

The impact of recent Russian sanctions on European lenders and English law governed financings

March 22, 2022 Jennifer Passagne

PRACTICES Finance

Economic sanctions

The sanctions imposed by the UK, European Union and US following the recent invasion of Ukraine by Russia target the Russian economy. Whilst Russia is the largest country in the world, in terms of the global economy it only made up 3.11% of Global GDP in 2020. The sanctions imposed however will still have wide ranging impacts on all areas of the global market, and can already be seen in dramatically rising energy prices. Although the full extent of sanctions imposed on Russia (and the retaliatory sanctions that Russia has threatened on the West) are yet to be seen, there are some immediate considerations for lenders and businesses when reviewing existing deals, and entering into new transactions in order to ensure compliance with new sanctions rules.

In this note we look at the impact on European lenders and documentary and contractual issues for existing and new style financings.

What are the sanctions that could impact lenders and financings?

- Territorial sanctions: sanctions against trading with Crimea have been extended to include the Donetsk and Luhansk Peoples Republics;
- Blocking sanctions: these are levelled against a number of named entities and individuals and will prevent lenders from advancing credit to them. Generally these sanctions will also bite on any entity that is 50% or more owned by such a sanctioned entity, whether or not they are named on The Office of Foreign Assets Control of the United States Department of Treasury's ("OFAC") list of 'specially designated nationals';
- Financial services sanctions: Financial institutions are prohibited from extending loans or credit to sanctioned entities, individuals or legal persons who are connected to Russia;
- Asset sanctions: Certain asset classes will be particularly affected, for example:
 - embargoes on arms dealings with Russia;
 - restrictions on Russian financial institutions from issuing transferable securities and money-market instruments in the UK market;
 - US sanctions also prohibit new transactions involved in the importation of oil and gas. This would extend to the financing of such transactions; and
 - the European Commission has made clear that the EU sanctions also cover crypto-currencies.

What is the impact on European banks?

Sanctions prohibiting financial institutions from extending credit to those connected with Russia have seen European banks taking steps to close their subsidiary branches in Russia. Banks with direct exposure to Russian clients are seeing their share prices fall due to investor concerns around sanctions.

In turn, subsidiaries of Russian banks based in Europe have already started to fail as news comes that Sberbank Europe AG (owned by Public Joint Stock Company Sberbank of Russia, Russia's largest bank) in Austria and its subsidiaries in Croatia and Slovenia have been sold after being put in moratorium due to concerns over liquidity. The concern with failing subsidiaries of Russian banks based in Europe is that such failings could trigger deposit guarantee payouts in the country where such subsidiary is based, meaning that local banks in that country who also pay into that deposit guarantee scheme will be on the hook for their losses.

As the Great Financial Crisis taught us, banks do not act in isolation and lenders will not only be monitoring their direct exposure to Russian banks and borrowers, but also their indirect exposure due to their relationships with banks that do have a direct exposure. The Italian and French markets are particularly exposed to the Russian market, followed by the Austrian and German markets, with foreign banks (mainly in Europe) having an estimated \$121bn of exposure to the Russian market (according to the Bank of International Settlements). Although the UK has limited exposure to Russia directly, it's worth remembering that it does have a fairly substantial exposure to those markets which will be directly impacted by embargoes on trading with Russia.

Lenders who have a large exposure to the Russian market risk a downgrading in any credit rating they hold.

Documentary considerations for facility agreements

Most banks will have their own policy wording in relation to sanctions, which will be included in existing deals. Whilst the Loan Market Association ("**LMA**") doesn't provide proposed sanctions wording in its standard form documents, the LMA's 'Guidance Note: United States and European Union Sanctions' does provide helpful direction on this area. Key provisions to think about in the light of sanctions are:

- **Purpose:** The purpose clause of a facility agreement will set out what the proceeds of the facility can be used for, and in fund financing deals will often include a general statement that such purposes cannot be prohibited under the borrower's constitutional documents. Depending on the type of borrower, its constitutional documents may set out certain investment restrictions and due to investor pressure it would not be uncommon for such investment restrictions to state that the borrower cannot invest in certain geographical locations (e.g. those subject to sanctions) or certain sectors (e.g. arms and weaponry). It's important to consider what the facility will be used for at the outset of a deal in light of sanctions.
- **Know Your Customer ("**KYC**"):** It's standard for facility agreements to include an information undertaking regarding KYC checks. This undertaking allows the lenders to request updated KYC documentation from the obligors following, *inter alia*, the introduction of any change of law or regulation in order for the lenders to satisfy their KYC obligations.
- **Ratings:** As noted above, losses due to exposure to the Russian market could cause a bank to have its credit rating downgraded. Market standard syndicated documentation includes the concept of an "Acceptable Bank". To qualify as an Acceptable Bank, a financial institution will have to maintain a minimum credit rating (usually BBB+/Baa1). In a secured transaction it's market standard to require any secured accounts be held with an Acceptable Bank. If an account bank ceases to be an Acceptable Bank, the lenders can require that a new account be opened with an Acceptable Bank and such account be secured. Where a facility also includes a letter of credit option, a lender will have to be an Acceptable Bank in order to not

be qualified as a 'Non-Acceptable L/C Lender'. If a lender is a Non-Acceptable L/C Lender, then it can be required to post cash collateral in relation to a letter of credit.

- **Mandatory Prepayment**: Nearly all facility agreements will include an 'illegality' prepayment trigger, which allows the lenders to cancel any available commitments and demand repayment of any outstanding loans if it becomes unlawful for any lender to perform its obligations under the facility agreement or fund any of its participations. Before specific sanctions representations and undertakings became common in loan documentation, it was argued that lenders could rely on this mandatory prepayment trigger to exit for breaches of sanctions.
- **Representations**: It is market standard for a day 1 representation to be given stating that no obligor is named on a sanctions list (or controlled by a person who is), incorporated under the laws of a country that is the target of territory-wide sanctions (or is controlled by a person who is) or has received notice of any action, proceedings or investigation against it in regards to sanctions. Depending on whether there is an equivalent undertaking (see below) it wouldn't be uncommon for this sanctions representation to repeat and be deemed given each time a utilisation, increase or extension is requested. In addition, there is a general representation about 'no breach of laws', which is subject to material adverse effect and this is often a repeating representation. If a representation proves to be incorrect or misleading then an event of default by way of misrepresentation will occur and it can also act as a drawstop for further advances.
- **Information and General Undertakings**: It's common for an information undertaking to be included in facility agreements requiring obligors to notify lenders of details of any sanctions made against them or their assets. In addition, lenders usually have an information right to request information about the assets and operations of the borrowing group as they may reasonably request. Lenders will also often require that a general sanctions undertaking be included, which states that the obligors shall not directly or indirectly use the proceeds of the facility to fund any business activities or transactions with any person named on a sanctions list (or controlled by a person who is), incorporated under the laws of a country that is the target of territory-wide sanctions (or is controlled by a person who is) or that is otherwise prohibited by sanctions or engage in transactions that would violate sanctions or cause any group member to be designated as a sanctioned party. In lieu of a specific sanctions undertaking, the market standard 'compliance with laws' undertaking, subject to a material adverse effect qualifier, may capture sanctions. Breach of any undertakings will be an event of default under the standard 'Other obligations' event of default.
- **Events of Default**: It is also not uncommon for a specific sanctions event of default to be included in a facility agreement, which would mean that if the obligors or their assets become subject to sanctions then the lenders can call for an immediate event of default and accelerate the facility without any cure period applying. In addition, in some more extreme circumstances, lenders may consider relying on the 'Material Adverse Change' event of default.
- **Enforcement of security over frozen assets**: The case of *Taylor v Van Dutch Marine Holding Ltd* implies that pre-existing security granted over frozen assets will be honoured without the need to vary the freezing injunction as a freezing injunction does not operate as security itself. The purpose of a freezing injunction is to prevent the holder of the asset from

disposing of it, and the enforcement of security is not viewed as a disposition by the asset holder.

We are aware that many borrowers are currently undertaking reviews of their portfolios to ensure that they are not in breach of sanctions.

Subscription line facilities

As market leaders in the fund finance space, we have received queries from clients questioning what would happen if an investor becomes subject to sanctions.

In terms of new deals, we at Haynes Boone always search investor names (whether they are to be included in the borrowing base or not) against OFAC's list of 'specially designated nationals' using the search function on their website. Under US sanctions, these specially designated nationals have their assets blocked and US persons are generally prohibited from dealing with them.

In terms of existing deals, if an investor becomes subject to sanctions after being included in the borrowing base, it's market standard for an exclusion event to be included whereby it would drop out of the borrowing base. For institutional investors, it's worth noting that their credit rating could also potentially be downgraded if they have high exposure to the Russian market. If such an investor was included in the borrowing base in the first instance based on its credit rating, such a downgrade could mean that it's excluded from the borrowing base.