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THE IMPACT OF SANCTIONS ON OBLIGATIONS UNDER STANDBY LETTERS OF CREDIT

In *Celestial Aviation Services Limited and Constitution Aircraft Leasing (Ireland) 3 Limited and another v UniCredit Bank AG (London Branch)*[1], the English High Court has provided important clarity on the impact of Russian sanctions regimes on payment obligations under standby letters of credit.

The High Court heard two claims together to address whether sanctions imposed on Russia in response to the conflict in Ukraine extinguished payment obligations arising under standby letters of credit ("**LCs**").

Background

The Claimants, Celestial Aviation Services Limited ("**Celestial**") and Constitution Aircraft Leasing (Ireland) 3 Limited / Constitution Aircraft Leasing (Ireland) 5 Limited ("**Constitution**"), were Irish-incorporated aircraft lessors. Both were seeking payment as the beneficiaries of standby LCs issued in respect of aircraft leases agreed with Russian companies between 2005 and 2014. The LCs were payable in US dollars and governed by English law. The Russian bank Sberbank Povolzhsky Head Office ("**Sberbank**") issued the LCs between 2017 and 2020, and the London branch of the Defendant, UniCredit Bank AG ("**UniCredit**"), confirmed them.

As the confirming bank, UniCredit had agreed to perform the principal duties of Sberbank and it was common ground between all parties that the demands for payment made by the Claimants in March 2022 were valid. However, UniCredit withheld payment on the grounds that Russian sanctions imposed by the UK, EU and US prevented them from honouring the claims.

The Court was asked to consider:

1. Whether the UK sanctions regime (specifically Regulations 11, 13 and 28 of Russia (Sanctions) (EU Exit) Regulations 2019) prohibited payment under the LCs (it was agreed that the same analysis would apply to the position under EU sanctions).

2. Whether the requirement to pay in US dollars would trigger US sanctions with the effect of suspending or otherwise excusing UniCredit's non-performance of their payment obligations.

Principal Judgment

Considering the effect of UK (and by implication EU) sanctions first, the Court rejected UniCredit's defence for the following key reasons:

- Applying the autonomy principle, standby LCs are a separate financial instrument to the wider transaction, with distinct contractual obligations. Payment by the London branch of a German bank (UniCredit) to Irish-incorporated companies (Celestial and Constitution) was considered wholly independent from the lease of aircraft to Russian companies.
- Any independent obligations of Sberbank and lessees towards the Claimants that may be discharged by UniCredit's payment was a "wholly collateral matter". Importantly, payment by UniCredit to the Claimants did not extinguish Sberbank's liability to UniCredit, nor did it extinguish the Russian lessees' liability to Sberbank in turn. As a result, no financial benefit would be given to the Russian entities involved in other elements of the wider transaction and the sanctions did not 'bite'.
- The sanctions do not have retrospective effect. Since the aircraft were supplied to Russian lessees and UniCredit confirmed the LCs before the sanctions came into force in March and April 2022, the obligations were perfectly lawful at the time they arose and should continue.

[1] [2023] EWHC 663 (Comm) and [2023] EWHC 1071 (Comm)

Turning to the impact of US sanctions, the Court held:

- The requirement to pay in US dollars did not necessitate the involvement of a US correspondent bank. Where payment under a contract is to be in US dollars, the recipient party is entitled to demand such payment is made in cash (*Libyan Arab Foreign Bank v Bankers Trust Co*[2] applied). Accordingly, the foreign illegality rule developed in *Ralli Bros v Compania Naviera Sota y Aznar*[3] (by which an English court will not enforce an obligation that requires a party to commit an unlawful act by the law of the country in which that act must be done) is not triggered.
- There were no relevant US sanctions in place when the payment obligations accrued towards Celestial, although some later obligations that matured towards Constitution might be caught. Nevertheless, the burden of proving to an English court that payment in US dollars would breach US law is high. In the Court's words, "*The final arbiter as to what US law is is the US Court*".

Consequential Judgment

The Court was subsequently asked to consider whether UniCredit had reasonable belief that it was prohibited from making payment under the LCs. This was crucial to determining whether UniCredit could rely on the defence provided by section 44 of the Sanctions and Money-Laundering Act 2018 ("**SAMLA**"), which excuses parties from civil liability for any acts and/or omissions done in the "reasonable belief" of compliance with UK sanctions law.

Parties seeking to rely on this section 44 SAMLA defence must pass two stages:

- First, the party must prove its actions were governed by the belief it was complying with the law (a subjective test). In this instance, the Court held that UniCredit had established it had the relevant subjective belief.
- Second, and if successful in stage one, the party must convince the Court that its actions were *reasonable* (an objective test). Returning to the principal judgment and the autonomy principle that underpins standby LCs, the Court found against UniCredit on this point. It should have been clear to UniCredit that any obligation to pay the Claimants under the standby LCs was in no way dependent upon reimbursement by Sberbank and therefore was not impacted by the sanctions regimes.

UniCredit was liable to the Claimants for interest and costs.

HFW's Perspective

Standby LCs give rise to autonomous payment obligations which are wholly independent from any other elements in a transaction. These judgments confirm how this principle applies in relation to the application of sanctions. They also confirm that the introduction of new sanctions regimes will not automatically discharge parties from pre-existing, lawful obligations.

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[2] [1989] 1 QB 728

[3] [1920] 2 KB 287

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