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U.S. and European Loan Markets: Comparative Approach to Sanctions Provisions

Economic sanctions, when imposed by a regime, have the purposes of advancing national security, foreign policy or economic goals. Sanctions can take multiple forms, including restrictions on investment, restrictions on trade, restrictions on travel, and economic or financial sanctions intended to freeze the assets of the sanctioned subject or to block access to capital markets and financial services. Financial sanctions imposed by any number of jurisdictions can have significant relevance in international loan market transactions, and a breach of financial or trade sanctions carries serious reputational risks for a financial institution in addition to the risk of heavy financial penalties.

Overview of EU and U.S. Sanctions Regimes

EU Regime

The EU applies sanctions and restrictive measures to third countries, entities and individuals as part of its Common Foreign and Security Policy, including implementation of U.N. Security Council Resolutions. EU sanctions are implemented through regulations which are directly applicable in all Member States, the administration and enforcement of which rests with the competent authorities in each Member State. In the U.K., EU financial sanctions are administered by HM Treasury.

EU sanctions are generally applicable to "**EU Persons**", being any person within the EU; any person who is a national of a Member State; any legal person, entity or body which is constituted in a Member State or which conducts any business within the EU; and any person on board an aircraft or vessel under the jurisdiction of a Member State. Entities incorporated outside the EU are not required to comply with EU sanctions except in respect of business carried on within the EU.

EU sanctions are generally targeted against designated individuals, groups or entities (each, a "**Designated Person**") together with other specific prohibitions or controls which are directed at particular industries, sectors and/or activities. In relation to finance transactions, EU sanctions generally prohibit EU Persons from making any funds or economic resources available, directly or indirectly, to or for the benefit of a Designated Person, with an accompanying requirement to freeze funds or economic resources which are owned, held or controlled by a Designated Person. EU sanctions may also impact the ability of EU Persons to engage in transactions with (non-designated) entities that are owned and/or controlled by Designated Persons.

In addition to the sanctions measures enacted by the EU itself, individual Member States of the EU may themselves impose domestic measures, for example, to target individuals, groups or entities which are deemed to pose a domestic threat.

U.S. Regime

The Office of Foreign Assets Control (**OFAC**) of the U.S. Department of the Treasury is the primary federal agency administering and enforcing U.S. economic sanctions programs, including those derived from U.N. Security Council Resolutions. Sanctions may be imposed against geographical areas and all persons within those areas, or against designated governments, organizations, individuals and entities (**Persons**) wherever located.

Generally, U.S. sanctions apply globally to "**U.S. Persons**", being U.S. citizens and permanent U.S. residents, persons within the U.S. and entities organized under U.S. law (including foreign branches). OFAC regulations can also apply to non-U.S. subsidiaries of U.S. firms either directly (in the case of the Cuba and Iran sanctions programs) or in the form of "secondary" sanctions targeting certain territories, and may apply to non-U.S. Persons in relation to transactions through the U.S. financial system (including transactions in U.S. dollars that transmit through the U.S. banking system). Separately, U.S. export controls regulations administered by other U.S. government agencies such as the Bureau of Industry and Security of the U.S. Commerce Department may also apply to the exportation or re-exportation of U.S.-origin goods by non-U.S. Persons.

Under the U.S. sanctions programs administered by OFAC, U.S. Persons are generally prohibited from engaging in transactions, directly or indirectly, with certain designated Persons and countries (together, "**Sanctions Targets**") unless the transactions are exempt or licensed by OFAC. Further, OFAC regulations prohibit U.S. Persons from "exporting" financial, legal or other services to or for the benefit of a Sanctions Target or "facilitating" transactions undertaken by non-U.S. Persons which, although entirely legal for a non-U.S. Person, would be in breach of U.S. sanctions for U.S. Persons to undertake directly.

Types of U.S. Sanctions

Territorial Sanctions. OFAC administers comprehensive, territorial sanctions against specific countries or regions and their governments, government entities, agencies and instrumentalities. Generally, Persons located, organized or resident in a target sanctioned country are also considered target Persons. These countries and Persons are the targets of various trade embargoes that ban imports and/or exports of goods, technology and services by or to U.S. Persons (and in some cases their non-U.S. subsidiaries). The countries or regions subject to embargo by the U.S. government are Crimea, Cuba, Iran, North Korea and Syria.

List-Based Sanctions. OFAC also administers "list-based" sanctions that are imposed on Persons designated under various programs for certain acts. These parties' names are generally placed on OFAC's list of Specially Designated Nationals and Blocked Persons (**SDNs**). U.S. Persons are generally prohibited from conducting financial or commercial transactions with SDNs, and any assets of SDNs within the U.S. or within the possession or control of any U.S. Person are "frozen" or "blocked." In addition, any entity (or asset) that is 50 percent or more owned, directly or indirectly, by one or more SDNs in aggregate is blocked property – meaning that subsidiary entities would constitute target Persons whether or not they themselves are placed on the SDN list.

Sectoral Sanctions. OFAC may also impose certain (non-comprehensive) sanctions on a particular country, territory or Person, for example, "sectoral" sanctions targeting certain Russian energy and defense companies and financial institutions. Sectoral sanctions may prohibit U.S. Persons and their non-U.S. branches from extending credit to or purchasing equity in certain targeted Persons, among other transactions.

Secondary Sanctions. Secondary sanctions are an extension of U.S. jurisdiction to non-U.S. Persons who would not normally be subject to U.S. law. The secondary sanctions are intended to discourage non-U.S. Persons from transacting with Persons or territories targeted by U.S. sanctions programs. A non-U.S. Person who transacts with a target Person or territory may lose access to the U.S. financial system, credit support from the U.S. Export-Import Bank, rights to obtain U.S. export licenses, U.S. government procurement eligibility or U.S. visas, or even risk becoming designated as a targeted Person itself.

Primary Sanctions Risks for Lenders

Financial institutions should consider several potential sanctions-related risks that may arise in lending transactions.

- First, they face potential civil or criminal penalties. In particular, OFAC's aggressive enforcement posture (as supplemented by actions by other state and federal agencies) has resulted in a number of very large settlements with financial institutions in recent years, causing U.S. and non-U.S. financial institutions to become increasingly conservative in managing their sanctions risks.
- For non-U.S. lenders, there is a risk of secondary sanction by OFAC for conducting business with Sanctions Targets (such as denial of opening or maintaining correspondent or payable-through accounts with U.S. financial institutions).
- In addition, lenders could face the credit risk of possible non-repayment if the borrower were to become the target of blocking sanctions. The loan agreement itself could become blocked property, and any payments received from the borrower would have to be placed in a blocked account.
- Finally, lenders want to protect themselves against franchise and reputational risks resulting from sanctions violations. In some cases this may extend to transactions that are technically lawful under U.S. sanctions regulations but have any connection to Sanctions Targets, notably loans to non-sanctioned companies that engage in certain types of business with Sanctions Targets.

"***De minimis***" **exception:** Despite the various sanctions prohibitions, in order to allow U.S. businesses to remain competitive in the global market, OFAC does not generally require lenders to refuse transactions merely because the borrower does a small amount of business with Sanctions Targets, provided that the lender has verified through due diligence that the financing itself does not involve or relate to the borrower's business with the Sanctions Target and also that the borrower's activities are not primarily focused on Sanctions Targets and are *de minimis* in that respect. There is no official rule or definition of what level of business is considered "*de minimis*" but, depending on the circumstances, up to 10 percent of assets, revenues or profits may be permissible. However, Lenders should use caution when relying on the *de minimis* exception as it is fact specific, and OFAC may apply a threshold below 10 percent depending on current relations between the U.S. and the sanctioned jurisdiction. For example, at present, a borrower's business with Iran or Russia creates the greatest risk for lenders and requires a much more stringent due diligence exercise.

Mitigating Sanctions Risk

Due Diligence

Lenders use various tools to mitigate their sanctions-related risks. First, it is prudent for lenders to conduct their pre-contractual due diligence investigation into sanctions compliance by the borrower, its group, businesses, and the jurisdictions in which it operates. The issues to be addressed will generally be transaction-specific and addressed by KYC and customer/transaction diligence processes. The following issues will generally be covered:

- Whether the transaction directly or indirectly involves:
  - A target country or target person; or
  - A non-sanctioned entity with substantial business interests with target countries or target persons;
- Whether U.S. Persons or (as applicable) EU Persons will be involved in or supervise the transaction;
- Details about the borrower group's level of business with Sanctions Targets generally, and a description of any such business activities (including potential application of the "de minimis" exception); and
- In relation to U.S. sanctions, if any of the borrower group conducts any business with or relating to Cuba, Iran, North Korea, Russia or Syria, additional due diligence related to whether these activities could make them targets of secondary sanctions which could ultimately trigger the blocking of property within U.S. jurisdiction and potential blocking of the loan repayment.

Contractual Provisions in the Credit Agreement

In terms of the key risks, lenders' opening proposals often seek assurances in relation to the following:

- ***Target persons and target countries:*** The borrower group and its shareholders, directors, officers and employees are not the target of sanctions nor does the group operate in countries subject to comprehensive sanctions.

- ***Compliance:*** The borrower group's compliance with specified "Sanctions".
- ***Use of proceeds and "clean funds":*** The proceeds of the facility will not be used in breach of sanctions and will not be repaid with the proceeds of sanctioned activities.
- ***Absence of pending investigations:*** The absence of pending investigations by sanctions authorities.
- ***Absence of past violations:*** The absence of violations of applicable sanctions regulations and resulting penalties or warnings.
- ***Policies and procedures:*** The existence and maintenance of policies and procedures designed to facilitate and achieve compliance with sanctions and to detect any systemic weaknesses in compliance programs.

Once the list of topics on which lenders are to be given contractual assurance has been agreed, the detailed text of representations and/or undertakings requires discussion. Common negotiating points include:

- ***Limitations on the concept of "sanctions" for the purposes of any representations and undertakings:*** The lenders' starting point may be that any provisions regarding sanctions compliance should encompass all applicable laws, while borrowers would seek to limit their scope to capture only sanctions regimes in key jurisdictions, commonly the U.S. OFAC regime, the EU regime and the U.K. regime.
- ***Limitations by reference to the borrower's knowledge:*** For example, in respect of representations or undertakings relating to the "direct or indirect" use of the proceeds of the facility in breach of sanctions, or relating to compliance with sanctions by the borrower's shareholders, directors, officers and employees. However, note that violations of OFAC sanctions programs are strict liability offenses, meaning that there need be no knowledge of or intent to violate the sanctions for a violation to occur. Lenders should therefore resist efforts by borrowers to insert knowledge qualifiers in U.S. sanctions program compliance representations, warranties and covenants.
- ***Other qualifications:*** For example, materiality qualifications may arise or appropriate carve-outs may be agreed where the borrower group undertakes activities in countries that are subject to sanctions — for example, under license.
- ***Hair-trigger Event of Default:*** Consideration should be given as to whether an immediate Event of Default is the most appropriate consequence of a breach of sanctions representations and/or undertakings, particularly given the potential complexity of issues and regulatory regimes. In syndicated transactions, grace periods or other mechanisms to avoid triggering a full Event of Default and consequential cross-default may be appropriate, such as:
  - An appropriately drafted "mandatory prepayment" provision under which an individually-affected lender could exit a syndicated facility; or
  - A bilateral side letter between the borrower and an individual lender. The borrower would then be liable to the lender for a breach of the terms of the side letter but the arrangement would be set up such that the breach would not trigger a drawstop or Event of Default.

- ***Currency of repayment:*** Credit agreements may include provision for the lenders to permit repayment in an alternative currency in circumstances where a U.S. dollar-denominated repayment (which must involve a U.S. correspondent bank) would otherwise be blocked/frozen as the result of a (non-U.S.) borrower's designation subsequent to the execution of the credit agreement. Care should be taken in such cases to ensure that switching could not be construed as evasion or circumvention of applicable sanctions.

European Credit Agreements — Market Practice

Historically, standard contractual assurances regarding illegality and unlawfulness were considered sufficient to address sanctions risks (subject to due diligence) in most European lending transactions. Specific sanctions-related assurances were normally required only from borrowers operating in sectors or countries perceived as high risk in this context.

More recently, increasingly aggressive enforcement action by the U.S. sanctions authorities has prompted lenders in the European market to seek specific sanctions-related representations and undertakings, both to crystallise the results of their due diligence and to provide continuing assurance that no compliance issues arise over the life of the loan facility. Although some strong investment grade credits are able to borrow without sanctions provisions (where lenders are comfortable that due diligence suffices), sanctions provisions of some type are now included in the majority of European syndicated loan agreements, often resulting in lengthy negotiations.

Lenders in the European market take a range of views on the appropriate scope of such provisions and each major bank will have generated its own set of provisions. The more wide-ranging protections sought by certain banks reflect the breadth of the legislative regimes they need to address, notably where those lenders may be subject to different (or more extensive) sanctions regimes than their borrowers. The contention often stems from the difference between U.S. sanctions (with which most international lenders comply, but which may not directly affect the operations of U.K. or European-based borrowers) and sanctions in place in the EU and other jurisdictions. Generally, EU sanctions have tended to be quite focused on named individuals and entities connected with particular regimes and organizations, while the U.S. often takes a broader approach by combining country or sector-based sanctions with targeted designations.

While European market participants have become familiar in recent years with the key risks, contentious areas and possible compromise contractual positions, there remain no European market “standard" sanctions-related contractual assurances and the Loan Market Association (**LMA**) has advised that it does not intend to draft recommended form sanctions-related provisions for its template facility documentation. It considers that this is a difficult issue upon which to provide generalized guidance because of the complexity and breadth of the issues and applicable regimes governing individual lenders. The precise wording of any representation and/or undertaking is therefore settled on a case-by-case basis and will depend on the transaction, the parties involved and the sanctions regime(s) that the parties wish to address. The LMA also suggests that the parties may consider whether amendments and waivers affecting any such provisions (if included) should be matters that require the consent of all lenders — something certain lenders are currently insisting on.

In addition, particularly in the EU, potential conflicts of laws may affect individual lenders and borrowers in different ways. Notable in this regard is the EU's "blocking" legislation counteracting specified U.S. extra-territorial sanctions. The EU Blocking Regulation (Council Regulation (EC) No. 2271/96 of 22 November 1996) broadly prohibits compliance by EU Persons with specified U.S. measures, with the stated objective of protecting EU business interests against U.S. extra-territorial sanctions identified as being prejudicial to those interests. EU subsidiaries of U.S. parent companies are required to comply with all provisions of the EU Blocking Regulation, which may create a conflict between their obligations to comply both with certain of OFAC's sanctions programs (such as on Cuba or Iran) with the EU Blocking Regulation. This, in turn, may impact the ability of those borrowers to provide sanctions-related assurances under their loan documentation.

The breadth of regimes and of issues that may affect individual lenders, including potential conflicts of laws aspects, will need to be addressed on a transaction-specific basis. Where appropriate, representations and covenants will be limited to non-conflicting sanctions or rules or will be applied only to those lenders that can take benefit from them; alternatively, relevant sanctions provisions could be set out in a separate side letter in favour of individual lenders which is crafted so that a breach of that arrangement would not trigger a breach of the syndicated facility itself.

U.S. Credit Agreements — Market Practice

While acknowledging that the lenders' due diligence along with the transaction specifics will be critical to determining the provisions to best protect U.S. financial institutions from OFAC risk in a particular situation, the Loan Syndications and Trading Association (LSTA) has provided detailed commentary and drafting of supporting recommended representations and undertakings for the purposes of their template U.S. market credit facility agreements.

The LSTA has adopted the following recommended provisions:

A. Sanctions Representation: Status

A credible representation that the borrower is not a sanctions target protects U.S. financial institutions from violating prohibitions against dealing in blocked property or engaging in transactions with Sanctions Targets. For this purpose, the LSTA recommends the following sanctions representation:

> "None of the Borrower [and any Guarantors], any of its Subsidiaries or [, to the knowledge of the Borrower,] any director, officer, [employee, agent, or affiliate] of the Borrower or any of its Subsidiaries is an individual or entity ("Person") that is, or is owned [50 percent or more, individually or in the aggregate, directly or indirectly] or controlled by Persons that are: (i) the [subject/target] of any sanctions administered or enforced by the U.S. Department of the Treasury's Office of Foreign Assets Control ("OFAC"), the U.S. Department of State, [the United Nations Security Council, the European Union, Her Majesty's Treasury [, or other relevant sanctions authority]] (collectively, "Sanctions"), or (ii) located, organized or resident in a country or territory that is the

subject of Sanctions, [including] [currently,] Crimea, Cuba, Iran, North Korea, and Syria)."

However, note that this representation does not obviate the need for the lender to conduct its own due diligence on the identity and ownership of the borrower or any other parties to transaction to ensure they are not a sanctions targets.

B. Covenant — Use of Proceeds

Lenders should obtain an undertaking that the borrower will not use loan proceeds to finance business with sanctions targets, in particular if the loan proceeds are not fully dedicated to specified, non-sanctions-related use or if due diligence indicates that the borrower has operations in or with sanctions targets. Such a covenant would be essential if those operations are material or have significant capital needs that are not expressly funded out of alternative sources.

This covenant protects against U.S. Persons "exporting" financial, legal or other services to or for the benefit of a sanctions target, or "facilitating" a transaction that they themselves are prohibited by sanctions from engaging in directly.

Depending on the circumstances, the LSTA recommends the following "use of proceeds" provision to be included as a negative covenant, breach of which would trigger an immediate Event of Default:

> "The Borrower will not, directly or indirectly, use the proceeds of the Loans or Letters of Credit, or lend, contribute or otherwise make available such proceeds to any subsidiary, joint venture partner or other Person, [(i)] to fund any activities or business of or with any Person, or in any country or territory, that, at the time of such funding, is the subject of Sanctions [except to the extent permissible for a Person to comply with Sanctions] [, or (ii) in any other manner that would result in a violation of Sanctions by any Person (including any Person participating in the Loans or Letters of Credit, whether as Administrative Agent, Arranger, Issuing Bank, Lender, underwriter, advisor, investor, or otherwise)]."

A knowledge qualifier (borrower will not "knowingly," directly or indirectly, use the proceeds…), which avoids covering activities by a party several transactions removed from the borrower, is frequently a point of negotiations with borrowers. U.S. lenders worry about adding such language because U.S. sanctions prohibitions, including facilitation prohibitions, typically have no knowledge requirement. Some agreements contain the compromise language "will not, directly, or to the Borrower's knowledge, indirectly" while in other agreements, lenders refuse to include any knowledge qualifiers because of the potential risk that OFAC could hold them liable for a downstream use of the loan proceeds that involves sanctions targets.

C. "Clean Hands" Covenant

> "The Borrower will not fund all or part of any payment under the Credit Agreement out of proceeds derived from transactions that violate Sanctions."

The above covenant is not regarded by the LSTA as typical, especially where due diligence has not identified any involvement of sanctions targets and the lenders obtain a “status under sanctions” representation. As described above, it is generally permissible for a U.S. Person to receive payment from a non-U.S. Person that conducts some business, and receives some revenue from, sanctions targets, assuming that the U.S. lender has conducted due diligence regarding the level of business conducted by the borrower that involves sanctions targets and confirmed that it is *de minimis* given current OFAC posture on the jurisdictions or sanctions targets involved.

D. Assurances Regarding Compliance With Sanctions Regulations

It is becoming more common for lenders to require specific representations and/or covenants regarding the borrower’s compliance with certain sanctions regimes (in addition to the general “compliance with laws” representations and covenants, which are often subject to “material adverse effect” qualifiers). Although lenders would not be liable in respect of a borrower’s past sanctions violations or any future violations that do not involve the proceeds of the loan, they will be concerned about potential reputational risks of an association with a borrower that has violated sanctions or has demonstrated a culture of non-compliance or lack of sophistication in sanctions matters. Even more critically, where non-U.S. borrowers are involved, U.S. lenders should consider the inclusion of specific representations and/or covenants regarding OFAC sanctions compliance by the borrower. This is because non-U.S. Persons which are unaffiliated with U.S. Persons are generally not required to comply with OFAC sanctions programs as a matter of law (being outside of U.S. jurisdiction). Therefore, a general “compliance with applicable law” representation will not impose OFAC sanctions compliance obligations on a non-U.S. borrower. The specific representation and/or covenant in the loan documentation creates a contractual right in favour of the lender for which the lender may be able to bring a claim in the event of a sanctions violation by the borrower. If included, a sanctions compliance representation or covenant may contain a materiality qualifier. Whether to include such provisions, and their precise language and coverage, will depend on various factors, including the identity of the borrower and the nature and location of its operations.

The LSTA’s template form of credit agreement includes the following “sanctions compliance” assurances:

Representation

> “The Borrower, its Subsidiaries [and their respective directors, officers and employees] [and, to the knowledge of the Borrower, the agents of the Borrower and its Subsidiaries,] are in compliance with all applicable Sanctions in all material respects. The Borrower and its Subsidiaries have instituted and maintain policies and procedures [reasonably] designed to [promote/achieve/ensure] compliance with applicable Sanctions.”

Covenant

> “The Borrower will maintain in effect policies and procedures [reasonably] designed to [promote/achieve /ensure] compliance by the Borrower, its Subsidiaries, [and their respective directors, officers, employees, and agents] with applicable Sanctions.”

Conclusion

Given the complexity and breadth of the issues, and the substantial risks faced by lenders for non-compliance with sanctions regulations, international lenders must be cognizant of the sanctions risks that may arise in lending transactions, and they must duly mitigate these risks through due diligence and appropriate contractual provisions in credit agreements. The ultimate goal is not only to avoid sanctions violations, but to establish a documentary record demonstrating that the lender's compliance efforts were appropriate to the risk presented by the particular transaction. Under the OFAC sanctions programs, applicable records must be kept for a minimum of five years.

The LSTA, like the LMA, acknowledges that there is no "one size fits all" language appropriate to sanctions-related representations and covenants across individual loan transactions. Lenders should consider their risk tolerance in a particular transaction, given the identity of the borrower, its industry, and where it conducts business, among other factors.

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