Rejection of "General Principle" That U.S. Sanctions Prevent Performance of Contracts Governed by English Law

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On 4 November 2020, the English High Court issued a summary judgment in *Banco San Juan Internacional Inc v Petróleos De Venezuela S.A* (the "*BSJI* Judgment"), which rejected arguments that U.S. primary sanctions could excuse non-repayment of a loan governed by English law. The case illustrates the limits of reliance on non-UK sanctions regimes to excuse non-performance under a contract governed by English law in the absence of appropriate contractual language. It also affirms the limited nature of the decision in *Lamesa Investments Ltd v Cynergy Bank Ltd* ("*Lamesa*"), which excused a borrower from repaying a loan on the basis of U.S. secondary sanctions.[1] The *BSJI* Judgment affirms that the *Lamesa* decision was based on an interpretation of the relevant contract and the facts of that case, rather than articulating a broader principle that U.S. sanctions prevent performance of contracts governed by English law.

The *BSJI* Judgment emphasises the need for parties to consider the explicit and implicit allocation of sanctions risks when drafting contracts. It also shows that English courts exhibit healthy scepticism towards a party arguing that non-UK sanctions prevent its performance of a contract where it appears to be relying on those sanctions purely for commercial advantage and where the party actually required to comply with the relevant sanctions is willing to accept payment.

Background. In 2016 and 2017, Banco San Juan Internacional Inc ("BSJI"), a bank based in Puerto Rico, lent funds to Petróleos De Venezuela S.A. ("PDVSA"), the Venezuelan state-owned oil and gas company, under two credit agreements governed by English law (the "BSJI Credit Agreements"). Both credit agreements included a covenant that PDVSA would not repay the loans with the proceeds of (i) activities prohibited by U.S. sanctions or (ii) business in a country or territory subject to sanctions (the "Sanctions Covenants").

Starting in May 2017, the United States imposed increasingly stringent sanctions against Venezuela, targeting the government of Venezuela and state-owned entities. In August 2019, the United States imposed blocking sanctions against PDVSA, which meant that U.S. persons could no longer enter into transactions relating to PDVSA or its property.

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[1] See here and here for our summaries of the *Lamesa* first instance and appeal decisions, respectively.

PDVSA subsequently defaulted on the BSJI Credit Agreements. BSJI appropriated a PDVSA trust account to extinguish PDVSA's overdue principal and interest on one loan, but principal and interest remained outstanding on the other loan. BSJI launched English court proceedings to recover this outstanding principal and interest and to claim loss of anticipated profits on the loan extinguished by the trust account.

In opposing BSJI's application for summary judgment, PDVSA argued that it was entitled to withhold payments because making them would be a breach of the Sanctions Covenant. Specifically, PDVSA claimed that all of its funds arose out of operations in a sanctioned country or from sanctioned conduct as a result of the new U.S. sanctions against Venezuela and PDVSA. PDVSA also sought to rely on an English contract law principle that a contract is unenforceable if its performance is prohibited in the place of performance and made a technical argument relating to conflicts of laws provisions under the EU Rome I Regulation.[2]

Decision. The English High Court issued summary judgment in favour of BSJI.

The court held that the Sanctions Covenant was a negative covenant in favour of BSJI and not a condition for PDVSA's repayment obligations to take effect. The court noted that a breach of the covenant allowed BSJI to accelerate repayment (the opposite of suspending it), and that the BSJI Credit Agreement at issue contained other suspension provisions, which the Sanctions Covenant did not trigger. Further, because the Sanctions Clause was a negative covenant in favour of BSJI—as opposed to a condition precedent—the court ruled that BSJI was entitled to waive it even if it had prevented repayment.

The court rejected PDVSA's argument that the *Lamesa* decision established that it was "*normal and sensible*" for commercial agreements to suspend payment obligations if the payment would be in breach of U.S. sanctions. The court distinguished *Lamesa*—as well as another ruling on the operation of sanctions clauses, *Mamancochet Mining Limited v Aegis Managing Agency Limited*, discussed in our previous Client Update here—on the basis that those cases involved clauses that expressly suspended a party's repayment obligations and were limited to their facts. The *Lamesa* decision related to a non-U.S. borrower successfully arguing that U.S. secondary sanctions constituted a "*mandatory provision of law*" for the purposes of a contractual payment suspension mechanism in circumstances where the borrower would have faced serious U.S. secondary sanctions consequences if it had continued to make payments to the lender (who had been targeted by U.S. sanctions).

[2] PDVA also unsuccessfully argued that BSJI's claim for lost profits was based on an unenforceable penalty clause.

The court also rejected PDVSA's contention that the BSJI Credit Agreements were unenforceable because the payments had been rendered illegal in their place of performance under the rule in *Ralli Bros v Compania Naviera Sota y Aznar* [1920] 2 KB 287 ("*Ralli Bros*"). PDVSA contended that one loan required repayment to a bank account held with the Federal Reserve Bank of New York, and the other loan required repayment in Puerto Rico, in U.S. Dollars, which meant that the funds would go through a U.S. correspondent bank. Because U.S. banks are required to comply with U.S. sanctions, it would have been illegal for them to accept these payments. The court held that the *Ralli Bros* principle required that the performance of the contract "necessarily" involve the performance of an illegal act. Here, PDVSA could have made the payment legally, for example by applying for an OFAC licence, and indeed was contractually obligated to make such an application.

Although this point had been conceded for the purpose of the summary judgment application, the court commented that it was not convinced that it would have been illegal for BSJI or a U.S. bank to receive payment in a blocked account. The court observed that PDVSA was closer to arguing that the payment was impractical, rather than illegal, and even expressed doubt as to the actual impracticality faced by PDVSA.

The court dismissed PDVSA's argument that, under the EU Rome I Convention, which addresses how EU Member State courts resolve conflicts of laws, the English court should give effect to U.S. sanctions obligations, as such U.S. sanctions are "overriding mandatory provisions" of law in the place of performance of the contract. The court held that it was not appropriate to exercise discretion in this case and that the argument faced the same hurdles as application of the *Ralli Bros* principle.

Analysis: Judicial Consideration of Sanctions Covenants. The *BSJI* Judgment mentioned two factors when distinguishing PDVSA's arguments from the borrower's position in *Lamesa*, which should be borne in mind when negotiating sanctions provisions. First, the *Lamesa* decision revolved around a contractual clause that expressly included, as grounds for non-payment, a mandatory provision of law, which was interpreted to cover U.S. secondary sanctions. The Sanctions Clause in the BSJI Credit Agreements, on the other hand, was a free-standing negative covenant not linked to PDVSA's repayment obligation. Second, the *BSJI* Judgment noted that the Court of Appeal in *Lamesa* had found "*good reason*" for the parties to have included a right for the borrower to suspend repayments due to U.S. secondary sanctions risks. This appears to be an indirect reference to English law principles of contractual interpretation, which require weight to be given to business common sense and reasonableness when determining the meaning of a particular clause.

Although the *BSJI* Judgment did not focus on this distinction, that case involved U.S. primary sanctions, whereas *Lamesa* involved U.S. secondary sanctions. Under the latter,

if the borrower in *Lamesa* had made repayments to the entity subject to U.S. sanctions, the borrower itself would have been at risk of being sanctioned. In the *BSJI* case, an entity subject to U.S. primary sanctions (PDVSA) sought to argue that it no longer had to repay a commercially agreed loan by virtue of having been sanctioned. In that sense, in the *BSJI* Judgment, the English court prevented a sanctioned person from gaining a commercial advantage as a result of being sanctioned.

The *BSJI* Judgment will bring welcome relief to lenders or businesses worried that their counterparties could "weaponise" contractual sanctions clauses to avoid their obligations. In particular, the court accepted that the Sanctions Covenant was intended for the benefit of BSJI and was not a provision intended to protect both parties.

Notably, the Sanctions Covenants prohibited the borrower from making repayments using the proceeds of business activities in or with "*a country or territory that is the subject of Sanctions*", followed by a non-exhaustive list of countries meeting this definition: Cuba, Iran, North Korea, Sudan and Syria. This formulation is commonly used in financing documents as a definition for "*Sanctioned Countries*" but can lead to ambiguity as to which sanctions regimes qualify given the variety of sanctions restrictions used by the European Union and the United States. The court did not have to decide this point, but it noted that the current U.S. sanctions against Venezuela may not be sufficient to fall within this definition because they are not "*country wide*", which provides some guidance on how this type of clause may be interpreted.

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Please do not hesitate to contact us with any questions.

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