

# Fund Finance Friday



## Addressing Russia Sanctions Risk

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By **Kurt Oosterhouse**  
Partner | Fund Finance

It happened in an instant. Almost overnight Russia, the world's eleventh-largest economy, was transformed from an important player in global financial markets – both as a destination for investment and a source of capital – into a country shunned by much of the international community. In response to Moscow's invasion of Ukraine, the United States, European Union, and United Kingdom, along with a host of other countries, have imposed crushing economic sanctions impacting nearly every corner of Russia's economy.

The measures that have been adopted reflect the growing “arsenal” of economic sanctions available to regulators. This includes categorical “blocking” sanctions, which generally prohibit any dealings with specific designated parties (and entities they own), as well as more limited “sectoral” sanctions, which ban some dealings with the target (e.g., related to their new debt or equity), but not others. In some cases, non-U.S. parties risk being targeted by sanctions themselves, if they continue to do business with a sanctioned person (so-called “secondary sanctions”).

With respect to Russia, sanctions targets to date have included some of the country's largest banks and corporations, as well as the Central Bank and Ministry of Finance, and President Vladimir Putin himself. There are also prohibitions on dealings in the country's sovereign debt, as well as the importation of oil and other energy products. In addition, sanctions have targeted some of Russia's wealthiest individuals, and, by extension, the companies and assets in which they own a 50 percent or greater interest.

### Bankers' Burden

Financial institutions unavoidably stand on the front lines of sanctions compliance, managing as they do the flow of funds around the world. And memories have not faded of the criminal and civil settlements agreed by many banks over the last decade or so, arising from sanctions compliance lapses. Many of those cases involved alleged practices that turned a blind eye towards, or actively concealed, the involvement of sanctioned persons in funds transfers and other activities, with penalties totaling in the hundreds of millions and billions of dollars. Accordingly, the stakes are high for financial institutions, as they seek to navigate the recent slate of sanctions on Russia.

Fund finance is no exception, and problems can arise in myriad ways. Most obviously, if a borrower is sanctioned, the lender's provision of funds will of course be prohibited. And the result may be the same if the borrower is owned or controlled by a sanctioned person – depending on the extent of the ownership or control, and on the type of sanctions involved. Even admitting a sanctioned investor into a borrower fund can have significant sanctions implications. (Indeed, it has been **reported** that in recent days at least one private equity firm has cut ties with a sanctioned Russian oligarch.) Sanctions also may be violated if the borrower uses the lender's funds to do business with sanctioned parties, or if the borrower repays its obligations using funds that are obtained from a sanctioned person. To make matters worse, sanctions violations are based on strict liability, meaning that a financial institution could be on the hook for the actions of its borrower, even if it had no knowledge of the relevant conduct.

### What to Do?

While sanctions risk can almost never be eliminated entirely, it can often be mitigated through effective diligence, contractual protections, and foresight.

**Do your diligence.** Ensuring sanctions compliance begins with a clear understanding of risk. In fund finance, key considerations include the ownership and control of the borrower and potentially other relevant parties (guarantors, investment advisers, feeder vehicles, etc.), as well as the borrower's line of business, geography, and use of funds. A fund investing domestically in U.S. real estate generally presents significantly less risk than funds investing in oil in the Caribbean, for example, due to potential exposure to Venezuela sanctions. In the current climate, connections to Russia, as well as Belarus, must be closely scrutinized and may present unacceptable risk.

Risks identified through diligence should be carefully evaluated, and further inquiries should be made, as needed. Such inquiries, and their responses, should be documented for future reference, and as support for the bank's funding decisions – as well as evidence of its efforts to effectively control sanctions risk, which will be of keen interest to regulators should any issues later arise.

**Get it in writing.** In addition to conducting appropriate diligence, lenders have developed a catalogue of sanctions-related contractual representations, warranties, and covenants. While specific language varies, these contractual protections cover key sanctions topics, including (i) the status under sanctions of the borrower and related parties; (ii) compliance with sanctions; and (iii) use of funds, and direct or indirect dealings with sanctioned persons.

Contractual protections should be flexible enough to accommodate changes to sanctions laws. For example, any list of "sanctioned territories" should be qualified so that it also covers any new countries and regions targeted by sanctions during the life of an agreement (like the recently sanctioned separatist regions of Ukraine referred to as the Donetsk People's Republic and the Luhansk People's Republic), rather than remaining static. As recent events demonstrate, sanctions can change suddenly, and new prohibitions often have immediate effect.

Strong contractual provisions confirm the parties' mutual understanding of essential facts and, when breached, they provide (or should provide) the basis to declare an Event of Default. This can help avoid significant issues in the future, for example by ensuring that a lender is not contractually obligated to continue providing funds to a borrower after the borrower is sanctioned. Contractual protections unfortunately cannot immunize a lender from potential liability for the actions of its borrower. However, along with diligence, they can help to demonstrate to a skeptical regulator the seriousness with which the lender approached sanctions compliance, in case any issues arise.

**Think broadly.** In addition to ensuring legal compliance with current sanctions, lenders must consider whether they are willing to allow borrowers to do legally permissible business with parties that are subject to only limited sanctions, or who are affiliated with sanctioned parties (but not themselves sanctioned). For example, China-related sanctions imposed in late 2020 restrict transactions on the purchase or sale of publicly traded securities, but they do not prohibit other dealings with the sanctioned companies. Thus, a borrower could permissibly enter into a supply agreement with these sanctioned companies without risking legal exposure for itself or the lender.

In the case of recent Russia sanctions, however, we have already seen that yesterday's partially sanctioned firm might be targeted by full blocking sanctions tomorrow. For example, in 2014 VTB Bank Public Joint Stock Company ("VTB") was targeted by limited "sectoral" sanctions on dealings in its new debt and equity. Now, VTB is fully blocked, and all dealings with it are prohibited absent a valid authorization. In addition, continued dealings with partially sanctioned parties – even where legally permitted – can have reputational consequences that many lenders may want to avoid. Borrowers have historically resisted prohibitions on legal dealings with partially sanctioned parties, but the current sanctions on Russia change the risk calculus. Given the widespread public demonstrations in support of Ukraine, and the flight of many U.S. and European companies from Russia, lenders can be expected to take a closer look at such carve-outs.

## **Conclusion**

In this period of upheaval and rapid change, tread carefully with respect to dealings with or involving Russian or Russia-affiliated parties, and keep abreast of developments affecting the constantly evolving sanctions landscape.