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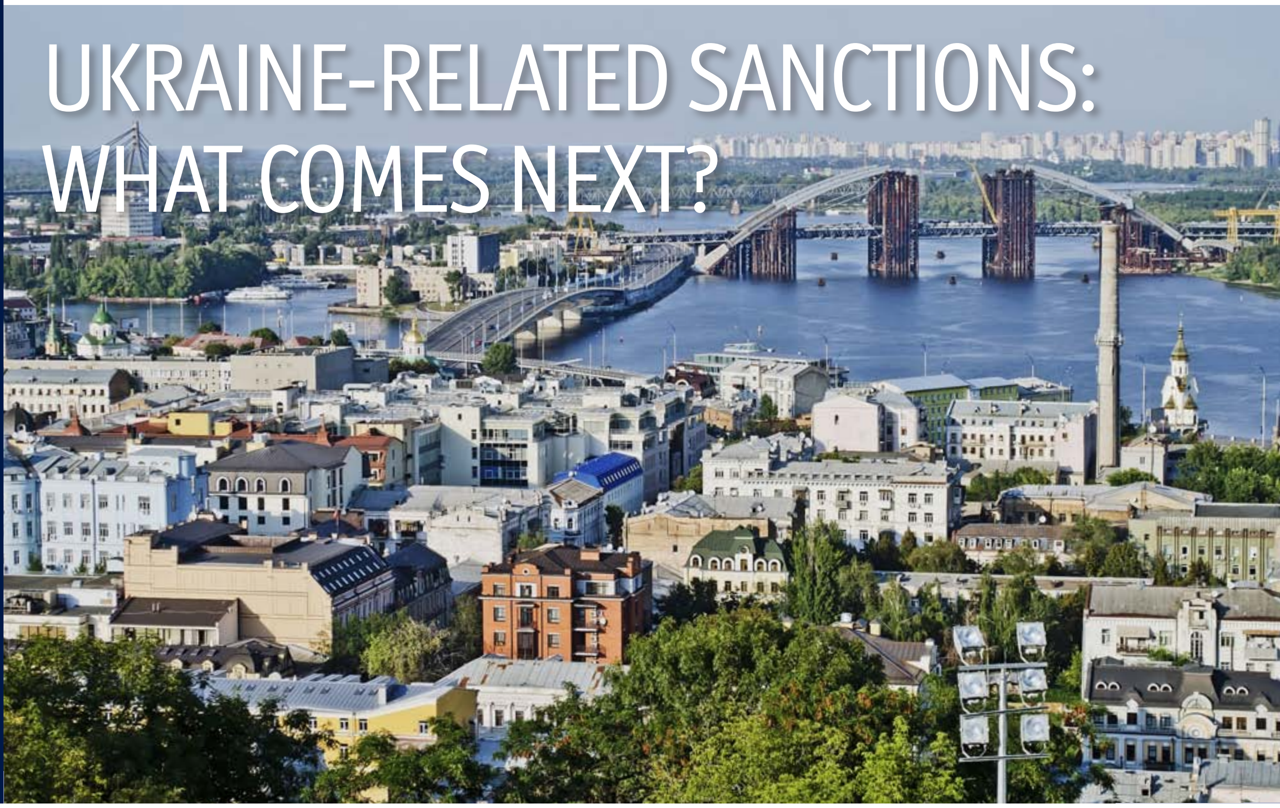
UKRAINE-RELATED SANCTIONS: WHAT COMES NEXT?



With limited signs of diplomatic progress in Ukraine, despite the imposition of multiple phases of sanctions by the EU, US and other countries, including Switzerland, Australia and Canada, businesses which trade with Russia or Ukraine need to plan against the risk that further sanctions could be imposed if there is any escalation of the current crisis.

That will involve looking carefully not only at counterparties, including their shareholders and key individuals, but also the relevant contractual terms, so that a strategy can be worked out in advance of any further sanctions being imposed.

"Phase 1" restrictions

As we explained in our Briefings on 3 and 7 March, the so-called "Phase 1" measures in the EU and the US focused on those individuals who had been accused of "embezzlement of Ukrainian state funds" (EU sanctions) or "undermining democratic processes in Ukraine" or "misappropriating Ukraine's assets" (US sanctions).

At the time, 18 Ukrainian individuals were designated by the EU. While the legal framework was in place from 6 March, the US designations did not follow until 17 March, at which time four individuals were designated. The Swiss authorities designated 20 individuals on 26 February 2014.

"Phase 2" restrictions

The so-called "Phase 2" measures expanded the restrictions, to include sanctions targeted at Russian officials, businessmen and a Russian bank.

On 20 March, the US listed 20 individuals and one entity, including Russian governmental officials, Russian businessmen (Arkady Rotenberg and Gennady Timchenko) and Bank Rossiya, the first entity to be designated.

The EU adopted its own Phase 2 measures on 17 March, listing 21 individuals, including Russian politicians and military personnel, and a further 12 individuals on 21 March. On 19 March, Australia said that it would impose travel bans and asset freezes against 12 Russian and Ukrainian individuals.

At the same time, Russia imposed retaliatory sanctions against nine US governmental officials and 13 Canadian governmental officials.

Effect of Phase 1 and Phase 2 restrictions

The second phase of EU and US designations was designed to increase the pressure on Russia, by virtue of the individuals and entities who were named in the Phase 2 measures. By way of example, press reports on 21 March indicated that Visa and MasterCard had stopped providing services for clients at Rossiya Bank following the designation of that bank.

The Phase 1 and Phase 2 measures are limited to a travel ban and an asset freeze. The asset freeze not only freezes the designated persons' funds and economic resources, but also makes it an offence to make funds or economic resources available to the designated persons, meaning that businesses which trade with Russia or Ukraine need to carry out due diligence to check that their transaction does not have any direct or indirect connection with a sanctioned individual or entity.

One key issue (and challenge for businesses seeking to comply with the EU and US sanctions) is establishing the breadth and depth of designated individuals' and entities' shareholdings in other non-designated entities, particularly as the Office of Foreign Assets Control (OFAC) in the US adopts a policy that an entity in which a blocked entity has a shareholding of 50% or more will itself be treated as a blocked entity.

Both the EU and the US have indicated that more sanctions will be imposed if the situation in Ukraine deteriorates, particularly if Russia intervenes in eastern Ukraine. So what might these "Phase 3" measures look like?

Potential "Phase 3" restrictions

The US has already signalled an intention to designate commercial organisations and, in particular, persons who operate in "such sectors of the Russian Federation economy as may be determined ... such as financial services, energy, metals and mining, engineering and defense".

It is important to stress that no individual or entity has so far been designated under the relevant Executive Order, but it does give a clear sense of where the US might look next and, by extension, those sectors which should be looking particularly closely at their exposure to the Russian market.

The EU position is more complicated and more difficult to predict. The EU is of course more reliant on trade with Russia than the US is, and there are also differences within the EU. For example, Germany is Russia's biggest trade partner in the EU and the biggest buyer of Russian gas. It has been reported in the press that more than 6,000 German firms are operating in Russia and that 300,000 jobs in Germany depend on trade with Russia.

If the EU were to consider sanctions against Russia, then the critical issues to resolve would seem to relate to finance, defence and energy. Within the EU, the UK probably has the most to lose if financial sanctions are imposed against Russia, France has hugely valuable defence contracts with Russia, and sanctions in the energy sector would cause Germany problems.

Recommendation

Given the continuing uncertainty, businesses which trade with Russia and Ukraine should look carefully at their counterparties, to assess the risk that the counterparties might be added to a sanctions list. Where the precise shareholding or ownership is unclear, it might be prudent to carry out some additional due diligence now, so that the position is clarified in advance of any further measures.

In light of the risk that the scope of sanctions might be broadened to cover more types of commercial dealing, businesses should also look carefully at their contracts, to consider whether there are express sanctions clauses, which might vary the parties' contractual obligations, or give rise to a right to suspend performance or even terminate the contract, in the event that additional sanctions are imposed. Alternatively, more general clauses, such as force majeure, might operate in the circumstances.

Given the continuing uncertainty, businesses which trade with Russia and Ukraine should look carefully at their counterparties, to assess the risk that the counterparties might be added to a sanctions list.



A careful review of the contracts at this stage may allow a considered strategy to be formulated in advance, rather than waiting for sanctions to be imposed.

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What is clear, is that any business with any exposure to Russia or Ukraine should carefully monitor the situation, so that it is not caught out by any sudden developments.

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