TRADE FINANCE

Trade finance under fire? Exploring the impact of sanctions

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For those in the trade finance business, navigating the matrix of domestic and international sanctions legislation, rules and guidance is a daily necessity. However, the breadth of the sanctions implemented, and continuing to be implemented, by sanctions authorities across the globe in light of the Russian invasion of Ukraine, and the speed of such implementation, has posed a challenge for even the most seasoned members of the industry.

The direct and indirect impact of sanctions

One of the key challenges in assessing the impact of sanctions is the varied ways in which they can affect a supply chain. While it is often easier to identify the direct application of sanctions on a particular transaction, the consequence of that application, for that transaction and any connected transactions, is far more difficult to assess. For example, if an entity is listed on a sanctions list, then a trader or lender that is required to comply with the relevant sanctions will know that this will have an impact on its contractual relationship with that sanctioned entity. However, determining what that impact will be will depend on the terms of the relevant sanctions, any applicable law and the terms of the relevant contract with that sanctioned entity.

If, for example, sanctions prevent the provision of financial assistance to the sanctioned entity, does that only prevent new lending by the lender or does it require that the lender calls in any outstanding loans? Sanctions may not be explicit in what is or is not permitted in any given scenario and careful consideration must be given to the application of sanctions to a particular set of circumstances. Furthermore, while English law provides that a party cannot be obliged to perform under an agreement where that performance would be illegal under English law, this may not protect a non-performing party if, for instance, there is a licensing regime under the relevant sanctions which would, if the licence is obtained, permit performance.

The indirect impact of sanctions can take many guises. For example, if a trader is prevented from buying goods from its seller due to it being sanctioned, that trader may not be able to perform under the sale contract it has entered into to on-sell the goods or it may be much more expensive for the trader to source other goods in order to be able to perform. In such a case the trader may be exposed to either breaching its contract or performing on terms that are no longer profitable. The doctrines of *force majeure* and frustration may potentially offer some protection for the trader (each having experienced something of a renaissance during the pandemic). However, *force majeure* is not a recognised English law concept and instead relies on there being a contractual *force majeure* clause and, in respect of both doctrines, the English courts have not been quick to find that a party has satisfied the high threshold needed to rely on either of these concepts as a defence.

SANCTIONS MAY NOT BE EXPLICIT IN WHAT IS OR IS NOT PERMITTED IN ANY GIVEN SCENARIO.

We are also seeing wider, non-legal implications of the current sanctions against Russia. Many financiers and traders are taking steps to distance themselves from connections with Russia, whether that be through avoiding the use of Russian-owned vessels or the winding down of relationships with Russian counterparties. These in turn are placing pressures on the supply chain as alternative arrangements without a Russian connection are sought to perform existing transactions.

What to do?

Parties may be able to protect themselves with the terms of their contracts (for example, most sophisticated finance documents will expressly deal with the rights of a lender if the borrower becomes a sanctioned entity) but it is not possible to provide contractual protection for every scenario, or at least not in a manner that most contractual counterparties would be willing to agree to. There will be many contractual counterparties now trying to ascertain what the scope of the sanctions provisions that they contractually agreed to actually mean. For example, how far up the supply chain should a party look in order to comply with its obligation not to 'indirectly' allow the use of funds for a purpose which might involve a sanctioned entity or goods?

There is also the risk of a knee-jerk reaction to the events we are seeing now. This is particularly the case in the context of trade finance instruments (such as letters of credit) where there has long been a tension between the independence and certainty such instruments are intended to offer and the desire of the issuer to limit its obligations where payment may be in breach not only of sanctions but the issuer's internal sanctions policies.

Pragmatic solutions may be needed to deal with the current challenges being faced by the industry. However, the current circumstances serve as a reminder, if one was needed, of the importance of careful consideration of contractual terms at the outset, rather than at the time a problem arises. Now may be just the time to do this.

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