UK SANCTIONS: WELCOME GUIDANCE FOR INSOLVENCY PRACTITIONERS

In the case of *Hellard & Ors v OJSC Rossiysky Kredit Bank & Ors*[1], the English High Court considered how the Russia (Sanctions) (EU Exit) Regulations 2019 apply in the context of bankruptcy proceedings where there are Russian creditors who may be subject to sanctions. The trustees in bankruptcy sought directions from the court on how to deal with this thorny and, at present, relatively untested issue.

1 [2024] EWHC 1783 (Ch) (**Hellard v OJSC**).

Having examined the legal issues raised and the factual matrix in this case, the Court held that:

1. Whether an individual / entity (including creditors) is controlled by a *"Designated Person"*, and therefore caught by the UK's Sanctions Regime, is a question of fact.
2. Creditors' voting rights under the UK's statutory Insolvency Regime do not constitute *"funds"* or *"economic benefits"* for the purposes of the UK's Sanctions Regime.
3. Creditors using such rights, or Insolvency Practitioners accepting such votes, does not amount to *"dealing with"* funds or with economic benefits under the UK's Sanctions Regime[2].

The Court's findings are of great significance to the insolvency industry and to creditors alike. Given the prospect of an extended war in Ukraine, this decision is likely to be one of an increasingly important line of authorities which will remain relevant for many months and years to come.

Background

In December 2022, the applicants were appointed as the trustees in bankruptcy (**Trustees**) of Mr Anatoly Leonidovich Motylev (**Bankrupt** and his **Bankruptcy**). The First to Fourth Respondents are Russian banks who are creditors of the Bankrupt and are, themselves, in liquidation (**Russian Bank Creditors**). The Fifth Respondent is the Office of Financial Sanctions Implementation (**OFSI**).

The Russian Bank Creditors were controlled by the Bankrupt and collapsed shortly before the Bankrupt left Russia for London in 2015. The Russian authorities charged the Bankrupt *in absentia* with alleged crimes involving fraud and financial mismanagement relating to the Russian Bank Creditors.

The Bankrupt was declared bankrupt in Russia in February 2018. His Russian Financial Manager (akin to a trustee in bankruptcy) obtained recognition of his Russian bankruptcy in the UK and a freezing order. The Financial Manager presented a bankruptcy petition in England relying on the Russian debts and the Bankrupt was declared bankrupt in England in November 2020.

Collectively, the Russian Bank Creditors hold the majority of the claims submitted in respect of the Bankruptcy[3] and make up four out of the five members of the creditors' committee.

While the OFSI was aware of the matter, and had provided limited guidance on *"certain aspects of its approach"* to the Trustees, it was unwilling to confirm the OFSI's view.

Being caught *"between a rock and a hard place"*[4], the Trustees sought guidance from the Court and applied for directions under s303(2) of the Insolvency Act 1986 (**IA 1986**) and / or declarations, on the following matters (**Issues**):

1. Whether the Trustees should treat the Russian Bank Creditors as being caught by the sanctions imposed under the Russia (Sanctions) (EU Exit) Regulations 2019 (**Regulations**).
2. If the Russian Bank Creditors were to be treated as caught by sanctions under Issue (1) above, whether it would be lawful for the Trustees to accept votes cast by those creditors during any creditors' decision procedure and / or to allow those creditors to participate in meetings of the creditors' committee.
3. Whether the Trustees were *"providing financial services"* in breach of Regulation 18A of the Regulations.

Issue 1: Should the Trustees treat the Russian Bank Creditors as being caught by the sanctions imposed under the 2019 Regulations?

As explained by the Court, criminal liability arises if someone deals with the assets of a ***"Designated Person"*** as defined by Regulation 7 of the 2019 Regulations (i.e. a sanctioned individual / entity) and this is broadly defined[5]:

> *"There are various offences that are committed if one does some act that deals with or directly or indirectly makes available to a designated person "funds" or "economic benefits" owned, held or controlled by a designated person. Funds or economic benefits will be treated as being so owned, held or controlled by a designated person if they are owned, held or controlled by a person who is owned or controlled directly or indirectly within the meaning of Regulation 7."* (the **Control Issue**)

The Russian Bank Creditors are not, themselves, Designated Persons. Issue (1) centred on whether the Russian Bank Creditors were controlled by a ***"Designated Person"***[6].

The fact that the Russian Creditor Banks were subject to Russian insolvency proceedings was of particular concern to the Trustees. The Trustees had investigated the position *vis a vis* control of the Banks. However, the position was not clear, the 2019 Regulations are relatively new and the factual position was a novel one. The Trustees were therefore concerned that criminal and civil liability could arise under the UK's Sanctions Regime if they permitted the Russian Creditor Banks to participate in the Bankruptcy as creditors and that, on the other hand, civil liability could arise if they wrongfully excluded them.

2 Hellard v OJSC, at paragraph [206].

3 52.88% of the claimed debt, which totals £741m.

4 Hellard v OJSC, at paragraph [2].

5 Hellard v OJSC, at paragraph [49].

6 Such as Mr Vladimir Putin, the President of the Russian Federation (**President Putin**) and Ms Elvira Nabiullina, the Governor of the Central Bank of Russia (**Governor Nabiullina**).

The Judge considered the case law on the interpretation of Regulation 7 of the Regulations, including the prior decisions in *Mints*[7] and *Litasco*[8], the Control Issue and the different categories of control discussed therein[9], concluding that:

> *"...control should be looked at in the context of control that would result in direct or indirect control of the property (amounting to funds or economic benefits) in question."*

and that, in the context of this case, the question was:

> *"...whether President Putin or Governor Nabiullina would be able to exercise control over the Russian Bank Creditors via their liquidators so as to affect their dealings with these assets."*

The Judge carried out a detailed analysis of the available evidence of control, commenting that the Trustees had gone to *"strenuous efforts"* to obtain relevant evidence.

The Judge concluded that there was insufficient evidence before the court to determine whether the Russian Bank Creditors should be regarded as *"owned or controlled"* by a Designated Person, noting that there was no basis upon which the Trustees could know, or have reasonable cause to suspect, that any recoveries made by the Russian Bank Creditors from the Bankruptcy (or the underlying judgment debts) are held or controlled by a Designated Person (or by an individual / entity which is owned or controlled by one).

The Judge did not consider that there was evidence of present or future *du jure* control; evidence of any actual present *de facto* control; or evidence of any future *de facto* control and held that:

> *"until Governor Nabiullina or President Putin do take steps to control the liquidators in the carrying out of their duties, it is going too far to say that either of them they (sic) could, if they wished, do this, as this would be to ignore the fact that other people would need to cooperate with this and also to ignore the difficulties and political and reputational costs to them in bringing this about."*

Despite these findings, the Judge concluded that it was not appropriate for him to make a declaration (which would be binding on the OFSI) to this effect. Firstly, Issue (1) was a question of fact, not law, and secondly the matter touched on criminal liability and the OFSI, the relevant prosecuting authority, did not support the making of a declaration.

However, having noted that the Trustees had done all that they could be expected to do in order to comply with the Regulations and, in light of the guidance published by the OFSI, the Judge commented that it would be *"perverse"* for the OFSI to take action against the Trustees, unless new facts came to light, and gave directions to the Trustees under IA 1986 to provide them with *"an alternative means of protection"*. The Judge directed the Trustees to, inter alia, proceed on the basis that the Russian Bank Creditors are not Designated Persons (or controlled by one) and to undertake *"enhanced monitoring of the position"* so that they can identify any change of circumstances.

Issue 2: Is Voting by the Russian Bank Creditors caught by Sanctions?

The Trustees were seeking guidance on whether the Trustees could count

7 *PJSC National Bank Trust and another v Mints and others* [2023] EWCA Civ 1132. We discuss *Mints* in detail in our Commodities Case Update of February 2024, which you can read here.

8 *Litasco SA v Der Mond Oil & Gas Africa SA* [2023] EWHC 2866 (Comm), also discussed in our Commodities Case Update of February 2024.

9 (e.g. *de jure* control, *de facto* control, actual and present control and potential control.)

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votes cast by the Russian Bank Creditors or this was prohibited by Regulations, in particular the asset freezing provisions set out in Regulation 11.

Given that Issue (2) is one of significant public interest, the Judge elected to provide authoritative guidance on this point by making a declaration as to the proper interpretation of the relevant law.

The Judge was *"prepared to assume"* that creditor claims in a bankruptcy were *"funds"* for the purposes of the Regulations, but did not accept that exercising such voting rights involved *"using those funds"*, which is the test set out in Regulation 11(4):

- A creditor's right to participate in insolvency proceedings by casting its vote on various matters and / or establishing a creditors' committee is a right afforded by the English **Insolvency Regime** set out in IA 1986 and the Insolvency (England and Wales) Rules 2016. It is not attached to the debt owed to the creditor. The right is derived purely from statute and this statutory process is a collective one, which is supervised by the Court.
- the debts would be unaffected by the exercise of voting rights, so voting in and of itself could not be seen as *"dealing with"* the debts within the meaning of Regulations 11(4)(a)-(c)[10].
- creditor voting rights could not be regarded as a benefit which fell within the definition of *"funds"* in the Regulations because the voting rights granted by the IA 1986 have no intrinsic value and cannot be divorced from the statutory bankruptcy regime.
- there is a *"strong argument"* that the phrase *"financial assets and benefits of every kind"* needs to be read sui generis with the list of assets set out in section 60(1) of the Sanctions and Anti-Money Laundering Act 2018 (SAMLA) and the Judge concluded that creditor voting rights under IA 1986 are not of the same nature as the financial rights set out therein.
- Insolvency Regime voting rights cannot be used to obtain funds, goods or services and are not, therefore, *"economic resources"* within the meaning of section 60(2) of SAMLA.

The Judge therefore concluded that the Regulations did not prevent the counting of creditor votes in bankruptcy proceedings by sanctioned persons (i.e. individuals / entities to which Regulation 7(4) of the Regulations applies) because voting rights are neither funds nor economic benefits for the purposes of the acts prohibited by the Regulations.

The Judge also commented on the *"highly inconvenient, if not absurd"* consequences if the UK Sanctions Regime were to prohibit the exercise of creditor voting rights. Various issues arise:

- A bankruptcy (or liquidation) could develop contrary to the wishes of the majority of creditors (a strong risk here: the Russian Bank Creditors make up the majority of the creditor pool).
- Insolvency proceedings should proceed according to the statutory machinery set out in the Insolvency Regime "which is supposed to operate for the collective benefit of all creditors and in the public interest".
- If creditor voting rights were prohibited by the Regulations, it is likely that insolvency proceedings would be beset by *"unnecessary delay, uncertainty, court applications and licencing applications to OFSI"*.

10 Unless the creditors voted to approve a distribution from the bankrupt's estate and that caused a designated person to obtain funds (or control of them).

Issue 3: Are the Trustees in Breach of Regulation 18A of the 2019 Regulations?

The OFSI had tentatively invited the Trustees to consider whether they were providing financial services to a Designated Person, in breach of Regulation 18A of the Regulations.

The Judge agreed with the Trustees that they were not breaching Regulation 18A, giving three reasons for this:

1. The Trustees were undertaking the statutory functions of a trustee in bankruptcy and this does not fall within the definition of *"financial services"*.
2. The Trustees were not providing any services *"for the purpose of foreign exchange reserve and asset management"* as required by Regulation 18A(1)(e).
3. The Trustees were not providing the alleged financial services to any of the persons listed in Regulation 18(2). Trustees / liquidators carry out their duties under the Insolvency Regime, under the supervision of the court and *"it would be wrong to think of them as providing services to particular creditors"*.

The judge did not make a declaration on Issue (3) because *"the answer to this question is so clear that I do not consider that there is any need to make a declaration to this effect."*

HFW's perspective

The Court's judgment provides helpful and timely clarity on how the UK Sanctions Regime applies in the context of insolvency proceedings and how the two statutory frameworks interact. In particular, the judgment provides welcome guidance on:

1. The potential liability facing trustees in bankruptcy and liquidators where the creditor pool includes sanctioned parties and the proper approach to be used (such as investigations into and gathering evidence of control) when assessing whether creditors are Designated Persons and / or the act in question falls foul of the Regulations and the legal analysis which will be applied by the courts.
2. How the exercise of creditor voting rights is viewed in relation to the prohibition on providing a direct or indirect benefit to a sanctioned party, confirming that the Regulations do not prevent the counting of creditor votes in a bankruptcy by a person to whom Regulation 7(4) applies because voting rights are neither funds nor economic benefits. However, it should be noted that applying the results of a vote – particularly where funds and economic resources are then distributed to a sanctioned person – could result in a breach of sanctions.
3. The statutory functions of a bankruptcy trustee or liquidator do not, in and of themselves, constitute the "*provision of a service*" for the purposes of the UK's Sanctions Regime. This is, in our view, the only correct analysis. A trustee in bankruptcy does not provide services to a particular creditor, in the sense required by the UK Sanctions Regime. Insolvency proceedings are a plenary process. Trustees and liquidators are officers of the court who provide services in a general sense while fulfilling their duties under the Insolvency Regime. They act for the benefit of the body of creditors as a whole and, ultimately, under the supervision of the court. This may afford some protection to insolvency practitioners in certain situations but, given the breadth of the Sanctions Regime, it would always be wise to take a cautious approach and to analyse matters on a case-by-case basis and to continually monitor the Control Issue in case the known factual matrix changes over time.

Moreover, the Court provided further guidance on the Control Issue and the decision in *Mints*, emphasising that the question of whether an individual or entity is owned or controlled by a Designated Person is a matter of fact. However, we note with interest that the Court refrained from commenting on Russia's status as a 'command economy' and how this affects the proper interpretation of the Control Issue (discussed at length in *Mints*). That being said, the Judge appeared to accept the guidance published by the UK government in the wake of the *Mints* decision (which can be found here), namely that there cannot be a default assumption that all Russian entities are controlled by a sanctioned person.

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