CELESTIAL – WHEN IS AN "AUTONOMOUS" PAYMENT OBLIGATION NOT QUITE "AUTONOMOUS"?

In June the Court of Appeal handed down judgment in a case which will be of significance to all those involved in the movement, financing, and insurance of goods around the world.

In *Celestial Aviation Services Limited v Unicredit Bank GmbH, London Branch* the Court has considered the application of Russian sanctions in the context of payment obligations under standby letters of credit, scrutinising the operation of such legally distinct contracts, including guarantees, trade finance products and reinsurance, in the context sanctions.

Background

The claimants, Celestial Aviation Services Limited (**Celestial**) and Constitution Aircraft Leasing (Ireland) 3 Limited/Constitution Aircraft Leasing (Ireland) 5 Limited (**Constitution**), were Irish-incorporated aircraft lessors. Both were seeking payment as the beneficiaries of standby letters of credit (**LCs**) issued in respect of aircraft leases agreed with Russian companies between 2005 and 2014. The standby LCs were payable in US dollars and governed by English law. The Russian bank, Sberbank Povolzhsky Head Office (**Sberbank**), issued the LCs between 2017 and 2020, and the London branch of the Defendant, UniCredit Bank AG (**UniCredit**), confirmed them.

As the confirming bank, UniCredit had agreed to perform the principal duties of Sberbank and it was common ground between all parties that the demands for payment made by the claimants in March 2022 were valid. However, UniCredit withheld payment on the grounds that Russian sanctions imposed by the UK, EU, and US prevented them from honouring the claims.[1]

The Law

Regulation 28(3) of the Russia (Sanctions) (EU Exit) Regulations 2019 (the UK Russia Regulations) states:

"A person must not directly or indirectly provide financial services or funds in pursuance of or in connection with an arrangement whose object or effect is:

(a) the export of restricted goods to, or for use in, Russia;

(b) the direct or indirect supply or delivery of restricted goods to a place in Russia;

(c) directly or indirectly making restricted goods or restricted technology available

(i) to a person connected with Russia, or

(ii) for use in Russia;

(d) the transfer of restricted technology

(i) to a person connected with Russia, or

(ii) to a place in Russia; or

(e) the direct or indirect provision of technical assistance relating to restricted goods or restricted technology

(i) to a person connected with Russia, or

(ii) for use in Russia."

Section 44 of the Sanctions and Anti-Money Laundering Act 2018 (**SAMLA**) states:

"(1) This section applies to an act done in the reasonable belief that the act is in compliance with —

(a) regulations under section 1, or

(b) directions given by virtue of section 6 or 7.

(2) A person is not liable to any civil proceedings to which that person would, in the absence of this section, have been liable in respect of the act.

(3) In this section "act" includes an omission."

The UK Russia Regulations were enacted pursuant to section 1 of SAMLA and the section 44 defence can therefore apply in appropriate circumstances in respect of acts undertaken in the reasonable belief that they are in compliance with the requirements of those regulations.

First Instance Decision

In April 2023, the High Court held that:

- Standby LCs are separate from any underlying transaction.
- Any obligation of Sberbank and lessees towards the claimants that may be discharged by UniCredit's payment was a wholly "collateral matter".
- Regulation 28(3) of the UK Russia Regulations did not prevent payment under the standby LCs.
- Sanctions do not apply retrospectively to a transaction.
- Payment under the standby LCs in US Dollars was still possible, as it could be made in cash and not through a US correspondent bank.
- No relevant US sanctions were in place when the payment obligation accrued towards Celestial (while noting that some later payments to Constitution may be caught by US sanctions).
- UniCredit could not rely on any defence under section 44 of SAMLA. While the High Court found that UniCredit had a subjective belief that payments under the LCs would breach sanctions, this was not an objectively reasonable belief.

Court of Appeal

UniCredit appealed the first instance decision, raising four issues:

- Whether payment under the standby LCs by UniCredit would have been "in connection with" an arrangement which had the object or effect of supplying aircraft to or for use in Russia, or to a Russian person, and so prohibited by Regulation 28(3) of the UK Russia Regulations.
- If that prohibition did not apply, whether UniCredit nonetheless has a defence under section 44 of SAMLA, on the basis that its belief that it was complying with the UK Russia Regulations was reasonable.
- Whether the question of illegality under the US sanctions regime was engaged under the Ralli Bros principle (*Ralli Bros v Compañia Naviera Sota y Aznar* [1920] 2 KB 287) on the basis that effecting payment in US Dollars required the involvement of a correspondent bank in the United States.
- If the US sanctions regime was engaged, whether payment in accordance with the demands under the standby LCs would have been illegal under that regime.

Regulation 28(3) of the UK Russia Regulations

The Court of Appeal overturned the High Court's assessment of Regulation 28(3) of the UK Russia Regulations. The Court of Appeal found, on an ordinary meaning of the words used in the prohibition, that the prohibition

1 For a full analysis of the first instance decision please access our article which may be found here.

"The Court of Appeal concluded that there was no inherent obligation on Unicredit to pay in cash or use an alternate currency under a standby LC where it had set out and confirmed a specific and express method of payment."

would have prevented UniCredit from paying under the standby LCs. This is on the basis that the prohibition applies to the provision of *"financial services or funds in pursuance of or in connection with an arrangement"* that directly or indirectly makes restricted goods available to a person connected with Russia or for use in Russia. The Court of Appeal concluded that the phrase *"in connection with"* was the broadest possible term that could be used in the prohibition and that this would encompass transactions where the goods had been provided prior to the imposition of sanctions if funds or financial services were provided after the imposition of sanctions. In essence, for Regulation 28(3) of the UK Russia Regulations to apply, there simply needs to be a *factual* connection to a relevant arrangement. The scope of the prohibition is not limited to circumstances where there is a *legal* connection to a relevant arrangement.

While adopting a closer textual analysis than the High Court, the Court of Appeal held that the purpose of the UK Russia Regulations was to put pressure on Russia and that they do so by *'cast[ing] the net sufficiently wide to ensure that all objectionable arrangements are caught.'* Regulation 28(3) is therefore a *'relatively blunt instrument'* but unintended negative consequences are addressed to the extent deemed necessary by exceptions and licensing grounds. There is no basis to limit a reading of Regulation 28(3) to future supplies of goods.

Section 44 SAMLA

Having found for UniCredit in respect of Regulation 28(3) of the UK Russia Regulations, the Court of Appeal addressed the applicability of section 44 of SAMLA in obiter comments.

Again, the Court of Appeal disagreed with the view taken by the High Court.

To rely on section 44 of SAMLA, the Court of Appeal reconfirmed that:

- Section 44 operates as a defence to civil liability; and
- A party must have subjectively believed it would have been acting in breach of sanctions and that such belief was objectively reasonable.

The Court of Appeal concluded it is not necessary for a party to "show its workings" and the reasonableness of the belief should be assessed objectively. The novelty of the relevant legislation and the time available to reach a decision on how best to comply are relevant factors and determinations on section 44 of SAMLA should not be made from a position of hindsight pursuant to which clarity can often be inferred in circumstances in which such clarity would not have been possible at the relevant time.

The Court of Appeal does, however, indicate that this defence can only be relied upon until licences are obtained. The court did not address whether a party looking to avail itself of the section 44 defence was under an obligation to pursue a licence application, although this may be inferred from the language of the judgment.

Section 44 of SAMLA cannot be used to excuse liability for a debt claim or for interest on that debt, provided the debt is lawfully payable. It is only available for damages claims. The Court of Appeal indicated that a claim for interest at a default rate provided for in a contract may be within scope of the section 44 defence as opposed to simple interest on an existing debt.

US Sanctions

The Court of Appeal concluded that there was no inherent obligation on Unicredit to pay in cash or use an alternate currency under a standby LC where it had set out and confirmed a specific and express method of payment. However, the Court of Appeal also confirmed that the illegality defence could only be relied upon if a reasonable effort is made to obtain licences from relevant authorities or if it can be demonstrated that any such application would be in vain (as it would be refused).

The Court of Appeal considered the illegality defence in the context of the recent Supreme Court judgment in *RTI Ltd vs MUR Shipping BV* [2024] UKSC 18, concluding that it was of limited relevance, but that it confirmed the power of contracting parties to agree terms of their choice – including as to the manner of performance.

HFW's Perspective

The Court of Appeal, in finding for UniCredit, has upended the principle that standby LCs are wholly independent from any other elements in a transaction. This has significant consequences for companies with any form of exposure to Russia, and particularly those in the financial services sector. Some of the consequences of this judgment include:

1. The autonomy principle in relation to standby LCs no longer, prima facie, applies in connection with sanctions.
2. Beneficiaries under standby LCs will not be able to call on them if the purpose of the underlying transaction has a factual link to an activity prohibited by sanctions.

3. The wording of standby LCs will need to be carefully scrutinised in order to ascertain their operation in the event of the imposition of future sanctions in different jurisdictions.
4. Beneficiaries seeking to mitigate credit exposure in respect of their counterparties may wish to pursue alternative options.
5. Financial institutions which provide a variety of structured trade finance products should seek to ascertain whether the Court of Appeal judgment has any consequences for the products they offer.
6. Insurers and reinsurers who have written coverage for risk which is ultimately connected with potentially prohibited activity may not be able to argue that such cover is no longer available simply because they have subsequently discovered that the activity in question does have a sanctions exposure.
7. If parties are seeking to rely on a defence of illegality in respect of sanctions-related payments, subject to any contract terms or statutory considerations, they must first, at least, attempt to procure a licence for the relevant activity from the competent authority or be almost certain that such a licence would not be granted. Anything less will essentially prevent any arguments of illegality being advanced.

It is not yet known whether Celestial and Constitution intend to appeal the Court of Appeal judgment to the Supreme Court. Given the significant impact this judgment has on the financing and insurance of global trade we consider it likely that such an appeal will be made.

For more information, please contact:

DANIEL MARTIN
Partner, London
T +44 (0)20 7264 8189
E daniel.martin@hfw.com

DAVID SAVAGE
Partner, London
T +44 (0)20 7264 8094
E david.savage@hfw.com

JAMES NEALE
Senior Associate, London
T +44 (0)20 7264 8470
E james.neale@hfw.com

STEPHEN GREEN
Associate, London
T +44 (0)20 7264 8346
E stephen.green@hfw.com

HFW has over 600 lawyers working in offices across the Americas, Europe, the Middle East and Asia Pacific. For further information about our Trade Sanctions capabilities, please visit hfw.com/Trade-Sanctions.

© 2024 Holman Fenwick Willan LLP. All rights reserved. Ref: 006159

Whilst every care has been taken to ensure the accuracy of this information at the time of publication, the information is intended as guidance only. It should not be considered as legal advice. Holman Fenwick Willan LLP is the Data Controller for any data that it holds about you. To correct your personal details or change your mailing preferences please email hfwenquiries@hfw.com

Americas | Europe | Middle East | Asia Pacific