a party to show that it was expressly prohibited from making a payment (not merely that it was possible that secondary sanctions would be imposed). Lamesa also argued that the relevant law would have to be applicable to a UK party acting in the UK pursuant to a contract governed by English law.

The court applied the standard English law approach to contractual interpretation to establish the meaning of the "mandatory provision of law" clause. The court considered the documentary and factual and commercial contexts of the clause and held that: (1) there was no territorial restriction on which laws could trigger the clause, (2) the parties were aware at the time that the facility agreement was signed that Lamesa could become sanctioned by the United States and (3) Cynergy and Lamesa would have been aware (or should have been aware) at that time that the risk arising out of Lamesa becoming sanctioned by the United States would be limited to the risk of a party becoming targeted by secondary sanctions, as the parties were not required to comply with U.S. primary sanctions. Therefore, the court ruled, it would have been "*improbable*" that the parties had intended the "mandatory provision of law" clause to apply only to primary sanctions.

Against this background, the Court ruled that "*mandatory provision of law*" meant a law that the parties could not vary or dis-apply, not a law that applied within a particular territory. The court rejected Lamesa's argument that the "*in order to comply*" element of the clause meant that it applied only to laws that expressly prohibited Cynergy from acting (which U.S. secondary sanctions did not do). The court instead concluded that

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[1] For further details on U.S. secondary sanctions against Russia, see our Client Update dated 28 July 2017 at https://www.debevoise.com/insights/publications/2017/07/us-congress-passes-final-sanctions-legislation.

this element covered situations where a party acts or refrains from acting in a manner that could result in imposition of a sanction or penalty by operation of the law.

The court rejected the application of the "*territoriality*" principle, which provides that English law will not excuse contractual performance based on foreign law unless that foreign law governs the contract or the place of performance. The court held that the "mandatory provision of law" clause constituted an agreement by the parties to dis-apply this rule.

Analysis. Although the court expressly stated that it did not consider this decision to create "*enormous uncertainty*", it appears to have adopted a particularly broad view of the "mandatory provision of law" clause in the parties' facility agreement. The decision leaves open the question of the circumstances in which an agreement with no jurisdictional nexus to the United States or, indeed, to any other foreign jurisdiction, will be held to allocate the risk of a contracting party becoming subject to sanctions in that foreign jurisdiction.

In this case, the court placed weight on the fact that Cynergy had exposure to U.S. banking relationships, which would mean that secondary sanctions could have a particularly negative effect on its business. The court considered this a factor in determining that the parties intended the clause to cover this type of risk. However, it is difficult to accept that Lamesa would have seen itself as accepting that risk solely by virtue of agreeing to a market-standard contractual provision. There is also substantial ambiguity in U.S. secondary sanctions and the types of transactions that could be targeted by such sanctions. The court interpreted OFAC guidance as making "*clear that the default position would be that the sanctions would generally apply*". There is, however, no discussion in the decision of whether a payment of interest under a pre-existing loan agreement would constitute a "significant financial transaction", which would create risk of imposition of secondary sanctions. It is not clear whether the Court considered that since the introduction of the relevant sanctions provision in 2014, no financial institution has actually been sanctioned under this provision.

It seems likely that many commercial parties would not consider these types of extraterritorial sanctions regimes to fall within the commonly accepted meaning of a "*mandatory provision of law*".

Perhaps most significantly, the decision leaves open the question of whether other secondary sanctions regimes or similar sanctions mechanisms would trigger a "mandatory provision of law" clause. Secondary sanctions apply not only to financial institutions and could have an equally negative effect on any international trading company. Further, U.S. secondary sanctions against Russia could potentially extend to transactions with entities subject to sectoral sanctions, including major Russian financial institutions and energy companies, albeit subject to guidance that they will not be applied unless the transactions are deceptive or structured to evade sanctions. Going beyond U.S. secondary sanctions, EU sanctions legislation similarly sets out grounds for adding entities and individuals to EU asset freeze lists, which can be broadly worded. It could be argued on the basis of the court's decision that a party required to take an action that could theoretically result in it being included on an EU asset freeze list would be subject to a mandatory provision of law.

The decision underscores the importance of paying careful attention to the potential impact of sanctions on contractual provisions. For example, parties may wish to restrict the territorial scope of provisions such as the mandatory provision of law clause, expressly limit it to certain forms of applicable law or carve out the risk of secondary sanctions. Ultimately the decision highlights the need for parties to a contract to consider consciously and explicitly the allocation of sanctions risks between them.

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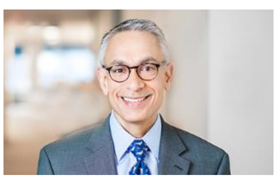

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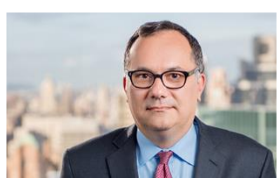

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