KEY POINTS

- With focus turned to sanctions, market participants may well revisit the terms of Facilities Agreements and Secondary Debt Documentation to enhance protections for parties against the imposition of sanctions on their contractual counterparties.
- Much commentary has been written about the impact on financings of a borrower entity being the subject of sanctions; in this article we focus on the challenges created for a debt-financing arrangement or a secondary debt trade as a result of a syndicate lender or other finance party, such as the facility agent, being the subject of sanctions.
- We consider commonplace terms in market-standard facilities agreements to analyse this impact as well as forms of secondary debt trading documentation that are commonly adopted in the secondary debt trading market.
- This Spotlight article makes a handful of suggestions as to how documentation may be revisited in the context of sanctions, for example the introduction of an "Impaired Lender" concept or provisions to facilitate the orderly exit of a Sanctioned Lender from the syndicate. However, these suggestions should be considered on the basis that a variety of commercial drivers specific to each financing dictate how Facilities Agreements and Secondary Debt Documents are drafted.

Authors Luka Lightfoot, James Clarke and Natalie Butchart

I would if I could, but I can't: the impact of sanctions on finance party interactions in typical debt-financing transactions

Recent events have thrown the spotlight on sanctions. Sanctions provisions in facilities agreements are frequently keenly negotiated, and most lenders have minimum requirements. We typically see lenders focus more on the activities of the obligor group and its business than on the other lenders and finance parties to the transaction. Accordingly, we anticipate many of our clients revisiting their sanctions policies and giving greater weight to mitigating risks associated with any party to a transaction becoming the subject of sanctions, not just members of the obligor group.

This Spotlight article analyses the impact on a lender (which, for the purposes of this article, we assume to be a financial institution) of the application of sanctions (defined below) on another lender or finance party (again, which we assume to be a financial institution) with which it has transacted. We consider commonplace terms in market-standard facilities agreements (Facilities Agreement) to analyse this impact. We also consider forms of secondary debt trading documentation that are commonly adopted in the secondary debt trading market (Secondary Debt Documents) to analyse the impact of a counterparty becoming the subject of sanctions.

In this article, we use a definition of "sanctions" that we consider to be widely adopted by parties to English law governed finance documents in the European markets, as follows:

"Sanctions" means the economic or financial sanctions laws, regulations, trade embargoes or other restrictive measures enacted, administered, implemented and/or enforced from time to time by any of the following:
(a) the United Nations;
(b) the European Union;
(c) the government of the United States of America; and
(d) the government of the United Kingdom.

IMPACT ON THE SYNDICATE

Sanctioned Lender: payment from borrower permitted

If a member of the lender syndicate becomes the target of sanctions (a Sanctioned Lender), but:

- both the borrower and the facility agent are permitted under applicable law to continue making payments to that Sanctioned Lender; and
- the Sanctioned Lender is permitted under applicable law to continue to perform all of its obligations under the Facilities Agreement or to fund or maintain its participation in all loans made thereunder (eg the Sanctioned Lender is placed on a SSI (Sectoral Sanctions Identifications) List or is otherwise subject to lending and capital markets measures only),

then the borrower will likely be compelled to continue making scheduled payments under the Facilities Agreement to the facility agent. The facility agent will be obliged to turn over the Sanctioned Lender's portion of each payment, subject to the terms of the Facilities Agreement. Unless specifically addressed under the terms of the Facilities Agreement, no party can compel the Sanctioned Lender to transfer its rights and obligations to another financial institution, nor compel its commitment to be prepaid.

Sanctioned Lender: payment from borrower *not* permitted

If the borrower is precluded by the implementation of sanctions from making a payment to the Sanctioned Lender

Biog box
Luka Lightfoot is a partner in the Baker McKenzie London Banking team where he advises lenders, sponsors, borrowers and ECAs on a wide variety of international and emerging markets financing transactions and restructurings. He is primarily involved in cross-border export and project finance, structured trade finance, emerging markets syndicated lending and restructuring. Email: luka.lightfoot@bakermckenzie.com

(eg the Sanctioned Lender is placed on the US SDN (Specially Designated Nationals) List), and accordingly does not make available to the facility agent the full amount of the next repayment instalment when due, then unless the Sanctioned Lender transfers its commitment to another financial institution before that repayment date (which may not be lawful under applicable sanctions), an event of default will occur on that repayment date. The facility agent, acting on the instructions of the requisite majority of lenders (which may be calculated taking into account the Sanctioned Lender's commitments), will be able to exercise its acceleration rights. A waiver of this event of default would typically require the consent of all of the lenders (including the Sanctioned Lender). Perhaps somewhat frustratingly for the facility agent and the lenders that are not the subject of sanctions, not only is the facility agent typically precluded from paying those lenders their share of the repayment instalment, as partial payments are usually required to be applied pro rata among all of the lenders, but it may be likely in these circumstances that in order to avoid indirectly facilitating a breach of sanctions the borrower would refuse to make any payment if there was a risk that some of that payment would be paid over to the Sanctioned Lender. Many Facilities Agreements contain rights to amend the Facilities Agreement following a "Disruption Event" or similar, but this is typically reserved for events of a technical or systems-related nature. Unless specifically amended to address this particular circumstance, typical single-lender replacement rights are also of no help – these are usually restricted to lenders who are required to charge a borrower higher finance costs because of their tax status or because they must pass on increased costs imposed by regulations to the borrower.

Sanctioned Lender: payment from borrower permitted but payment from facility agent prohibited

If the borrower is permitted to make a payment to the facility agent, but the facility agent is precluded from making a payment to the Sanctioned Lender (eg because the facility agent is incorporated in a jurisdiction that has imposed sanctions on the Sanctioned Lender but the borrower is incorporated in another jurisdiction that has not[1]), then it is most likely that no event of default will occur. However, the facility agent may be in breach of contract (specifically, in respect of its obligations to distribute repayment proceeds to all lenders pro rata to their commitments) unless it can rely on general provisions protecting it from having to take any action that it reasonably believes to be prohibited by applicable law or regulation or can successfully raise defences such as illegality or frustration.

In the worst-case scenario, a Sanctioned Lender that is also the majority lender (or whose commitment tips the balance in favour of one group of lenders) can require the facility to be accelerated (albeit this seems unlikely especially where sanctions preclude the facility agent from sharing any enforcement recoveries with the Sanctioned Lender). However, it may be more likely that a Sanctioned Lender would wish to exit the syndicate – either by selling its commitment to another bank or financial institution (if it no longer wishes to participate in the financing) or by selling its commitment to another bank or financial institution and then entering into a funded participation (as participant) with that other bank or financial institution (if it still wishes to participate in the financing). The parties will be mindful of two deadlines – the next repayment date and grace periods under applicable sanctions that permit parties to transact with the Sanctioned Lender in order to achieve an exit or otherwise wind down the relationship. Finding a replacement lender who would be willing to transact with the Sanctioned Lender may be a further challenge.

Sanctioned agent

We are increasingly seeing borrowers requesting the inclusion of impaired facility agent provisions. The impaired facility agent provisions permit obligors and lenders to make payments directly to the intended recipient (rather than via the facility agent) or to make a payment into a trust account. If a facility agent becomes impaired, the syndicate lenders will be keen to exercise their rights to replace the facility agent in order to revert to the customary repayment mechanics of parties making payments via the facility agent. Where a member of the syndicate is a Sanctioned Lender, these provisions are helpful to a borrower because for such time as the facility agent is impaired the borrower may be able to avoid a payment default by paying a Sanctioned Lender's portion of finance charges into a trust account, but troubling for non-sanctioned lenders, who will be concerned that the borrower may exercise its discretion to pay all of the repayment instalment into a trust account. Accordingly, syndicate lenders will usually wish to replace an impaired facility agent as swiftly as possible.

IMPACT ON PARTICIPATIONS

If a participant (Participant) or a grantor or seller – ie the lender of record (Grantor), becomes the subject of sanctions in the period between the trade date and the settlement date, the other party will likely want to pull out of the trade. Although some Secondary Debt Documents provide for termination rights if a party becomes insolvent during the period between the trade date and the settlement date, it is not customary for Secondary Debt Documents to provide for termination rights if a party becomes the subject of sanctions during this period. In such a scenario, if the sanctioned party wished to continue the trade but the counterparty did not, such counterparty may be liable to the sanctioned party for breach of contract if it failed to consummate the trade, but it may be able to rely on certain defences such as illegality or frustration.

Funded participations

Where a party to a funded participation becomes the subject of sanctions, the other party will likely seek to exit the funded participation. If the subject of sanctions is the Participant (a Sanctioned Participant), the Grantor may be able to rely on the termination provisions if the imposition of sanctions has resulted in the Sanctioned

Biog box
James Clarke is a senior associate in the Baker McKenzie London Banking team with particular expertise in trade and commodity finance, including in full and limited recourse receivables financing, warehouse financing, supply chain financing, risk distribution, pre-export finance facilities and borrowing base facilities.
Email: james.clarke@bakermckenzie.com

Participant breaching a material term of the funded participation or making a misrepresentation (although we note that most Secondary Debt Documentation either does not require either party to give representations as to sanctions or contains only a representation as to maintaining sanctions-related policies and procedures). Once any applicable remedy period has expired, the Grantor can cancel the funded participation and sell it for fair market value on arm's length terms. The Grantor must account to the Sanctioned Participant for an amount equal to the proceeds of such sale (after deducting reasonable costs and expenses). However, Grantors in this scenario face a number of challenges. Terminating a funded participation by selling it in the open market is only possible if there are parties interested in purchasing the funded participation. This might not be the case if the borrower or another obligor is also the subject of sanctions or has or is about to enter into an insolvency process. Also, because of the Grantor's requirement to account to the Sanctioned Participant for the sale proceeds, terminating the funded participation does not address the issue of the Grantor being precluded from making payments to the Sanctioned Participant by the imposition of sanctions.

Another option available to the Grantor is to exercise its rights of elevation (which may upgrade a funded participation to a true sale following which the Sanctioned Participant will replace the Grantor as the lender of record). However, elevating a funded participation also presents some challenges. The obligations on parties to effect elevation in funded participation agreements are usually soft, requiring "reasonable efforts" or "reasonable endeavours" only. Any elevation is also subject to transfer documentation under the underlying loan agreement being executed, and most market-standard documents:

- provide that such transfer documentation is only effective if also signed by the facility agent; and
- allow the facility agent to refuse to execute such transfer documentation by conferring on the facility agent wide discretions to protect it from taking actions which it believes to be contrary to applicable law or regulation.

This could place the Grantor in the invidious position of being unable to terminate the funded participation because of the challenge of arranging for the necessary documentation to be executed. In such a scenario, the Grantor may be liable for breach of contract if it fails to make payment to the Participant under the funded participation agreement but may be able to rely on certain defences such as illegality or frustration.

Where the Grantor becomes the subject of sanctions (a Sanctioned Grantor), the non-sanctioned Participant will face similar challenges as those described above. However, crucially, in this scenario the non-sanctioned Participant will be out of the money – it is neither receiving payments in respect of its participation nor able to have its funded participation returned to it. It is likely that the termination provisions will not be exercisable by the Participant (as these are customarily held by the Grantor only) and so the Participant's only option is to elevate. Again, similar problems will be faced in the execution of the necessary documentation – importantly the Participant is not required to pay the settlement amount ahead of the facility agent executing the transfer documentation. In any event, it will need to be determined whether or not the Sanctioned Grantor can return (and the Participant can accept) the Participant's funded participation. Additionally, if the borrower is the subject of sanctions, becoming a lender of record may not put the Participant in a better position.

Risk participations

Elevation is not available under a Risk Participation. Most termination provisions are similar to those under the funded participation agreement – exercisable by the Grantor only upon material beach or misrepresentation.

Assignability

Although both funded participation agreements and risk participation agreements permit the parties to assign their rights or transfer their rights and obligations, the other party's consent is usually required. Any party wishing to assign or transfer may face challenges in identifying a willing transferee, and accordingly is unlikely to be able to transfer at par.

Set-off

Where parties have entered into both a funded participation and a risk participation in connection with the same credit documentation, the set-off clauses included in the funded participation agreement and risk participation agreement will need to be examined carefully to determine if they would allow one party to exercise contractual set-off in respect of the parties' obligations under that funded participation agreement and risk participation agreement. Equitable rights of set-off may apply, but legal advice should be sought to analyse whether the legal requirements have been met for doing so, which are outside the scope of this article.

SANCTIONS REVISITED

With focus turned to sanctions, market participants may well revisit the terms of Facilities Agreements and Secondary Debt Documentation to enhance protections for parties against the imposition of sanctions on their contractual counterparties. We set out below a handful of areas that may attract more consideration.

Facilities Agreement

- Borrowers or lenders may wish to amend the Facilities Agreement to introduce an Impaired Lender concept, where the borrower can make a payment to an individual lender either directly (if the facility agent is unable to do so) or into a trust account (if neither the borrower nor the facility agent can make such a payment). Similarly, the facility agent could be given the right to make a payment into a trust account if it is prohibited from paying a Sanctioned Lender.

Spotlight

Biog box
Natalie Butchart is the lead knowledge lawyer for the Baker McKenzie Global Banking & Finance team. Email: natalie.butchart@bakermckenzie.com

- The "Disruption Event" concept could be the blueprint for the creation of a similar provision allowing amendments to be made to the Facilities Agreement to permit payments to be made to a Sanctioned Lender, or to facilitate that Sanctioned Lender's orderly exit from the syndicate.
- An ability for a borrower to prepay or replace a single lender usually only applies if that lender is entitled to gross-up payments or increased costs. Borrowers and lenders alike may consider allowing the borrower to force a Sanctioned Lender, or a lender that is reasonably likely to become a Sanctioned Lender, to transfer its commitment or to be prepaid.

Secondary Debt Documents

- The suite of representations given by both Grantor and Participant could be widened to include a representation as to not being the subject of sanctions. This may allow the parties to exercise termination rights for misrepresentation.
- The elevation timetable could be accelerated, compelling a party that is about to be the subject of sanctions to unwind a participation.
- Provisions governing automatic termination on insolvency, which are standard in the market, allowing the termination of a trade which has no realistic prospect of settlement because one of the parties is insolvent, could be broadened to also allow termination if a party becomes the subject of sanctions.

A variety of commercial drivers specific to each financing dictate how Facilities Agreements and Secondary Debt Documents are drafted, and the above considerations are only a handful of suggestions as to how documentation may be revisited in the context of sanctions and how the risk of the imposition of sanctions on parties might be allocated among those parties. However, given the recently renewed attention given to the impact of sanctions on financing transactions, we anticipate heightened scrutiny of sanctions provisions in the months to come and greater instances of deviation from the more commonly seen sanctions provisions adopted in recent times. ■

1 This is on the understanding that the contractual terms in such situation (albeit this is not always the case) limit the application of sanctions to only those measures which are applicable to the relevant parties within the jurisdiction.

Further Reading:

- Arms to Iran or a Cuban cigar? A risk sensitive approach to sanctions for the loan market (2014) 8 JIBFL 501.
- Sanctions clauses in loan agreements (2020) 9 JIBFL 592.
- LexisPSL: Banking & Finance: Practice Note: The effect of sanctions on loan agreements.