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INSIGHTS

The Sanctioned Lenders Problem

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Anyone who has been involved in the negotiation of loan documentation in recent years – not just in the project finance arena but in the wider syndicated debt markets – will be well aware of the greatly increased attention banks place on sanctions clauses in loan agreements. These clauses are there to protect the banks, and entitle them to default the borrower, if a member of the borrower group – and very often its officers, employees, agents and sometimes others connected with the borrower group – become the subject of sanctions.

Following Russia's invasion of Ukraine and the resultant sanctions on Russian banks and also against the backdrop of heightened political tensions between Russia and China, an issue that has not previously been focused on in loan negotiations is starting to attract some attention: what are the consequences for the borrower, the agent bank and the wider syndicate if a lender becomes sanctioned? Historically, loan agreements have been silent on this, and this silence can result in outcomes that are not just very problematic for the borrower but may also be very problematic for the agent bank and the rest of the syndicate.

This article examines the issue of lenders becoming sanctioned as it has historically been dealt with, or perhaps more accurately overlooked, in loan documentation and considers how documentation could be adjusted to ensure there is a fairer risk allocation as between the parties and greater clarity on what should happen if a lender is sanctioned.

Imagine the following scenario: prior to the commencement of Russia's war with Ukraine, a borrower incorporated outside of Russia and which has no business interests in Russia enters into a financing to develop a project. The facility agreement, as is typical, includes various sanctions representations and covenants to be given by the borrower – with an event of default for any breach of these. The facility provides for a staggered drawdown period to fund the development, depending on certain project development milestones being reached. The facility has a broad international syndicate of lenders backing it. The first milestone is reached, and the borrower has nearly achieved the second milestone, following which it will submit a utilisation request to draw funds for the next stage of the project development. Russia then invades Ukraine and one of the Russian banks lending to the project is sanctioned. Depending on the drafting of the facility agreement, some or all of the following consequences could occur:

- The borrower and the agent bank would be prohibited from receiving from the sanctioned lender that lender's committed portion of further loan drawdowns.

- The payment by the borrower of any amount interest or principal to the sanctioned lender would be prohibited. Yet refusal by the borrower to make a payment required under the terms of the facility would result in a non-payment event of default.

- The now illegal performance of the borrower's obligation to pay the sanctioned lender and the sanctioned lender's obligation to fund the borrower would quite likely create breaches of representation by the borrower if the facility includes typical representations that all authorisations required for the exercise of rights or performance of obligations under the finance documents have been obtained and that the performance of the transactions contemplated by the finance documents will not violate any sanctions and other transactions. Breach of these provisions would result in an event of default.

- There would likely be additional events of default on the basis of unlawfulness/ unenforceability of the facility agreement in relation to payment obligations from or to the sanctioned lender.

- The occurrence of the events of default referred to above would give every lender a right to drawstop further drawings by the borrower of its facility.

- Even if no event of default occurred as a result of the relevant lender becoming sanctioned, and the borrower was able to submit further utilisation requests, the borrower and the agent will not be able to receive funds from the sanctioned lender thereby creating a project funding gap. This is problematic for the borrower, as its project will not be fully funded, and non-sanctioned lenders as they are lending to a non-fully funded project.

- To rub salt in the borrower's wounds, the fact that it would be illegal for the sanctioned lender to fund the borrower would trigger the illegality provisions in the facility agreement entitling the sanctioned lender to cancel its commitment and call for immediate repayment of all amounts owed to it with which the borrower would not be able to comply even if it had the funds to do so because payment to the sanctioned lender would breach sanctions.

- Failure by a sanctioned lender to fund a utilisation would result in the sanctioned lender being deemed to be a defaulting lender under the standard LMA drafting, which could also result in the borrower being required to provide cash cover to any relevant fronting bank of standby letters of credit issued under the facility in relation to that lender's participation in such letters of credit.

Obviously, the consequences set out above are not in the interests of the borrower – who is the unwitting victim of a lender being sanctioned – nor in the interests of the rest of the lenders of the syndicate or the facility agent (or any other relevant agents of the lenders, such as any security agent). Therefore, all parties would benefit from mechanics being built into the facility agreement from the outset that address the risk of a lender becoming sanctioned by ensuring that:

- The borrower would not be in breach of the facility agreement by virtue only of a lender becoming sanctioned;
  There is a regime in place to modify payment/ payment transfer obligations for the borrower and the facility agent to take account of what is and is not permitted by law when a lender is sanctioned; and

- The borrower has a right to replace a sanctioned lender to avoid any funding gap on account of the sanctioned lender's commitment to fund not being performed.

There are a number of different provisions that could be written into a facility agreement to implement these principles:

- The ideal for the borrower would be to negotiate a blanket overriding clause that provides that: (i) notwithstanding any other provision of the facility agreement, no representation by the borrower will be breached and no event of default will occur as a result only of a lender becoming sanctioned, and (ii) the borrower will not be obligated to perform any obligation that would breach sanctions. The alternative, which would arrive at the same place though with more precision, would be to specifically address all the relevant provisions – ie representations, covenants, events of default, drawstop etc – and ensure that the fact of a lender being sanctioned would not result in breaches or default by the borrower.

- Provisions addressing the borrower's obligation to pay interest and repay principal to a sanctioned lender could be adjusted. Clearly such payments cannot lawfully be made but equally it would be an odd result if the borrower did not at least have to provide for the payment. There are a variety of ways this could be addressed such as providing that the borrower should pay amounts owed to a sanctioned lender into a blocked account and that payment will discharge the relevant payment obligation. If and when the relevant lender ceased to be sanctioned then amounts from that account would be transferred to that lender.

- If there is a project funding test that is run at intervals during the tenor of the facility, the parties may agree that there will be a grace period if there is a funding gap as a result of a lender becoming sanctioned before any breach of the funding test occurs. During that grace period no event of default would occur, and further utilisations would not be drawstopped.

- The right of a lender who becomes sanctioned to rely on standard illegality mandatory pre-payment clause to cancel its commitment and require its loans to be pre-paid could be disapplied.

- A right to designate a sanctioned lender as a defaulting lender could be introduced, which would then permit the borrower to require that lender to transfer its commitments to a new lender, if this is practically possible, which it may well not be, or otherwise cancel that lender's available commitments and appoint a new lender to assume that lender's cancelled commitments. If there is a revolving credit facility that forms part of the facility, the sanctioned lender/ defaulting lender's loans would be termed out. In addition, the sanctioned lender/defaulting lender would be disenfranchised from voting.

- If the facility includes a standby letter of credit component, and the borrower would otherwise be required to provide cash cover to the fronting bank as a result of a sanctioned lender/defaulting lender, the parties may consider including provisions for a negotiation period between the borrower and the fronting bank before any such cash cover is demanded in order to identify an alternative solution.

Recent events have served to remind us all that the issue of sanctions can apply as much to lenders as to borrowers and provisions in facility agreements should recognise that. The consequences of a lender becoming sanctioned could be (at best) highly disruptive and at worst catastrophic for the borrower and the non-sanctioned lenders.

To answer the question "Sanctioned Lenders: Whose problem is it?" the answer is that it is everyone's problem and therefore the parties to a loan agreement should recognise that their interests are aligned in including provisions that address the risks associated with sanctioned lenders. There are a small number of facilities that have done just this, but general awareness of the issues and problems for all parties that come with a lender becoming sanctioned is low.

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