SANCTIONS AGAIN – AND ALSO PENALTIES

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***Banco San Juan Internacional, Inc. v Petroleos De Venezuela SA* (PDVSA)[1] is another case in which the effect of US sanctions has come before the English courts. In this instance, unsurprisingly, the court did not agree with PDVSA that it could rely on sanctions provisions in finance documents to escape its obligations as borrower on the basis of sanctions aimed, in part, at PDVSA.**

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Shipping and ship finance have always been in the front line in relation to sanctions, as some of the other cases referred to below demonstrate. This inevitably continues to be the position, as has been shown by a number of Greek tanker companies being hit, albeit temporarily, by US secondary sanctions earlier this year for trading with Venezuela. In 2019, shock waves were sent through the industry by Cosco Dalian, also temporarily, being made subject to US secondary sanctions for trading to Iran. See our earlier article on sanctions and shipping here.

The PDVSA case is the latest manifestation of the lack of sympathy, evident from a number of earlier cases, with which the English courts treat parties who attempt, without good grounds or contrary to the risk allocation of the contract, to invoke sanctions or sanctions-related contractual provisions to escape liability. The judgment also addressed issues relating to the doctrine of penalties in a way which is of interest and potentially helpful in the context of finance and commercial documents following the re-casting of the law by the decision of the Supreme Court in *Cavendish Square*[2].

THE PDVSA CASE: FACTS AND BACKGROUND

The case arose from the well-known US sanctions targeted at the Maduro regime in Venezuela. The defendant, PDVSA, is the Venezuelan state-owned oil and gas company, which was both indirectly and specifically targeted in a series of sanctions made by Executive (Presidential) Order. The effect of these was, among other things, to freeze and block all property of PDVSA in the United States or in the possession or control of a US person. The relevant Executive Orders have, as usual, a carve-out for permitted or licensed transactions.

The plaintiff, Banco San Juan Internacional Inc (BSJI), a bank incorporated in Puerto Rico, sought summary judgement against PDVSA under two US dollar credit agreements governed by English law. PDVSA argued that it had a real prospect of defending the claims, based on the US sanctions and the relevant provisions of the credit agreements; a separate argument based on the doctrine of penalty is addressed further below. PDVSA argued that, by reason of the effect of foreign (US) law illegality BSJI was prohibited from receiving funds from PDVSA and that any US correspondent bank was prohibited from receiving funds and processing payments to BSJI. PDVSA placed some reliance on a recent decision of the US District Court for the Southern District of New York[3]. In that case, PDVSA had successfully resisted a claim for summary judgement based on illegality under <u>domestic</u> (i.e. US) law. The judge in Dresser-Rand held that there were genuine issues of material fact related to the illegality defence, so summary judgment was inappropriate. The judge claimed at one point: "As a matter of law these sanctions make it legally impossible here for PDVSA to pay Dresser-Rand"[4]. It is not at all clear whether this statement is correct, as PDVSA could have applied for a licence to make payment, or made payment into a blocked account, with respect to which Dresser-Rand could have applied for a licence to have the funds released. In any event, given that the claim for summary judgment was brought by Dresser-Rand rather than PDVSA, the judge's statement must be treated as non-binding dicta. In contrast to *Dresser-Rand*, the case before the English courts turned partly on illegality under <u>foreign</u> law, which was a very different matter – as the judge was quick to point out.

> **"The judge noted that, in general, illegality under foreign law does not frustrate or otherwise relieve a party from performance of an English law contract."**

THE RESULT OF THE CASE ON THE SANCTIONS ISSUE

PDVSA's case turned in the first instance on the wording in each of the credit agreements (section 7.03) which stated that PDVSA would not repay the loans with the proceeds of business activities which were the subject of US sanctions. Among the arguments deployed by PDVSA, it cited *Mamancochet Mining Limited v Aegis Managing Agency Ltd*[5] and *Lamesa Investments Limited v Cynergy Bank Ltd*[6] as authority for the proposition that "*It is perfectly normal and sensible in commercial agreements to suspend payment obligations where payment would otherwise be in breach of unilateral US sanctions*". The judge's main findings as regards that can be summarised as follows:

- Those two cases cited by PDVSA, *Mamancochet* and *Lamesa,* did not support any such proposition. Those decisions turned on their very different facts and quite different contractual wording, in one case making the non-liability to pay and in the other making non-payment, where relating to sanctions, an express carve-out to the default position;
- Section 7.03 was a negative covenant, separate from the obligation to pay and which did not suspend PDVSA's payment obligation, nor did it create a condition precedent to payment. It was for the benefit of BSJI, giving BSJI a right to refuse receipt and a right of recourse against PDVSA if it were breached; and
- The factual matrix and contractual framework also argued against section 7.03 being intended to have a suspensory effect and an intention by the parties to deal with impending US sanctions by a suspension mechanism. PDVSA was obliged by another term of the credit agreements to obtain all licences and consents to enable it to perform and this obligation would encompass any licences needed under the relevant sanctions regime to permit payments.

PDVSA also sought to rely on the rule in *Ralli Bros v Compania Naviera Sota y Aznar*[7] that an English law contract is not enforceable if performance is required in a friendly foreign state which would be unlawful by the laws of that state. PDVSA's argument was that payment to BSJI in US dollars could not be achieved without actions in the US which would be unlawful under US law. The judge did not agree and noted that the rule in *Ralli Bros* is of narrow application. The judge noted that, in general, illegality under foreign law does not frustrate or otherwise relieve a party from performance of an English law contract; the rule in *Ralli Bros* operates as a limited exception and provides that an obligation under an English law contract is invalid and unenforceable, or suspended in the case of a payment obligation, insofar as the contract requires performance in a place where it is unlawful under the law of the required place of performance. It does not apply if the contract can be performed in some other way which is legal or if the illegal act has to be performed somewhere else. PDVSA could have made payment to a blocked US dollar account. Or – with a waiver from BSJI which it was apparently agreeable to – payment could instead have been made in euros. Above all, a party relying on the doctrine will not be excused if he could have done something to bring about valid performance (such as apply for a licence) and has failed to do so.

THE COURT HAD LITTLE TIME FOR A DEFENDANT SEEKING TO TURN SUCH A CLAUSE AROUND AND RAISE IT AS A DEFENCE TO ITS PAYMENT OBLIGATIONS.

PDVSA also raised an argument based on implied contractual terms, which does not appear to have been pursued vigorously and was quickly dismissed. Finally, PDVSA raised an argument based on Article 9(3) of the Rome I Regulation which gives the Court a discretion to give effect to *'overriding mandatory provisions of the law of the country where the obligations arising out of the contract have to be or have been performed, in so far as those overriding mandatory provisions render the performance of the contract unlawful'*. This argument was also unsuccessful, partly on the same basis that the *Ralli Bros* principle did not apply – PDVSA could have applied for a licence to make payment – and the judge held it would not be appropriate to exercise the discretion afforded by Article 9(3).

THE DECISION IN CONTEXT AS REGARDS SANCTIONS

This case should be seen in the wider context of the way English commercial court judges approach cases involving sanctions issues, whether applying the common law, applicable statute or where – as in the PDVSA case – express contractual provisions are invoked. From some earlier cases it can be discerned that the courts are not sympathetic to defences based on sanctions on, at best, specious grounds. These cases did not involve contracts containing specific sanctions provisions. Nonetheless, the PDVSA case has echoes of *DVB Bank SE v Shere Shipping Co. Ltd*[8], where an obligation to repay a loan was held not to be suspended by the effect of sanctions affecting the borrower and where, significantly, there was an obligation on the borrower to obtain a licence. Similarly, in *Melli Bank v Holbud*[9], where it was the bank creditor which was the subject of sanctions. In *Islamic Republic of Iran Shipping Lines v Steamship Mutual Underwriting Association (Bermuda) Ltd*[10] the court had to determine whether a marine insurance policy was frustrated by supervening illegality due to sanctions. It held that it was not. In *The Nancy*[11] the issue was whether a breach of US sanctions impacted the 'maritime adventure' for the purposes of the Marine Insurance Act 1906, section 41. It was held that it did not. These cases – and it is noteworthy that three out of four are shipping cases – indicate a generally careful but pragmatic approach by the courts to sanctions issues in circumstances where no sanctions-specific provisions are included in the relevant contract.

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Returning to the PDVSA case, it is perhaps no surprise that the court was unsympathetic to PDVSA's defence. Section 7.03 of the credit agreement was not untypical of provisions now included in finance documents, for the benefit of the lender/creditor, to try to avoid, among other things, the risk of it breaching or being subjected to US sanctions. Lenders who include sanctions clauses in loan agreements – no less than insurers and charterers who include similar or equivalent clauses in their contracts – may take comfort from the result of the PDVSA case. The court had little time for a defendant seeking to turn such a clause around and raise it as a defence to its payment obligations. Although neither case was referred to in the PDVSA case, because the issues were different, it nevertheless has parallels with the approach seen in *DVB v Shere Shipping* and in *Melli Bank v Holbud* in particular, as noted above.

> "The judge noted the contextual point that the decision in Makdessi expressly respects the legitimate commercial interests of the parties and held that it was significant that the payment obligation contained a discounting to net present value."

This approach is further shown by the judge's reaction to PDVSA seeking to invoke both *Mamancochet* and *Lamesa* (see above). In *Mamancochet*, the court had to consider whether an insurer was relieved by a sanctions clause from its obligation to pay. The insurer was unsuccessful, but the court considered the question of whether the sanctions clause, if triggered, would extinguish the obligation to pay and concluded that the clause would only suspend payment obligations (in an earlier case, *Arash Shipping Enterprises Co. Ltd v Groupama Transport*[12], an insurer's reliance on a sanctions cancellation clause was upheld, on different facts and in different circumstances). In *Lamesa*, a borrower successfully argued that a sanctions clause in a loan agreement had the effect of suspending its obligation to repay. The judge in the PDVSA case said each of *Mamancochet* and *Lamesa* were based on very different facts. Hence, they had no bearing. *Lamesa* in particular was unusual because the borrower was a bank which was concerned about the risk of being made subject to US secondary sanctions and negotiated wording in the loan agreement accordingly. See our earlier article on *Lamesa* here.

When sanctions clauses come before the courts it is possible to detect and list the following issues which inform the approach of judges:

- A careful analysis of the language will be made to determine its true contractual effect;
- An analysis of whether the provisions have been included for the benefit of one party or the other and the purposes for which they have been included;
- An analysis of whether the relevant provisions expressly relate to, and qualify, an obligation to pay or perform;
- The difference between a covenant or undertaking and a condition precedent;
- The overriding importance of an undertaking by one party to obtain any necessary approvals and consents (which will include licenses if the applicable sanctions contemplate licenses) where that party is seeking to invoke sanctions or a sanctions clause as a defence;
- The narrowness of the rule in *Ralli Bros* as regards foreign illegality in the place of performance and the obligation of the borrower to equip itself to perform (distinct from performance itself), irrespective of whether there is a specific contractual undertaking requiring it to so equip itself; and
- Some reluctance to find that an obligation is suspended and an even greater reluctance to find that it is discharged or released.

In relation to the last point above, the narrowness of the English law doctrine of frustration should also be noted. PDVSA did not claim that the credit agreements were frustrated, no doubt because had it done so and that claim had been upheld, the effect would have been that the loans would have been repayable by virtue of the effect of the Law Reform (Frustrated Contracts) Act 1943; see *DVB v Shere Shipping* on this point.

THE PENALTY ISSUE

Part of BSJI's claim under one of the credit agreements related to a payment in the nature of a 'make-whole' obligation where upon any acceleration or prepayment of the loan PDVSA was obliged to pay an amount equal to the discounted present value of all fees and interest which would have been payable had the loan continued to maturity. PDVSA claimed that this was an unenforceable penalty. This argument did not succeed and was dealt with more briefly than the sanctions issue. In dismissing it the judge made some interesting observations on the law of penalty as it has been re-cast by the decision of the Supreme Court in *Makdessi* (see above). The test for whether an obligation is a penalty following *Makdessi* can be stated as follows:

"The judge thought that the mixture of different circumstances in which the payment became due meant that it could not be a penalty even when triggered by breach of contract."

"a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation."

The judge noted the contextual point that the decision in *Makdessi* expressly respects the legitimate commercial interests of the parties – especially in a negotiated and lawyered contract between parties of equal bargaining power – and held that it was significant that the payment obligation contained a discounting to net present value. This is of comfort not only to lenders but also to lessors in the content of the calculation of liquidated termination sums in leases, hire purchase agreements and conditional sale agreements. It appears from the judgment, although it is not entirely clear, that all future interest was included, not just the lender's profit or margin. It can be argued that only that element of interest equal to a lender's (or lessor's) profit or margin should be taken into account – not the gross amount, including funding costs. Those will cease to be borne by the lender or lessor and, provided the lender is separately compensated for break-funding or redeployment exposure, the simple inclusion of the gross amount of interest in any liquidated damages or make-whole payment is open to question. But if indeed the gross amount of interest was taken into account in the PDVSA case, one can only assume that the legitimate commercial interest argument (see above) nevertheless prevailed. The next point meant that, irrespective of amount, the payment was held not to be a penalty in any event.

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In dismissing PDVSA's defence based on penalty, the judge regarded it as significant that the relevant payment also became due in circumstances where there was no default (i.e. voluntary prepayment) and in circumstances where default did not involve a breach of contract by the borrower (such as insolvency or change of control). The judge thought that this made it questionable whether the obligation was a 'secondary' obligation, as is required by *Makdessi* for an obligation to be a penalty. Even if this was not the case, the judge thought that the mixture of different circumstances in which the payment became due meant that it could not be a penalty even when triggered by breach of contract.

This last point is of great comfort to lenders – and more especially lessors. It would mean that a liquidated termination sum in a lease, hire purchase agreement or conditional sale agreement should not be a penalty if it is payable not only in circumstances which follow a breach of contract but also in other circumstances. This approach would almost certainly not have saved an obligation from being a penalty where a breach of contract was involved under the pre-*Makdessi* test, which was whether the payment was or was not a genuine pre-estimate of the recipient's loss. However, following BSJI's success, it seems that the risk of the doctrine of penalty being applied has been substantially reduced in many types of contract.

[1] [2020] EWHC 2937 (Comm)

[2] *Holding BV v Talal Makdessi, ParkingEye Ltd v Beavis* [2015] UKSC 67

[3] *Dresser-Rand Co v Petroleos De Venezuela, SA and PDVSA Petroleo S.A.,* 439 F.Supp. 3d 270 (S.D.N.Y. 2020)

[4] *Dresser-Rand*, 439 F.Supp. 3d at 274

[5] [2018] EWHC 2643

[6] [2020] EWCA Civ 8212

[7] [1920] 2 KB 287

[8] [2013] EWHC 2321 (Ch)

[9] [2013] EWHC 1506 (Com Ct)

[10] [2010]) EWHC 2661 (Comm)

[11] [2013] EWHC 2116 (Com Ct)

[12] [2011] EWCA Civ 620

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