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The International Comparative Legal Guide to: **Lending & Secured Finance 2019**

7th Edition

A practical cross-border insight into lending and secured finance

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EDITORIAL

Welcome to the seventh edition of *The International Comparative Legal Guide to: Lending & Secured Finance*.

This guide provides corporate counsel and international practitioners with a comprehensive worldwide legal analysis of the laws and regulations of lending and secured finance.

It is divided into three main sections:

Three editorial chapters. These are overview chapters and have been contributed by the LSTA, the LMA and the APLMA.

Twenty-five general chapters. These chapters are designed to provide readers with an overview of key issues affecting lending and secured finance, particularly from the perspective of a multi-jurisdictional transaction.

Country question and answer chapters. These provide a broad overview of common issues in lending and secured finance laws and regulations in 51 jurisdictions.

All chapters are written by leading lending and secured finance lawyers and industry specialists and we are extremely grateful for their excellent contributions.

Special thanks are reserved for the contributing editor Thomas Mellor of Morgan, Lewis & Bockius LLP for his invaluable assistance.

Global Legal Group hopes that you find this guide practical and interesting.

The *International Comparative Legal Guide* series is also available online at www.iclg.com.

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Credit Agreement Provisions and Conflicts Between US Sanctions and Blocking Statutes

Roshelle A. Nagar



Ted Posner



Weil, Gotshal & Manges LLP

Introduction

Most credit agreements contain representations and covenants affirming, requiring or prohibiting actions by the credit group, including general provisions regarding compliance with applicable laws. Under current market standards for US law-governed credit agreements, most lenders also expect to receive specific representations and covenants from the credit group with respect to compliance with sanctions laws and regulations promulgated by sanctions authorities in the US, EU, the United Nations Security Council and the UK. While US entities should be familiar with US sanctions restrictions and would generally have policies and procedures in place to ensure compliance, the same credit agreement provisions often apply to non-US subsidiaries and sometimes to their affiliates. For a multinational entity, this expanded group could include far-flung foreign subsidiaries as well as their officers, directors and employees, thereby creating potential monitoring issues for entities and individuals that would not necessarily expect to be restricted from doing business with persons sanctioned under US law. As a result, not only might a non-US entity inadvertently fail to comply with credit agreement sanctions provisions, but in some cases it may also be bound by foreign laws that are inconsistent with, or in some cases contravene, certain US sanctions, thereby leading to potential conflicts with US law.

A. US Sanctions Regime

Economic and trade sanctions are administered by the United States government (the “US”) primarily (though not exclusively) through the Department of State, the Department of Commerce and the Office of Foreign Assets Control (“OFAC”), an agency within the Department of the Treasury. The US utilises sanctions to implement US foreign policy and national security goals. Each sanctions programme targets specific countries, regimes, industries and related entities and individuals and addresses different objectives. Sanctions programmes are supported by one or more statutory authorities, including the International Emergency Economic Powers Act, which grants authority to the President of the United States that “may be exercised to deal with any unusual or extraordinary threat, which has its source in whole or in substantial part outside of the United States, to the national security, foreign policy, or economy of the United States...”.¹ Among other things, US sanctions prohibit US persons from engaging in specified transactions with foreign persons and entities that are included on OFAC’s Specially Designated Nationals and Blocked Persons List (the “SDN List”). Sanctions can be comprehensive or limited to specific individuals or entities, or to specified agencies, instrumentalities or industries of a target country

or regime. They can also take different forms: primary sanctions (addressed to activities of US persons); and secondary sanctions (addressed to activities of non-US persons).

Primary sanctions are those that apply to activities of US persons that have a direct jurisdictional nexus with the United States. The scope of US persons that are subject to OFAC regulations and other sanctions regimes is broad. It includes US citizens and permanent resident green card holders wherever located, US registered entities and their foreign branches, foreign persons to the extent of their activities while physically located in the US and, in certain cases, foreign subsidiaries that are owned or controlled by US persons. The individual sanctions programmes operate to prohibit or restrict economic activity between US persons or entities and a sanctioned country or sanctioned persons, entities or industries.

Secondary, or extra-territorial, sanctions have an impact on an even broader group of persons. They are intended to deter certain activities of non-US persons that may not otherwise be subject to US jurisdiction with a goal of further isolating the target of the sanctions. Since they indirectly target foreign individuals and entities for engaging in activities with countries, entities, individuals or industries that are subject to US sanctions, they can potentially sweep into their net transactions with no direct nexus to the US. For example, a foreign entity that engages in a sanctioned activity with Iran outside of the US in a transaction that does not involve US persons could potentially expose itself to sanctions by the US, notwithstanding such foreign entity’s lack of direct activities with US persons. This connection to the US can result from the foreign person’s efforts to access the US financial system or otherwise conduct business in a way that indirectly relates to US persons. The potential scope of secondary sanctions expands in concert with the growing list of sanctioned countries, individuals and entities.

The use of secondary sanctions by the US is on the rise. An example of new sanctions legislation is the Countering America’s Adversaries Through Sanctions Act, which became law in August 2017 and imposed secondary sanctions targeting Iran, Russia and North Korea and related persons and entities. Throughout 2018, further sanctions were imposed against specified Russian individuals and entities as punishment for allegedly meddling with the US 2016 presidential election (though a number of these additional sanctions were subsequently lifted), although such sanctions do not prohibit US entities from generally engaging in business with Russia. For example, secondary sanctions targeting Russia can be imposed against any person who knowingly engages in significant activities undermining cybersecurity on behalf of Russia or in transactions with persons that are part of the Russian government’s defence or intelligence sectors. Sanctions have also been imposed or expanded by the US against Syria, Cuba and Venezuela. Recently, much

attention has been focused on the US sanctions that were reimposed against Iran in connection with the US withdrawal from the Iran nuclear agreement, including secondary sanctions prohibiting, among other things, transactions with or the provision of financial messaging services to the Central Bank of Iran and other Iranian financial institutions, and the trading and transportation of Iranian petroleum products. This has had a direct impact on the other agreement signatories, as it significantly increased the risk of foreign countries, persons and entities acting in contravention of secondary sanctions as a result of their commercial dealings with Iran.

OFAC has the power to bring enforcement actions, issue civil penalties and, together with the Department of Justice, initiate criminal actions for primary sanctions violations. A number of financial institutions have been subject to sanctions-related enforcement actions in recent years. Most actions involve inadvertent violations such as inadvertently processing transactions through US financial institutions on behalf of corporate customers owned by entities and individuals on the SDN list, and have been settled with OFAC for relatively small amounts or just a warning. Wilful conduct, such as directly processing US financial transactions for sanctioned Iranian entities, can result in much more substantial penalties. If a foreign individual or entity not otherwise subject to US jurisdiction engages in restricted conduct with a sanctioned person, it would not be subject to administrative or criminal enforcement by the US since such foreign person or entity cannot “violate” US secondary sanctions by engaging in such sanctionable activity. The most common repercussions for a foreign person or entity that acts in contravention of US secondary sanctions would be the imposition of restrictions upon their ability to conduct business in the US. This could result, for example, in being excluded from accessing the US financial systems, limited or blocked in its ability to receive exports from the US, denied assistance from the US Export-Import Bank or prohibited from contracting with the US government. Individuals could have their visas revoked or be otherwise excluded from the US, and any property owned by such individual or entity located in the US could be frozen. Secondary sanctions may also impact the willingness of US persons to engage in commercial dealing with non-US persons because of concerns that such US counterparty would themselves indirectly be operating in contravention of primary sanctions. As an example, a US person could be held liable for financing or “facilitating” a commercial transaction by a non-US person that would be prohibited if conducted by a US person.

B. Blocking Statutes

Numerous countries have objected to attempts by the US to impose its sanctions laws on an extraterritorial basis – that is, to purport to restrict the activities of non-US persons. In response to the US secondary sanctions, some countries have enacted “blocking statutes” to address the impact of such sanctions on local individuals and entities. Examples of blocking statutes include Canada’s 1992 Blocking Order (the “1992 Blocking Order”), which was enacted pursuant to Canada’s Foreign Extraterritorial Measures Act (“FEMA”), an enabling statute that allows the Canadian government to pass orders blocking the effects of extraterritorial sanctions. In a commercial loan transaction, for example, if any of the credit parties are Canadian entities they will be subject to blocking statutes promulgated under FEMA, potentially setting up a direct conflict between compliance with credit agreement provisions and compliance with applicable law of their home jurisdiction.

The 1992 Blocking Order was intended to block the application in Canada of the US embargo against Cuba. It requires Canadian corporations and their directors, officers and employees to notify the

Attorney General of Canada of any “directive, instruction, intimation of policy or other communication relating to an extraterritorial measure of the United States in respect of any trade or commerce between Canada and Cuba that the Canadian corporation, director or officer has received from a person who is in a position to direct or influence the policies of the Canadian corporation in Canada”² and prohibits such Canadian entities and individuals from complying with such extraterritorial sanctions. It also requires Canadian entities and individuals to report any such sanctions compliance requests to the Canadian Attorney General.

Similarly, in 1996, the European Union (the “EU”) established Council Regulation (EC) No 2271/96 (the “EU Blocking Statute”) to address the challenges faced by EU persons engaging in international trade and commerce that was subject to the extraterritorial application of US sanctions then existing against Cuba, Libya and Iran. Such EU persons include, among others, residents in the EU, companies incorporated in the EU (including EU subsidiaries of US-incorporated companies with their principal place of business in the EU but excluding EU branches of US-incorporated companies), nationals of an EU Member State, shipping companies established outside the EU and controlled by nationals of EU Member States and any other natural persons within the EU, including territorial waters and air space (“EU Operators”). In response to the US withdrawal from the Iran agreement, the EU Blocking Statute was amended on June 6, 2018 to include within its scope all of the reimposed US-Iran sanctions with effect from August 7, 2018.

The aim of the EU Blocking Statute is, among other things, to address the impact of US extraterritorial sanctions on EU Operators doing business with Iran and other countries subject to US sanctions that is otherwise permitted under EU regulations. Given the EU’s existing commitment to the Iran agreement, it does not believe that its domestic operators should be subject to restrictions imposed by US extraterritorial legislation. The EU Blocking Statute attempts to block the application of the US sanctions that would restrict EU Operators from doing business with Iran. It further imposes an obligation on EU Operators to notify the European Commission if their economic and financial interests are impacted by any US sanction covered by the EU Blocking Statute. As the US increases its pressure on Iran through additional secondary sanctions, EU Operators are put in the unenviable position of having to choose between compliance with US law and compliance with the laws of their home jurisdiction. Since an EU Operator that is a subsidiary of a US entity is considered a US person for purposes of US sanctions laws and an EU person for purposes of EU law, it would be in direct conflict with the EU Blocking Statute if it restricts its business with Iran in order to comply with US primary sanctions. This conflict is increasingly a matter of focus for both lenders and multinational borrowers.

C. Potential Conflicts

The conflicting rules between the US secondary sanctions and the EU Blocking Statute create theoretical conflict of laws issues, but more importantly, they create practical challenges for EU Operators that go to the core of their commercial operations. EU operators that conduct their business in compliance with EU law may potentially face retaliatory consequences from the US for engagement in activities that are contrary to US policies. An EU financial institution may opt to stop processing financial transactions with Iranian entities, for example, but if it does so in order to avoid US secondary sanctions it would be in breach of the EU Blocking Statute. EU exporters conducting business with Iran in compliance with EU law may find their access to the US financial system and

access to US bank accounts restricted, which can create cash flow issues for the company. Similarly, EU Operators may be unable to receive payments from their Iranian customers or contributions from Iranian shareholders if such customers and shareholders no longer have access to SWIFT (the Society for Worldwide Interbank Financial Telecommunication). This tension may force companies to rethink the way they do business. While many EU Operators have stopped doing business with Iran in the wake of the latest round of US sanctions, some companies have been reluctant to submit to the pressures of the US to isolate Iran from international trade and restrict its access to financial systems. Given the threat of being excluded from the US banking system, the prevalence of the US dollar in global trade, the possibility of being penalised for engaging in transactions with an SDN and the possibility that key corporate officers may be prohibited from entering the US, it can be anticipated that most EU Operators, including European banks, are likely to adhere to the US-Iran sanctions, even if that means acting contrary to the EU Blocking Statute.

D. Credit Agreements

Banks and other financial institutions are affected by sanctions more than operators in other industries and bear the heaviest burdens both with respect to blocking property and property interests of those on the SDN List and monitoring transactions to ensure compliance with sanctions regimes. Banks and other financial institutions are extremely sensitive to the reputational risk and civil fines and potentially criminal penalties resulting from non-compliance with US sanctions. As a result, in recent years, there has been increased scrutiny by lenders regarding compliance with sanctions-related representations and covenants in credit agreements. Credit agreements typically contain representations that the borrower and all or a specific subset of its subsidiaries (the “Credit Group”) are in compliance with all laws that are applicable to the Credit Group and their properties and specifically that such Credit Group and its directors, officers and employees, and in many cases, agents and affiliates of the Credit Group are also in compliance with certain economic or financial sanctions. Whether the representations regarding compliance by agents and affiliates, and in certain cases, employees, are qualified by knowledge is a negotiated point and the outcomes vary depending on the strength of the relationship and relative negotiating leverage among the relevant borrower and their lenders. As sanctions regimes generally impose strict liability for lenders and compliance is generally unqualified, lenders have legitimate concerns about being held directly liable for financing or facilitating violations of sanctions. As such, lenders would want the sanctions representations and covenants to apply as broadly as possible to all applicable jurisdictions, while borrowers would seek to limit the scope to key sanctions regimes only, such as those that are administered or enforced by the US, the United Nations Security Council, the EU and the UK. A broad jurisdictional scope may be problematic for a multinational company where, on the one hand, certain of its subsidiaries are required to comply with US sanctions laws, and, on the other hand, other subsidiaries are prohibited from complying with US sanctions laws due to the application of blocking statutes that prohibit such compliance.

Given the complexities arising from multinational companies operating in different countries that have their own specific sanctions regimes or blocking statutes, it is appropriate for sanctions representations and covenants in credit agreement to be tailored to the specific circumstances of each Credit Group and the syndicate of lenders party to such credit agreements. By way of example, if the Credit Group includes both US and Canadian subsidiaries, it would be problematic for Canadian subsidiaries to be subject to

a sanctions representation or covenant that includes compliance with US sanctions against Cuba and Canadian credit parties might request a related carve out. This is because Canada’s 1992 Blocking Order prohibits compliance by Canadian entities with US sanctions targeting Cuba. Similarly, under section 7 of the German Foreign Trade Ordinance, German nationals and German branches of foreign organisations (so long as such German branches are managed in Germany and maintain separate accounts) are prohibited from participating in a boycott against foreign trade. As a result, it may be prudent to carve out German credit parties with respect to representations and covenants relating to compliance with US sanctions against Iran. As a general matter, where such conflict of laws may exist, one possible approach is for the applicable representation and covenant that is made by or with respect to such non-US person to be qualified by and be subject to any foreign laws that are applicable to such non-US person. Entities and individuals may also apply to OFAC for the issuance of licences to engage in transactions that otherwise would be prohibited. For example, certain individuals and organisations, such as those on the SDN List, are prohibited from receiving US exports. If there are transactions that may be lawfully undertaken by specified subsidiaries in the Credit Group (e.g. limited activities that are permitted under a licence), such activities will need to be appropriately carved out from restrictions relating to the sanctions regimes that are the subject of the sanctions representation and covenant.

Credit agreements also typically contain a representation and an affirmative covenant that proceeds of the loans will not be used in violation of sanctions. One often negotiated point between lenders and the Credit Group is whether the Credit Group can rely on a knowledge qualifier as to how the loan proceeds are used. From the perspective of a lender, the preferable position would be a flat representation and covenant that requires the Credit Group and its directors, officers, employees and agents not to use loan proceeds to directly or indirectly finance or facilitate any activities, business or transactions of or with any person or country subject to sanctions. On the other hand, a borrower would prefer the representation and covenant to be qualified by knowledge (i.e. the formulation to read “directly or, to its knowledge, indirectly”) for the practical reason that a Credit Party cannot make meaningful representations or covenants about downstream or indirect uses of proceeds undertaken or to be undertaken without its knowledge or control. Negotiations on the inclusion of any knowledge qualifier will ultimately depend on an “allocation of risk” analysis as between the lenders and the Credit Group, as well as negotiating leverage and client relationships. Financial sponsors, which banks count among their best customers, routinely see knowledge qualifiers and more narrowly defined references to sanctions regimes in the credit agreements of their portfolio companies due to their close relationship with the banks and relatively strong negotiating leverage.

Although lenders conduct rigorous “know-your-customer” diligence on their customers, the strict liability nature of many sanctions regimes means that such diligence will not protect lenders against liability if they are found liable for violating such sanctions. Expectations regarding sanctions diligence vary widely, both amongst lenders and among borrowers. The scope of sanctions diligence often depends on the nature of the underlying transaction and the intended use of loan proceeds and generally focuses on issues (with respect to the Credit Group and, if applicable, the target in an acquisition financing) relating to the type and geographic scope of the business it conducts and the Credit Party’s legal and compliance policies and procedures. Such issues include personnel training requirements, whether there are business transactions, direct or indirect, with sanctioned individuals, entities, countries or regions and whether the company has made sanctions-related disclosures or has been subject to related

investigations or penalties in the past. If, for example, the borrower (and target, in an acquisition financing) is a US company that has no direct international operations, and does not conduct international business through third parties, or if the proceeds of loans under a credit facility are being used exclusively to repay indebtedness that is specifically identified, the lenders may opt to undertake more limited diligence. Under other circumstances, lenders need to conduct more robust diligence to understand the borrower's (or, if applicable, the acquisition target's) potential connection to sanctioned countries, regions, entities and individuals and the manner in which the loan proceeds will be used.

In addition, credit agreements typically contain an affirmative covenant that the Credit Group will maintain in effect and enforce policies and procedures that are designed to ensure compliance by such Credit Group and the directors, officers, employees and agents of such Credit Group with applicable sanctions. Prior to agreeing to such covenant, it would be prudent for counsel to confirm with its borrower clients that they do, in fact, have policies in place to promote compliance with the sanctions regimes that are within the scope of the sanctions representations and covenants. It is also important for borrowers to periodically update their internal policies with respect to sanctions compliance in a way that is appropriate for the current legal landscape and that will enable the Credit Group to comply with both their legal and contractual obligations.

E. European Union

In an attempt to navigate conflicts between US and EU laws, the EU Blocking Statute contains a mechanism to allow an EU Operator to seek authorisation from the EU Commission to permit it to comply with US sanctions. EU Operators requesting the authorisation must specifically identify the US sanction listed in the EU Blocking Statute that they are seeking to fully or partially comply with. The onus is on the applicant to demonstrate how non-compliance with US sanctions would cause serious harm to the interests of either the EU Operator or the EU. To determine whether "serious harm" will occur within the circumstances presented by the applicant, the EU Commission will consider, among other things, the nature and origin of the damage to the EU Operator's or the EU's interest, whether there is substantial nexus between the EU Operator and the US and any preventative measures that could be taken by the EU Operator to mitigate the resulting damage or the effects on the economic activities of the EU Operator from non-compliance with the applicable US sanctions.

Notwithstanding the existence of the EU Blocking Statute, EU Operators are free to conduct business in accordance with their own corporate policies and practices as they may independently discontinue doing business with Iran based on commercial considerations, such as perceived credit risk of an Iranian counterparty or other geopolitical

concerns with doing business in the Middle East. At this stage, it is not clear if many EU Operators will seek authorisations under the EU Blocking Statute for permission to comply with US sanctions.

F. Conclusion

The conflicts between US secondary sanctions and non-US blocking laws create compliance issues for multinational companies with operations in the US and in non-US jurisdictions, which may affect their ability to make sanctions-related representations and comply with sanctions-related covenants in their credit facilities. As it is typical for representations (including the representation with respect to sanctions) to be brought down with each borrowing under the credit agreement and for the Credit Group to confirm that there are no outstanding defaults, multinational companies with subsidiaries in both the US and non-US jurisdictions that are seeking access to funding must also carefully consider whether the Credit Group as a whole is able to make such representations and comply with such covenants on a going-forward basis or whether, as noted above, specific exceptions are required for certain subsidiaries. Without question, potential exposure to secondary sanctions introduces an added level of complexity to the competing concerns of lenders and borrowers in the commercial loan context. However, it is important to keep in mind that while Iran, for example, is subject to comprehensive US sanctions, there are other situations where US sanctions may apply only to certain individuals, entities and business sectors of a sanctioned country without prohibiting *all* business activities with that country. This means that a "one size fits all" approach to dealing with compliance with sanctions laws in credit agreements may not always result in outcomes that are workable for all parties, and care should always be taken to tailor credit agreement terms to address both the concerns of the lenders and a particular Credit Group's business realities.

Endnotes

1. International Emergency Economic Powers Act (IEEPA), 50 U.S.C.A. §§ 1701 (West 2019).
2. Foreign Extraterritorial Measures (United States) Order, 1992, SOR/92-584 (Can.).

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