LOAN AGREEMENTS AND SANCTIONS: LAMESA INVESTMENTS LIMITED V CYNERGY BANK LIMITED[1]

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The decision of the UK Court of Appeal in this case has now been handed down. The decision at first instance was handed down about a year ago[2] and created a lot of interest and some surprise. The judge at first instance held that a borrower was for the time being not obliged to continue to make payments under a facility agreement, on the construction of the document, by reason of the imposition of US secondary sanctions affecting the lender due to its ultimate ownership. The lender's appeal has been dismissed by the Court of Appeal but on the basis of reasoning which is somewhat different from that of the judge at first instance. One of the judges in the Court of Appeal (Arnold LJ), while not going so far as to dissent, expressed some doubts about one aspect of the reasoning in the main judgment. The differing approaches of the judges involved and the importance of the issues, specifically the effect of US secondary sanctions on the obligations of parties to English loan documents and also, more generally, issues of contractual interpretation, mean that an appeal to the Supreme Court might be welcomed in order to give greater clarity and certainty.

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THE FACTS AND BACKGROUND

The defendant, Cynergy Bank Limited ("CBL") is an English company and a licensed retail bank. The plaintiff, Lamesa Investments Limited ("LIL") is a Cypriot company which lent money to CBL. Not long after the loan facility agreement was entered into, the ultimate beneficial owner of LIL was placed on the Special Designated Nationals and Blocked Persons (SDN) list by the US Department of The Treasury's Office of Foreign Assets Control (OFAC), with the result that LIL became a 'blocked person'. By operation of the US Ukraine Freedom Support Act 2014, section 5(b), foreign financial institutions are liable to have sanctions imposed on them by the US President (unless he determines that it is not in the national interest of the United States to do so) if they knowingly facilitate significant financial transactions with a person that is blocked by the applicable sanctions targeting LIL's owner. Those sanctions include a prohibition on the opening of, and strict conditions on the maintaining of, a correspondent bank account in the US. The consequences of being sanctioned for breach of secondary sanctions are therefore disastrous for a non-US financial institution, since it would be excluded from access to transactions in US dollars.

The facility agreement contained a proviso in the enforcement clause (9.1) which stated that as regards non-payment "[CBL] shall not be in default if during the fourteen days after [LIL's] notice it satisfies [LIL] that such sums were not paid in order to comply with the mandatory provisions of law, regulation or order of any court of competent jurisdiction". In reliance on this wording, CBL declined to make payments to LIL, which applied to the court for a determination that CBL continued to be obliged to pay.

THE FIRST INSTANCE DECISION

The judge considered the effect of foreign law generally, noting that it did not excuse contractual performance unless it was the law of the contract or the law of the place of performance[3]. The issue thus turned on what the facility agreement said and how it was to be interpreted. The judge went on to summarise the law on the principles of contractual interpretation[4]. These were not in dispute and were not directly relevant to the case on appeal.

The judge found in favour of CBL, with the main points being: CBL was mindful of the secondary sanctions risk when it entered into the facility agreement; and it was not necessary for there to be an express prohibition on payment in order to enable CBL to rely on the word 'mandatory' in the proviso to clause 9.1 of the facility agreement.

THE DECISION IN THE COURT OF APPEAL

The Court of Appeal dismissed CBL's appeal but applied reasoning which differs from that of the judge at first instance. There, the context and nature of the facility agreement had not been highlighted but in the Court of Appeal it was held significant that it was an agreement to provide Tier 2 capital to CBL for capital adequacy purposes, including CRD IV. It was written in a way which was different from other types of loan agreements but was found to be on broadly standard terms for an agreement funding Tier 2 capital. In giving the leading judgment, the Chancellor (Sir Geoffrey Vos) said that in such a case, when applying the "unitary" approach to contractual interpretation the words used had greater significance than the factual background or matrix. He observed that the first instance judge had focussed on what the parties might or might not have intended and also thought that he had focussed more on the commercial interests of LIL rather than, as he should, focussing on the commercial interests of each party in a balanced way. That requirement for a balanced approach sat alongside the principle that clear words would be needed to abrogate a payment obligation in a loan agreement.

Having set the background, the Chancellor then analysed the case, the main points being the following:

- a loan to fund Tier 2 capital had specific provisions as to payment. The loan was subordinated and only repayable in a winding-up, with the repayment events being controlled;
- Clause 9 was drafted to have wider application than just to US sanctions;
- Significantly, Clause 9 did not operate in such a way as to abrogate a payment obligation as such but, rather, it abrogated a default and delayed the payment obligation, albeit for a potentially long period;
- The language of Clause 9 was ambiguous, so it was relevant to consider the context and apply commercial common sense; and
- There were three relevant aspects of context:

"The requirement for a balanced approach sat alongside the principle that clear words would be needed to abrogate a payment obligation in a loan agreement."

(i) the terms of the EU Blocking Regulation[5], which operated on similarly worded U.S. sanctions and would have been known to the parties.

(ii) Clause 9.1 was a standard clause (in the relevant context).

(iii) The effect of US secondary sanctions would have been known to EU parties involved in Tier 2 capital transactions.

- Although it was not certain that CBL would in practice suffer from sanctions that did not matter because the imposition of sanctions is essentially mandatory, with limited circumstances in which they were not required to be imposed by the President. "What matters here is [CBL's] *reason* for the non-payment, not whether [CBL] is certain or only likely to be sanctioned if it makes the payment[6]"; and
- The balance between the interests of the parties to this type of facility agreement in respect of Tier 2 capital facility favoured the application of the proviso to Clause 9.1 (regarding non-default) to the standard form of US secondary sanctions legislation.

"Bespoke language will address sanctions generally but will also need to be written with US sanctions especially in mind because of their extent and complexity – and because of the known effect of US secondary sanctions on financial institutions."

THE WIDER IMPLICATIONS OF THE COURT OF APPEAL DECISION

The case is significant for the way in which it applies the rules of contractual interpretation to a document which is found to be a standard form. The facility agreement was held to be a standard form in the context of a specialised sector of the lending market[7]. Hence, greater weight was given to the textual analysis than the background or context. Much more common are facility agreements based on one of the LMA forms. The LMA does provide template sanctions definitions in its form of Developing Markets Facility but specific provisions directly addressed at sanctions has developed outside the LMA forms themselves (and the LMA itself acknowledges in the relevant User's Guide that sanctions provisions need to be bespoke). Such bespoke language varies not only from market to market but also from transaction to transaction. In that context, the significance attached in the case to the facility agreement being in a standard form might be less of a factor when applying principles of contractual interpretation to sanctions issues arising in other circumstances.

The relatively unusual facts of the case are also significant when considering its potential application in a wider context. First, it was the lender, not the borrower which was subject to US secondary sanctions. In most commercial loan transactions, the lender is concerned with the possibility of the borrower becoming subject to sanctions or engaging in sanctionable activity, rather than vice versa. Secondly, nothing similar to the wording of the form of Tier 2 capital facility agreement as regards repayment and enforcement is generally found in other contexts. On the contrary, there will most likely be bespoke language (see above) for the benefit of the lender and which attempts specifically to address the risks to the lender of the borrower being sanctioned or breaching sanctions in the conduct of its business. That language will address sanctions generally but will also need to be written with US sanctions especially in mind because of their extent and complexity – and because of the known effect of US secondary sanctions on financial institutions.

It is perhaps ironic that in *Lamesa v Cynergy* a general illegality provision, albeit one which was bespoke to a particular lending market, was upheld to protect the (bank) borrower from the effect of US secondary sanctions. When sanctions started to become of more concern in lending transactions well over a decade ago, initially driven by the US Iranian sanctions, the general illegality clause, which has long been a feature of loan agreements in an international context, was thought to be inadequate to protect lenders, leading to the development of extensive sanctions language. This was especially true of ship finance loan agreements because of the perceived likelihood of shipping companies falling foul of sanctions and also because of the way in which many US sanctions specifically target the shipping industry.

Taking these factors into account, the case might be thought to have little direct relevance to a case where a borrower is subject to sanctions. Most loan agreements in a commercial context (i.e. as distinct from the Tier 2 capital context of the loan in *Lamesa v Cynergy*) deal expressly and extensively with sanctions compliance by the borrower as regards its operations and the possibility of the borrower being or becoming a sanctioned entity. The consequences are cancellation of the commitment to lend and either an event of default (directly or by reason of breach of representation and warranty or undertaking) or a mandatory prepayment event.

> "Where close textual analysis is the main factor, a case can turn on the meaning of a single phrase or even word."

Despite the best efforts of the draftsman, it is always possible that the particular sanctions concerned, or their effect, might not clearly fall within the scope of this wording. The issue will then be resolved by application of principles of contractual interpretation, as set out in *Lamesa v Cynergy* and many other previous cases – but not including the nuances arising in the case from the specialist context and wording of that particular loan. Rather than the court construing a general, albeit market specific, illegality provision it will more likely be construing provisions specifically addressed at sanctions. If there is any ambiguity or uncertainty in the application of the words to a particular set of circumstances *Lamesa v Cynergy* confirms at least that the court will be mindful of the importance to financial institutions of not exposing themselves to the risk of US secondary sanctions. The courts will follow the "unitary" approach to contractual construction, involving the different factors of textual analysis, contextual analysis and business common sense, giving weight to each according to the circumstances. Where sophisticated parties are involved who have the benefit of legal advice, it seems that more weight will be given to a textual approach than to either a contextual approach or the requirements of business common sense. See, for example, *National Bank of Kazakhstan v Bank of New York Mellon SA*[8]*.* Where close textual analysis is the main factor, a case can turn on the meaning of a single phrase or even word: "*mandatory*" in *Lamesa v Cynergy*; "*any*" in *National Bank of Kazakhstan v Bank of New York Mellon SA*.

Although the generic drafting of a specialised standard form worked for CBL in the context of the case, parties will be best protected in relation to sanctions by considering the specific risks likely to arise and addressing them by bespoke language. It would be interesting to see the relative weight which the court would give to textual analysis and contextual background, respectively, in a case relating to sanctions language which did not involve standard form language and where the parties had the benefit of legal advice.

Finally, the EU Blocking Regulation was referred to in *Lamesa v Cynergy* as a relevant contextual factor because it operated on US sanctions provisions which were worded in a similar way to the US secondary sanctions provisions in *Lamesa v Cynergy*. This was helpful to Cynergy in this particular case but, in circumstances where the EU Blocking Regulation is engaged, it reinforces the dilemma created for parties which find themselves caught between a wish to comply with US secondary sanctions and a prohibition on doing so because of the EU Blocking Regulation. This case indicates that in such circumstances the EU Blocking Regulation would take precedence.

[1] [2020] EWCA Civ 82.

[2] [2019] EWHC 1877 (Comm).

[3] The main cases are *Ralli Brothers v Compania Naviera Sota Y Aznar* [1920] 2 KB 287 and *Libyan Arab Foreign Bank v Bankers Trust Co* [1989] 1 QB 728*.* There was no reference to the separate principle in *Regazzoni v KC Sethia (1944) Ltd* [1958] AC 301.

[4] The main cases are three Supreme Court decisions: *Arnold v Britton* [2015] UKSC 36*, Rainy Sky SA v Kookmin Bank* [2011] UKSC 50 and *Wood v Capital Insurance Services Limited* [2017] UKSC 24*.*

[5] Council Regulation (EC) No. 2271/96 of 22 November 1996.

[6] This aspect of the Chancellor's judgment was questioned by Arnold LJ, although he did not dissent.

[7] Reference was made in the case to cases involving the Credit Support Annex to the ISDA Master Agreement: *State of Netherlands v Deutsche Bank AG* [2019] EWCA Civ 771 which referred in turn to the *Lehman Brothers (No.8)* [2016] EWHC 2417 (Ch).

[8] [2018] EWCA Civ 1390, which was briefly referred to in *Lamesca v Cynergy* at first instance.

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