Falcon Chambers

"I think my landlord is sanctioned – can I safely withhold rent?"

Stephen Jourdan KC, Cecily Crampin, and Taylor Briggs look at the recent Celestial Aviation decision on section 44 of the Sanctions and Anti-Money Laundering Act 2018

Introduction

In this note, we review the decision of the Court of Appeal in *Celestial Aviation Services Limited v UniCredit Bank AG (London Branch)* [2024] EWCA Civ 628 ("*Celestial*"), which was handed down on 11 June 2024. Our case note of the first instance decision, published in March 2023, can be downloaded **here**.

Consider the following scenario: your client is the tenant of a commercial unit. The landlord is an overseas entity. A person, whom your client understands to be one of the directors of the landlord, is designated as subject to an asset freeze under the Russia (Sanctions) (EU Exit) Regulations 2019 ("the Regulations"), made under the Sanctions and Anti-Money Laundering Act 2018 ("SAMLA"). Your client believes that the landlord company is controlled by this sanctioned director. If that was the case, paying the rent would be a breach of Regulation 12 and a criminal offence. The landlord refuses to provide any evidence about its control, and insists that, if your client does not pay rent immediately into a Russian bank account, then it will sue. Your client refuses to pay, and the landlord then issues proceedings. In the course of the proceedings, it provides evidence that the director resigned from the directorship prior to the rent falling due. On receipt of this evidence, your client duly pays the rent. They are then faced with a claim for a considerable amount of interest on that rent, as well as the landlord's costs, which can be claimed under a covenant in the lease to "pay all costs of enforcing any breach of the Tenant's covenants on a full indemnity basis". Does your client have to pay?

You turn to section 44 of SAMLA. It says:

> *(1) This section applies to an act done in the reasonable belief that the act is in compliance with regulations under section 1 …*
> *(2) A person is not liable to any civil proceedings to which that person would, in the absence of this section, have been liable in respect of the act.*
> *(3) In this section, "act" includes an omission.*

Non-payment of the rent is an "act" for the purposes of section 44, because "act" includes an omission: see subsection (3). And the omission to pay the rent was "done in the reasonable belief that" it was in compliance with Regulation 12. So, on the face of it, section 44 means that your client was not liable to the proceedings because it reasonably believed that non-payment of the rent was required by the Regulations.

But according to the Court of Appeal in *Celestial,* the position is more complicated than this. The Court said that section 44 does not apply to claims to enforce an obligation or to an "adjunct" or "aspect" of an obligation. It only applies to claims for relief in respect of the consequences of a failure to comply with an obligation which are not adjuncts or aspects of the obligation. So, it is necessary to decide if the obligation to pay interest and costs is an adjunct or aspect of the obligation to pay the rent.

The *Celestial* decision

Briefly, *Celestial* is a case about non-payment under letters of credit, when the paying party took the view that it could not pay because of the effect of sanctions. Between issue and trial, licences permitting payment had been obtained from the Office of Financial Sanctions Implementation ("OFSI") and payments had been made. Accordingly, by the date of trial, the issues were limited to liability for interest and costs. One of the issues at trial was whether, prior to the obtention of OFSI licences, payment was prohibited by Regulation 28, which prohibits the provision of financial services to a person connected with Russia in connection with an arrangement the object or effect of which is the supply of aircraft to or for use in Russia, or to a Russian person (which is not an issue for our tenant client in the above example). A further issue, which only arose if Regulation 28 did not apply, was whether section 44 gave the paying party a defence so that, for example, it was not liable for interest. At trial, Christopher Hancock KC, sitting as a High Court Judge, had concluded that, although the paying party had established the necessary subjective belief, that belief was not a reasonable one, such that section 44 could not be prayed in aid.

On appeal, the Court of Appeal concluded that Regulation 28 did prohibit payment, such that the payment obligation on the paying party was suspended unless and until the UK licences

were obtained. It followed that interest was not payable for the period between the due date under the agreements and the date the licence process was completed. However, given their significance and the fact that they had been fully argued, the Court went on to consider the section 44 issues. The only reasoned judgment was delivered by Falk LJ; Snowden and Males LJJ simply agreed with her judgment.

We will first summarise two aspects of her judgment on section 44 which we agree with. We will then look at what she had to say about debt claims and explain our views on that.

(1) Section 44 only applies where the act or omission is in fact lawful but the defendant reasonably believed it was unlawful

The first point of interest is the ambit of section 44. It is not readily apparent from reading the section whether it is intended to assist:

- where the putative defendant's reasonable belief that the Regulations apply to prohibit the relevant act or omission turns out to be correct; or
- where that belief, while reasonable, is proved wrong; or
- in both situations?

In other words, is the section intended to assist where an act or omission is prohibited and hence illegal, so as to make clear by statute that contractual consequences are removed? Or is it intended to assist where the sanctions regime does not apply, but a party who should have acted fails to do so in the reasonable belief the act was illegal? Or in both cases?

The Court of Appeal treated that question as a straightforward one. Section 44 only applies where the act or omission is in fact lawful, but the defendant reasonably believed it was unlawful because forbidden by the Regulations.

At [76], Falk LJ set out the relevant sections of the Explanatory Notes for SAMLA in respect of section 44. The Explanatory Notes give the following example of section 44's application:

> '*It aims to protect people from any adverse results generated by compliance (for example, a breach of contract to supply goods that are prohibited from export by sanctions)*'.

At [77], Falk LJ held that the ambit of this section is wider than that example suggests, stating that:

> *'…the wording of this note does not reflect the fact that s.44 is in point where something is done or not done in the reasonable belief that sanctions are engaged, even if in fact they are not engaged*'.

The reason for that conclusion is that, if sanctions make an act illegal, then '*it is much less likely that the protection of s.44 would be required*' because, for example, a payment obligation which falls foul of the Regulations would be suspended by reason of that illegality: *Fortenova Grupa DD v LLC Shushary Holding* [2023] EWHC 1165 (Ch) at [51] to [52]. There is no failure to pay, and hence no liability, where it would have been unlawful to make that payment.

(2) The question of whether the defendant "reasonably" believed the act or omission was unlawful should not be viewed with the benefit of hindsight

The second point of interest is Falk LJ's discussion of the test which applies to determine whether the belief is "reasonable" or not. She confirmed that there are both subjective and objective elements: thus, subjectively, the belief must be genuinely held, but the question whether the belief is reasonable is an objective one.

In terms of objective reasonableness, what steps should your client have undertaken to check the information it had about control of the landlord company by the designated director? In the *Celestial* case, the paying party's views were formed following the advice of its compliance team that the sanctions regime applied. At [73], the Court said the following in relation to reasonableness:

> '*UniCredit was required to form a view about new legislation at short notice. There is no doubt that the literal words [of the Regulation] appear to catch payments … It is important to avoid viewing the position with the benefit of hindsight, having heard argument from well-prepared leading Counsel and with the benefit of judicial consideration that might ultimately appear to make clear what was in fact not at all clear at the relevant time*'.

A belief may be reasonable even though counsel and judges could, thereafter, find errors in it. That is surely a reassuring indication.

(3) Section 44 does not prevent proceedings to enforce an obligation but only proceedings for remedies in respect of the consequences of acting or failing to comply with an obligation

So far then, so good. Your client was wrong in concluding that Reg 12 applied to prevent rent being payable, but your client had a reasonable belief that the Regulations prohibited payment. Does that mean that section 44 is a solution to your client's issues?

That brings on to the third aspect of Falk LJ's judgment. Her reasoning appears at [86] to [90]. In summary, she said:

- The answer lay in focusing on the phrase "in respect of the act" in the phrase "civil proceedings to which a person "would, in the absence of this section, have been liable in respect of the act".
- The purpose of section 44 is to ensure that a person is not pressurised into doing something that risks breaching sanctions by a fear of being exposed to civil claims. The section is concerned to protect against a liability which is created as a result of something done (or not done) in the reasonable belief that it is in compliance with a sanctions regulation. It is not concerned to protect against pre-existing liabilities.
- Section 44 would, therefore, apply to proceedings seeking compensation for loss that has been caused by action taken, or not taken, in the reasonable belief that it was in compliance with regulations made under section 1 of SAMLA. For example, a seller may be concerned that a failure to deliver goods could expose it to claims from the buyer for loss of profit and/or to recover amounts for which the buyer becomes liable to its own customers. Section 44 would protect the seller from a claim for damages, provided that the belief that the supply would be sanctioned was a reasonable one.
- But section 44 should not protect a debtor from an action to recover a debt which is otherwise lawfully due but which has not been paid in the reasonable belief that its payment would be in breach of sanctions. Absent sanctions, the debtor would expect to have to pay that sum in the normal course. Exposure to a claim to recover it is not a

new financial exposure which might pressurise payment. It is a pre-existing liability. The mischief at which section 44 is aimed is not present.

- The wording of section 44 also supports an interpretation that would allow proceedings to recover a debt. This is because a claim for debt is just that: it seeks payment of the debt. While the inevitable trigger for the claim is that the debtor has not paid, the action is not an action for the non-payment as such (which is the relevant omission for section 44 purposes) and can therefore be said not to be "in respect of" it. Rather, it seeks recovery of an amount which is owed irrespective of any action or inaction in purported compliance with sanctions.

So, Falk LJ's interpretation was that section 44 is only concerned with proceedings seeking relief in respect of the consequences of a failure to comply with an obligation. Not proceedings concerned with enforcing the obligation itself.

We – the co-authors of this Note – do not agree among ourselves on whether this is the correct interpretation of section 44.

One view – Falk LJ was in error in saying that section 44 does not apply to failure to comply with an obligation

One view is that this is wrong both on the language and purpose of section 44.

As to language, when you issue a claim form seeking an order for the payment of an unpaid debt, the facts you have to plead to establish your cause of action are:

- the contract under which the debt fell due;
- the amount of the debt and the date it fell due; and
- the non-payment of the debt.

The omission to pay the debt is an essential part of the cause of action. So it seems wrong as a matter of language to say that the proceedings are not "in respect of" the omission to pay the debt.

As to purpose, Falk LJ says that the purpose of section 44 is to avoid people being pressurised into doing something that risks breaching sanctions by a fear of being exposed to civil claims. But her interpretation allows exactly that pressure to be applied. Somone who owes a debt to a

person they reasonably believe to be sanctioned will be under pressure to pay it on her interpretation.

The other view – Falk LJ was right to say that section 44 only applies to the consequences of failure to comply with an obligation

The other view is that Falk LJ was right to focus on precisely what section 44(2) applies to, namely civil proceedings to which a person '*would, in the absence of this section, have been liable in respect of the act*' – the "act", in a case like your client's, being the failure to make the payment. Despite the underlining in the judgment, the focus is on the wording "in the absence of this section" in section 44. Thus, the Court says that section 44 would assist as a defence to a claim for damages for loss caused by an action not taken, such as a failure to deliver goods. However, it does not assist in relation to an obligation to pay, because the liability to pay would be present in the absence of section 44.

Insofar as this reasoning relates to the debt itself, as opposed to the consequences flowing from non-payment of that debt (as to which, see below), then it is defensible. Your client's liability to pay the rent is not a consequence of the "act" (which, in this case, is actually an omission); rather, your client's stems from a pre-existing contractual obligation. It seems sensible that, as soon as it becomes apparent that payment would not involve a breach of the Regulations, your client should be liable to pay that sum. In much the same way, one would anticipate that, where the relevant "act" is the failure to deliver goods which have already been paid for, section 44 would not excuse the putative defendant from liability to return either the purchase price or the goods themselves.

What counts as proceedings in respect of the consequences of a failure to comply with an obligation?

However, where the authors of this Note do agree is that Falk LJ went wrong later in her judgment.

She had this to say in respect of interest at [93]:

> *'It is notable that a claim for interest on a debt under s.35A [of the Senior Courts Act 1981] is not independent of the claim for the underlying debt. Rather, the court's power to award interest arises in proceedings "for the recovery of a debt". On the basis that*

> *proceedings for the recovery of the debt itself are not barred by s.44 (as to which see above) it logically follows that a claim which is no more than an adjunct of that, and has no independent foundation, should also not be barred. Effectively, it is an aspect of the single claim for a debt…'.*

And at [96] she said:

> "*I should add that it does not follow that all claims for interest would be in the same category. In particular, a claim for interest at a default rate provided for in a contract would give rise to different issues. A claim for default interest is much closer both to the mischief at which s.44 is aimed and the language, because the claim is for an amount due as a result of ("in respect of") the failure to pay.*"

Likewise, at [99], she held that it followed that there was no immunity in respect of 'any associated costs exposure', explaining that:

> *'As with interest under s.35A of the 1981 Act, that is no more than an aspect of a claim for recovery of debt'.*

So, she distinguished between consequences which were an "adjunct" or "aspect" of a claim for recover of a debt – interest under section 35A and costs – and consequences which were not – contractual interest.

It seems to us that this distinction – between a claim for damages, on the one hand, and the "adjuncts" of a debt claim on the other – is wrong. In our view, the Court of Appeal's reasoning – that your client would have been liable to pay the sum regardless – does not apply to interest on that sum and the other consequences of non-payment, such as costs.

At [87], the Court of Appeal said that '*the evident purpose of s.44 is to ensure that a person is not pressurised into doing something that risks breaching sanctions by a fear of being exposed to civil claims*'. The Court went on to say (at [89]) that the reason why section 44 does not afford a defence in a debt case is because '*absent sanctions, the debtor would expect to have to pay that sum in the normal course. Exposure to a claim to recover it is not a new financial*

exposure which might pressurise payment'. However, while this may be true of the capital sum, it seems to us that the same cannot be said of interest on that sum. Absent sanctions, someone obliged to deliver goods would expect to have to pay damages if they delayed delivery. Why should it be any different if the obligation is to make payment at a particular time? After all, absent sanctions, the debtor would have paid the sum when due, such that the interest would not have accrued. It seems to us that the sort of pressure engendered by the fear of incurring civil liability for interest (whether statutory or at a contractually agreed rate) and costs is precisely the kind of pressure which may lead to someone risking breaching the sanctions regime. In this way, the Court's decision seems inconsistent with its own description of section 44's purpose.

Indeed, further examples of this inconsistency abound in the decision itself. For example, at [94], the Court of Appeal recognised that the aim of an award of interest is to achieve *restitutio in integrum*, and that *'without it, not only would the creditor be worse off but the debtor would obtain an unwarranted windfall'*. However, the relevance of this factor is not clear, given that damages are also compensatory in nature.

As set out above, the Court recognised, at [96], that not all claims for interest will be *'in the same category'* and that, in particular, a claim for default interest pursuant to the terms of a contract *'would give rise to different issues'* because '*the claim is for an amount due as a result of ("in respect of") the failure to pay'*. We cannot see any logically defensible justification for a such a distinction.

Ultimately, in the case of a failure to pay or a failure to deliver goods, the common law remedies for breach – namely, debt and damages – arise out of the agreement under which payment or delivery is required. In both cases, the reason why payment or delivery is delayed is the same: a reasonable belief that the failure to pay or deliver is necessary to ensure compliance with the Regulations. In the non-payment scenario, but for this reasonable belief, your client would have paid the rent on time, and hence no interest would have accrued and no costs associated with recovery would have been incurred. In just the same way, in the non-delivery scenario, but for the reasonable belief, the goods would have been delivered on time, and hence no liability for consequential loss would have been incurred. In both cases, there is a nexus between the relevant failure and the civil liability; but for section 44, your client is due to pay interest and

costs or damages for consequential loss as a result of ("in respect of") the failure to make payment or deliver the goods, as the case may be.

For this reason, in our view, a rigid dichotomy between "debt" and "damages" claims ought to be rejected. We cannot see any principled reason for drawing a distinction between (say) damages in respect of consequential losses and interest. Rather, the Court ought to approach matters by asking whether the relevant civil liability would not have been incurred but for the reasonable belief.

It remains to be seen whether *Celestial* makes its way to the Supreme Court. The Supreme Court has given permission to appeal in *PJSC National Bank Trust v Mints* [2024] 2 WLR 714. We hope that *Celestial* too will be reviewed by the Supreme Court.

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