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Mitigation of Sanctions Risks in Commerce, Lending and Letter of Credit

Recent global tensions have accelerated countries' use of sanctions as a geopolitical tool. These sanctions bring with them punishing penalties for those who transact in breach of them, including potential criminal liability and substantial financial penalties. Their growing use has also introduced new legal and practical challenges for corporates and financial institutions, especially regarding contractual performance in cross-border transactions.

Given this backdrop, it is becoming increasingly common for contracting parties to rely on various contractual mechanisms to manage and mitigate sanctions risks in commerce, lending and letters of credit. Such contractual mechanisms commonly take shape in the form of illegality clauses, force majeure clauses, and sanction clauses.

Illegality Clauses

Illegality clauses generally shield parties from performance of their obligations if doing so becomes illegal due to changes in law. However, standard illegality clauses may be insufficient to address sanctions-related risks. Under some sanction regimes, contractual performance can remain technically lawful even where sanctions are in place. For instance, a licence or exemption might permit the transaction to proceed. In such cases, standard illegality clauses may not be triggered, with the result that parties remain obliged to perform despite the increased practical and compliance burdens involved.

Force Majeure Clauses

Force majeure clauses generally define the parties' agreed consequences where contractual performance is hindered by events beyond their control. Typically, the agreed consequence would be to suspend performance for the duration of the force majeure event.

Sanctions may excuse contractual performance if they are classified as force majeure events under the force majeure clause. To be classified as force majeure events, such sanctions have to be a "radical event that prevents the performance of the relevant obligation (and not merely making it more onerous)". Accordingly, the sanctions must also not have been contemplated or be reasonably foreseeable to occur.

In light of the increased prevalence of geopolitical conflicts, a key consideration is whether sanctions imposed after the formation of a contract may nevertheless be regarded as reasonably foreseeable. For example, in the context of escalating geopolitical tensions in the Middle East, the imposition of additional sanctions on Iran could be considered as within the scope of reasonable contemplation for contracts entered into during this period.

Sanctions Clauses

Sanctions clauses are more targeted mechanisms designed specifically to address sanctions risk. They are commonly found in standard industry contracts.

At their core, these clauses:

a) prevent dealings with sanctioned persons, entities, assets or jurisdictions;
b) allocate risk if sanctions laws change or are breached; and
c) provide exit, suspension rights and other remedies if performance becomes illegal.

Parties seeking to incorporate sanction clauses into their commercial contracts should take note of the following key aspects in relation to such clauses.

(i) Representations and Undertakings

A sanctions clause may require parties to make certain key representations and undertakings to mitigate potential sanctions risk. In representations, the target party would typically be required to represent that it is not a sanctioned person, is not owned or controlled by any sanctioned person, and is in compliance with all applicable sanction laws. Such representations may also extend to confirming that the party is neither incorporated in, nor operating from, a jurisdiction subject to comprehensive country-wide or territory-wide sanctions.

Sanctions clauses may also take the form of undertakings. These commonly include commitments not to use goods, funds, or services in breach of sanctions, not to engage in transactions with sanctioned persons or entities, as well as to cooperate with compliance-related inquiries or checks. To facilitate the early identification of sanctions risk, parties may further undertake to maintain appropriate compliance policies and screening procedures, to notify counterparties promptly if they become subject to sanctions, and to disclose changes in ownership or control.

In return, the party providing such representations and undertakings would commonly negotiate for the inclusion of knowledge qualifiers. For instance, that their representations are made "to the best of the party's knowledge" only. Parties might also seek to include carve-outs for passive or incidental exposure to sanctioned entities. For example, permitting dealings with a sanctioned entity if such dealings are indirect or fall below an agreed materiality threshold.

(ii) Scope and Trigger Threshold

The ambit and reach of a sanctions clause depend heavily on its contractually defined scope and trigger threshold.

The scope of a sanction clause may be broadly or narrowly defined. For instance, a sanction clause covering "any applicable sanctions law" is more easily engaged than one limited to a specified regime. Sanction clauses may also vary in scope depending on the breadth of risks they are intended to address. They may be extended to capture secondary sanctions, which are measures imposed by a sanctions authority on persons who are not ordinarily within its primary jurisdiction. Similarly, the threshold required for an entity to be "owned or controlled by" a sanctioned party can be broadened or narrowed. Such criteria may adopt broad concepts of ownership and control, including deemed control, or alternatively be confined to narrower and more prescriptive thresholds. These affect how easily the sanction clause would be engaged.

Sanctions clauses can also be drafted to trigger at different thresholds. Parties can elect a higher threshold by requiring an actual breach of sanctions, or a lower trigger threshold requiring only the risk of a sanctions breach. The latter approach is useful to suspend or terminate contractual performance should sanctions be likely, but yet to be imposed.

The trigger for sanction clauses may also be framed on objective or subjective terms. Objective sanction clauses may require proof of a defined state of affairs before the clause can be invoked. In comparison, subjective sanction clauses could allow one party to exercise its own discretion in determining if the sanction clause is triggered.

The case of *Kuvera Resources Pte Ltd v JPMorgan Chase Bank, NA* illustrates the point on objective and subjective clauses. There, JPMorgan confirmed a letter of credit but added a clause that it would not be liable for failure to pay where documents presented involved an entity "subject to any applicable restriction". JPMorgan subsequently declined to honour the letter of credit based on its belief that a vessel carrying the goods under the letter of credit was owned by a Syrian entity, falling within the sanctions clause. The Singapore Court of Appeal held that the phrase "subject to any applicable restriction" rendered the applicability of the sanction clause to be determined by an objective analysis. Hence, JPMorgan failed in its claim as it had relied on its own subjective internal assessments rather than publicly available sources, such as the Office of Foreign Assets Control list.

Sanctions clauses may also be drafted to trigger only upon a change in the applicable sanctions regime. In the UK case of *Litasco SA v Der Mond Oil and Gas Africa SA*, the relevant sanction clause allowed parties to suspend performance where there was "an effective amendment to any existing Trade Sanctions". The buyer subsequently refused payment by relying on preexisting UK sanctions. The court, however, rejected this argument, holding that the wording of the sanction clause could not be engaged by preexisting sanctions. Rather, it required there to be a change to the applicable sanction regime.

(iii) Consequences

Sanction clauses carry significant commercial consequences. These may include termination of the contract, suspension of performance of the innocent party without liability, and indemnities for losses incurred by the innocent party as a result of the breach. In financing transactions, sanctions breaches may also trigger mandatory prepayment, cancellation of commitments, or events of default.

Ultimately, the consequences of the breach will depend on the contractual allocation of risk between the parties. Provisions relating to materiality thresholds, notice requirements, grace or cure periods should therefore be carefully negotiated and clearly defined. For instance, grace or cure periods can provide the party in breach a specific timeframe to remedy the non-performance of their obligations before the innocent party can begin to enforce its legal rights. Parties can negotiate the scope and duration of such periods or even delineate what breaches are too fundamental to be cured. However, absent any alternative non-contravening mode of performance, such grace or cure periods do little more than buy time for the sanctions to be lifted. The effectiveness of these clauses is therefore highly dependent on the actions of regulatory authorities. Should the sanctions remain in force beyond the duration of the grace period, parties would no longer be able to perform the contract lest they be in breach of sanctions.

Sanctions Clauses in Lending

Sanctions clauses in finance documents have become increasingly central to compliance, draw-stop mechanics and enforcement strategy, particularly in cross-border financing structures or transactions involving funds flows or assets spanning multiple jurisdictions.

The considerations discussed above are equally relevant in the context of lending and finance documents. In addition, sanctions clauses in such documents commonly address matters including restrictions on the use of proceeds, draw-stop rights, cancellation of commitments, mandatory prepayment, acceleration and enforcement.

For syndicated loans involving multiple lenders, it is also important to ensure that sanctions definitions and compliance positions are appropriately aligned across the lender group.

Beyond contractual protections, lenders are also enhancing their due diligence processes in relation to:

a) ownership, management, business and operations of financing counterparties;
b) the location of assets in sanctioned jurisdictions;
c) potential funds flows involving sanctioned jurisdictions; and
d) currency toggles and alternative payment systems.

Sanction Clauses in Letters of Credit

In recent years, sanctions have begun to assume a novel role in the context of letters of credit. Letters of credit occupy a foundational role in international trade finance. They are generally regarded as cash-in-hand, and on account of such reliability have been described as the lifeblood of international trade. Such reliability stems from the independence principle, under which the letter of credit is independent of any underlying contract between seller and buyer. As a result, beneficiaries are effectively assured payment. Traditionally, payment by an issuing or confirming bank under a letter of credit is subject only to the exception of fraud.

The International Chamber of Commerce in its guidance issued in 2022 on the use of sanctions clauses in trade finance-related instruments noted that the use of sanction clauses in trade finance-related instruments has become a problematic issue for banks involved in trade finance transactions. It advised against the routine inclusion of sanction clauses, and that they should only be used in specific transactions after consulting with the customer and counterparties. Sanction clauses should also be drafted in clear terms and limited to applicable mandatory law without reference to unparticularised laws generally or internal bank policy and procedure.

United Kingdom

A significant new constraint on letters of credit is now emerging in the form of sanctions, which the UK Supreme Court recently had to consider in *UniCredit Bank GmbH (London Branch) v Constitution Aircraft Leasing (Ireland) 3 ("**UniCredit**")*. In UniCredit, a series of standby letters of credit had been issued to secure aircraft lease agreements with Russian airlines. Following amendments to the Russia (Sanctions) (EU Exit) Regulations 2019, the provision of financial services "in pursuance of" and "in connection with" arrangements whose object or effect was to make aircraft available in or to Russia became prohibited. The issue was whether the letters of credit were caught under the amended regulation.

The Supreme Court found that payment under the letters of credit was prohibited. First, the overarching purpose of the regulations was to exert economic pressure on Russia. Second, the inclusion of the phrase "in connection with" alongside "in pursuance of" indicated a legislative intent to cast a wide net and capture all transactions with a factual link to the prohibited arrangement. On this basis, the letters of credit were held to fall within the scope of the regulations as they provided security to the aircraft leasing arrangements with the Russian airlines. Hence, the bank was prohibited from making payments under the letters of credit.

The broadly worded sanction regulations in the UK may require banks to now review the underlying contracts to their letters of credit before they issue or add their confirmation to the credit. This could potentially undermine the independence principle in letters of credit.

Singapore

The issue of whether sanctions are now recognised as an exception to payment under a letter of credit has not been fully tested in Singapore. However, the Singapore Court of Appeal in *Kuvera* has made obiter remarks on their potential applicability. While leaving the point open, the court expressed its concern that the uncertainty introduced by sanction clauses may be incompatible with the commercial purpose of a letter of credit. For instance, the beneficiary of the letter of credit may not know the real beneficial owner of the vessel, and hence, whether the applicable sanction clause had been triggered.

The case of UniCredit can arguably be distinguished in Singapore. Strictly speaking, the independence principle was not contravened in UniCredit, as the regulations were interpreted as operating on the letter of credit itself rather than through any taint from the underlying lease arrangements. Nevertheless, from a commercial perspective, banks may no longer be able to confine their assessment to the letter of credit in isolation but must examine related transactions to determine whether they fall within the scope of sanctions, an approach that runs counter to the rationale underpinning the independence principle.

Similarly, supervening sanction prohibitions pose a threat to letters of credit functioning as cash-in-hand. Given that sanctions generally target contracts at the time of performance, the payment under a letter of credit may be prohibited even if such sanctions were imposed after the issuance of the letter of credit, as was the case in UniCredit. This would mean that beneficiaries are not necessarily guaranteed payment once the letter of credit is issued.

Emerging Trend: Anti-Sanctions Blocking Laws

The rise of sanctions use has also instigated countries to implement counter mechanisms to negate sanctions impact. One such emerging mechanism is anti-sanction blocking rules. Blocking rules are legal measures intended to counter the extraterritorial reach of foreign sanctions by preventing entities under local jurisdiction from recognising, complying with, or enforcing foreign sanctions measures.

Blocking rules create significant conflict-of-laws issues for multinational companies, financial institutions and those with international dealings. On one hand, these entities may face exposure to penalties for breach of sanctions or even secondary sanctions imposed on themselves if they transact in breach of sanctions rule; on the other hand, they risk liability and damages for losses caused under blocking rules if they refuse to transact on the basis of those same sanctions.

Businesses operating internationally should therefore consider (a) applicable sanctions laws and corresponding anti-sanctions blocking laws, (b) nexus triggers, (c) coverage of sanctions clauses, (d) alternative termination rights, (e) reporting obligations, licences and waivers, and (f) proper segregation of decision making, operations, data systems and personnel.

Conclusion

In an environment of increasing geopolitical instability, the prevalence of sanctions regimes will continue to grow. The proper use of illegality, force majeure and sanction clauses can contractually mitigate or reallocate certain sanctions risks. However, it may not mitigate or reallocate certain risks such as regulatory, criminal or reputational liabilities. Therefore, it is equally important for parties to conduct the necessary due diligence on the applicability and impact of present and future sanctions on the parties and transactions.

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