Russia sanctions and guarantors

Stephen Jourdan KC and Taylor Briggs

Introduction

In this paper, we review the very recent *Celestial Aviation* decision, and discuss its implications for the situation where there is a sanctioned tenant and a non-sanctioned guarantor.

The *Celestial Aviation* decision

On 23 March 2023, Christopher Hancock KC, sitting as a High Court Judge, gave judgment in *Celestial Aviation Services Limited v UniCredit Bank AG (London Branch)* [2023] EWHC 663 (Comm). The judgment examines a number of aspects of the UK sanctions regime and offers guidance on the correct approach to the interpretation and application of the Russia (Sanctions) (EU Exit) Regulations ("the Regulations"). A copy of the decision can be downloaded **here**.

Boiling the case down to its essentials, two Irish companies claimed payment from a German bank, UniCredit, under letters of credit issued by UniCredit as confirming bank. The letters of credit related to payments due under leases of aircraft to Russian companies. They entitled the beneficiary to payment on serving a conforming demand on UniCredit. They had been issued between 2017 and 2021 and confirmed letters of credit issued by a Russian bank, Sberbank. They were governed by English law and created primary obligations which were independent from the underlying leases.

UniCredit accepted it was liable to pay under the letters of credit but argued that it could not pay without a licence from OFSI for a variety of reasons, all rejected by the Court.

Regulation 28 interpreted narrowly to give effect to the purpose of the Regulations

UniCredit first relied on reg 28, which concerns the provision of financing for the supply of restricted goods/technology, including aircraft. Reg 28(3) provides: "*A person must not directly or indirectly provide financial services or funds in pursuance of or in connection*

with an arrangement whose object or effect is …" a number of things, including making aircraft available to a person connected with Russia. That regulation applied with effect from 1 March 2022, long after the aircraft had been leased to the Russian companies and the letters of credit had been issued to guarantee payment under the leases.

There was no doubt that the aircraft had been leased to Russian companies, so providing financial services "*in pursuance of or in connection*" with the leasing of the aircraft was prohibited by reg 28(3). Payment under the letters of credit clearly constituted providing funds. So the question was whether payment under the letters of credit should be treated as "*in pursuance of or in connection*" with the leasing of the aircraft.

The Judge held that it should not. He said that "*the starting point is to identify the purpose of the regulation"*. That purpose was to ensure that financial assistance was not provided to Russian parties in relation to, among other things, the supply of aircraft.

Accordingly, reg 28(3) should be read as only operating prospectively, and not retrospectively. It would prohibit the issue of a letter of credit to enable the supply of aircraft to a Russian company after the regulation came into force. But it did not apply where, as here, the aircraft had been supplied and the letters of credit issued long before the prohibition came into effect, at a time when both the leasing of the aircraft and the issue of the letters of credit to guarantee payment under the leases were lawful. The letters of credit had been lawfully issued at a time when reg 28(3) did not apply and therefore payment under them was not prohibited. The Judge said that, when reg 28(3) came into effect on 1 March 2022, '*all that remained to be done…was for the obligation undertaken long before to be fulfilled*'. Although this fulfilment may have had the collateral result of discharging the independent obligations of the lessees and Sberbank towards the Claimants, the Judge regarded this as a '*wholly collateral matter'*. The Judge explained that, as Sberbank remained liable to UniCredit, and the lessees remained liable to Sberbank, neither Sberbank nor the lessees were benefited.

At [127], the Judge said:

> *'... it is important to take a step back in this regard and ask whether the fulfilment of an independent obligation owed by a German bank to Irish companies can be said to be intended to benefit the Russian entities who happen to be involved in other elements of the overall transaction. In my judgment, the answer to this question is quite clear – it cannot'.*

The Judge rejected UniCredit's submission that the Regulation should be read broadly on the basis that any vagaries that such a reading might lead to can be assuaged by the use of the licensing system.

Just as in the *Mints* case (discussed here), the Court took a purposive approach to the interpretation of the legislation. The purpose of reg 28(3) was to stop aircraft being supplied to Russian companies. Payment by a German bank to Irish companies of rent due under leases of Russian aircraft granted before the regulation took effect could not lead to that happening. Therefore, those payments should not be treated as being "*in connection with*" the supply of aircraft to Russian companies.

Regulation 11 interpreted as not applying to payments due prior to designation

Reg 11 is one of the asset-freezing provisions of the Regulations. It prohibits a person from "*dealing with*" funds or economic resources owned, held or controlled by a designated person if they know, or have reasonable cause to suspect, that they are dealing with such funds or economic resources.

Reg 11(6)(a) provides that funds are owned, held or controlled by a designated person where that person has any legal or equitable interest in them, regardless of whether any other person holds such an interest.

Regulation 11(4) provides that a person "deals with" funds if the person:

(a) uses, alters, moves, transfers or allows access to the funds,

(b) deals with the funds in any other way that would result in any change in volume, amount, location, ownership, possession, character or destination, or

(c) makes any other change, including portfolio management, that would enable use of the funds.

Both "funds" and "economic resources" are given wide definitions by section 60 of the 2018 Act, and "funds" is defined to include letters of credit.

Sberbank, the Russian issuing bank in respect of the letters of credit, was designated as subject to an asset-freeze under the Regulations on 6 April 2022. UniCredit argued that:

(1) The confirming letters of credit were funds "owned, held or controlled" by Sberbank, because Sberbank had a legal interest in the confirming letters of credit including rights to preserve their terms.

(2) Payment under the confirming letters of credit would be a "*dealing*" with them because it would both change their character and would involve a change enabling use of the letters of credit. Payment would extinguish Sberbank's obligation under its own letters of credit and would trigger an obligation on Sberbank to reimburse UniCredit.

The Judge rejected that argument for two reasons.

The first was that UniCredit's obligation to pay had arisen before Sberbank's designation. He said at [137(1)]: "*… since any sanction imposed under Regulation 11 did not come into force until after the date on which the obligation to make payment under the letters of credit matured, that sanction cannot have impacted on the relevant obligation*."

This is a surprising conclusion. There are provisions in the Regulations providing that, in specified circumstances, a payment in satisfaction of obligations which existed at the time a person was designated can be made - see e.g. reg 58(5) and Sch 5 Part 1 para 8. Those provisions would be unnecessary if the Judge's view on this point was correct.

We think the Judge was probably wrong on this point. We consider that reg 11 does prohibit using a designated person's funds to make a payment in satisfaction of a debt which accrued due for payment prior to designation. A licence permitting such a payment can be issued by OFSI under Sch 5 Part 1 para 8, but payment without such a licence is prohibited.

A confirming letter of credit is not to be treated as funds owned, held or controlled by the issuing bank

The second reason was, however, undoubtedly correct. The Judge held that the confirming letters of credit were not "*owned, held or controlled*" by Sberbank. UniCredit was not dealing with Sberbank's property when making payment under the letters of credit; rather, UniCredit was satisfying its own independent contractual obligations. The Judge explained as follows:

> *'In this connection, UniCredit's argument was, in essence, that because UniCredit could not unilaterally vary the letter of credit obligations, but had to have Sberbank's consent to a variation, that in turn gave Sberbank a proprietary interest in the contractual obligation owed by UniCredit to the Claimants. This is, in my judgment, a non-sequitur . The correct analysis under the UCP is that any variation of the obligations by the confirming bank relieves the issuing bank of its obligations; that does not give the issuing bank a proprietary interest in the obligation owed by the confirming bank'.*

Regulation 13 does not prohibit payment of a debt owed by a designated person by a person liable under an independent contract

Reg 13 prohibits a person ("P") from making funds available to any person for the benefit of a designated person if P knows, or has reasonable cause to suspect, that P is making the funds so available.

Reg 13(4)(a) clarifies that funds are made available for the benefit of a designated person only if that person thereby obtains, or is able to obtain, a significant financial benefit.

For these purposes, reg 13(4)(b) explains that "financial benefit" includes the discharge (or partial discharge) of a financial obligation for which the designated person is wholly or partly responsible.

UniCredit contended that if it paid the Claimants under the confirming letters of credit it would discharge the liability which Sberbank owed to the Claimants under its letters of credit. The Defendant argued that this would amount to a "*significant financial benefit*" for Sberbank, even though Sberbank remained liable to reimburse UniCredit for the payment.

The Judge gave two reasons for rejecting UniCredit's argument.

The first was the same as the first reason given in relation to reg 11 - "*since Regulation 13 did not come into force until 6 April 2022, it can have had no impact on UniCredit's obligations, which had matured before that date.*"

For the reasons given above, we think that is wrong.

The second reason was as follows:

> *'Whilst Sberbank's independent obligation to make payment to the Claimants may now have been satisfied, it remains under an equal obligation to reimburse UniCredit. There is no reduction in its overall liability; it is simply now obliged to one party and not two'.*

That was undoubtedly correct. The position prior to payment under the confirming letters of credit was that Sberbank owed money to the Claimants. The position after payment under the confirming letters of credit was that Sberbank owed money to UniCredit. That change was obviously not one that conferred any benefit on Sberbank, let alone a "*significant financial benefit*".

What lessons can be learnt from the decision in *Celestial*?

Drawing the above threads together, we suggest that the following general lessons can be extracted from the decision.

Firstly, the Regulations ought to be given a purposive, rather than literal, interpretation. Accordingly, when advising on the Regulations, it is essential to identify the purpose of the relevant provision and consider whether prohibiting the action under consideration would be contrary to that purpose.

Secondly, the judgment in *Celestial* highlights that the existence and operation of the licensing regime does not justify taking an unduly broad approach to the scope of the Regulations. In other words, the sanctions regime should not be treated as all embracing with the licensing regime there to prevent unsatisfactory outcomes.

Thirdly, the judgment offers some useful guidance on the correct approach to Regulation 13. Although the decision was concerned with standby letters of credit, the decision may bear on the approach to guarantees more generally, which we will now discuss.

The sanctioned tenant and the non-sanctioned guarantor

L is the freehold proprietor of an office block. One of the tenants, DP, has recently been designated as subject to an asset-freeze under the Regulations and is therefore a "designated person" for the purposes of regs 11-19.

Without an OFSI licence, L cannot accept rent from DP. Payment by DP of the rent using its own money would breach reg 11. If L was to accept the rent, knowing that DP was a designated person, then L would breach reg 19, which prohibits a person from intentionally participating in activities knowing that the object or effect of them is (whether directly or indirectly) to circumvent any of the prohibitions contained in Regulations 11 to 18 or to enable or facilitate the contravention of any such prohibition.

If Z, an associate of DP who is not herself sanctioned, was to pay the rent on DP's behalf, by way of gift to DP, she would breach reg 13. By discharging DP's obligation to pay rent, Z would thereby confer a "significant financial benefit" on DP. Acceptance of the rent by L would again breach reg 19.

What if Z is DP's guarantor under the lease?

In that case, L may take the view that it can demand and accept payment from Z on the basis that:

- payment of the rent by Z as guarantor for DP does not relieve DP of the obligation to make the payment. DP will still be liable to pay a sum equal to the amount of the rent, but now DP will owe it to Z, pursuant to the reimbursement obligation that a principal debtor owes to a guarantor who pays the principal's debt;
- therefore, applying the logic of the *Celestial Aviation* decision, payment of the rent by Z does not confer a significant financial benefit on DP.

However, there is an argument against that. In the case of a lease with a standard forfeiture clause, non-payment of rent not only creates a debt due from the tenant to the landlord, it also gives the landlord the right to terminate the lease.

In a pure debt scenario, as in *Celestial Aviation*, the identity of the person to whom the sanctioned individual owes the debt may not make any difference to their financial position. But in the case of a lease, payment of rent by the guarantor will remove the landlord's right to forfeit the lease and thus confers a benefit on the tenant, even though the tenant will still be obliged to pay an amount equal to the rent to the guarantor. The payment of the debt by the non-sanctioned guarantor, Z, enables the sanctioned tenant, DP, to continue enjoying the property free from the right of L, the landlord, to forfeit.

In financial terms, the payment of the rent obviates the need for DP to apply for an OFSI licence authorising payment of the rent and to apply for relief from forfeiture, including having to pay L's costs of the forfeiture as a condition of relief. That financial benefit might well be regarded as "significant", depending on the facts.

11 April 2023