Court of Appeal finds payment obligations under letters of credit suspended by UK Russian sanctions regime

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The Court of Appeal has handed down its much-anticipated decision in *Celestial Aviation Services Ltd v UniCredit Bank AG (London Branch)* [2024] EWCA Civ 628, holding that UniCredit Bank AG (**UniCredit**) was excused from making payment under various letters of credit (**LoCs**) that it had issued in connection with the supply of aircraft to Russian airlines, by virtue of the UK sanctions regime.

The Court of Appeal overturned the High Court's decision (see our blog post) based on its differing interpretation of Regulation 28 of the Russia (Sanctions) (EU Exit) Regulations 2019 (**Russia Regulations**), which is a restriction relating to the provision of financial services or funds in relation to the supply of certain restricted goods – in this case, aircraft.

The decision will, however, be of wider interest to any parties which are bound by contractual obligations agreed prior to Russia's invasion of Ukraine and which may engage various sanctions regimes globally. In particular, it provides welcome clarity on a number of points which financial firms have been following since the High Court's judgment:

- The Court of Appeal's decision ultimately turns on its statutory interpretation of Regulation 28(3), affirming a more literal interpretation than the purposive approach taken by the High Court. Restrictions on the provision of "financial services" and "funds", ancillary to restrictions on the supply/export or acquisition/import of different types of goods, are a feature of many of the trade sanctions restrictions in both the Russia Regulation and other sanctions regulations. The judgment should therefore provide guidance to financial firms as to the proper interpretation of these ancillary trade restrictions, and more broadly as to how the Russian Regulations as a whole will be construed by the court.

- Of particular interest to financial firms will be the Court of Appeal's rejection of the suggestion that payment obligations should be performed through payment in cash or in alternative currencies so as to avoid violations of US sanctions. This will offer some certainty as to what firms must do where a USD payment is permitted by UK but prohibited by US sanctions.

- The Court of Appeal's recognition that firms should be entitled to avail themselves of the protection provided by s.44 of the Sanctions and Anti Money Laundering Act 2018 (**SAMLA**) where they were forced to make complex decision in a fast-moving legislative landscape is helpful. The clarifications on the scope of the provision (and in particular, its limited application to debt claims such as the one in this case) will also be necessary for financial firms to note. In particular, the Court of Appeal found that s.44 SAMLA did not come to UniCredit's aid in this case, as the underlying debt obligation would still exist (albeit the timing of payment would be delayed), and interest and costs

did not fall within the scope of s.44 SAMLA.

- Finally, the decision provides a warning about the requirement for parties to use reasonable efforts to obtain licences in sanctions cases, in order to rely on the well-recognised foreign illegality principle under *Ralli Bros v Compania Naviera Sota y Aznar* [1920] 2 KB 287. This provides that the English court will not enforce an obligation which requires a party to do something which is unlawful by the law of the country in which the act has to be done. Notwithstanding that the *Ralli Bros* principle could apply in this case (because payment in USD was required), on the facts, the Court of Appeal held that UniCredit was precluded from relying on the principle because it had not made reasonable efforts to obtain a licence from the US Office of Foreign Assets Control (**OFAC**).

We consider the decision in more detail below.

Background

Between 2017 and 2020, Sberbank issued several LoCs to Celestial Aviation Services Limited (**Celestial**) and Constitution Aircraft Leasing (Ireland) 5 Limited (**Constitution**), both Irish-incorporated companies, in relation to leases of aircraft to Russian companies. The LoCs, denominated in USD and governed by English law, were all confirmed by UniCredit shortly after issue.

The leases were terminated during March 2022. Around the time of the terminations, Celestial and Constitution made conforming demands for payment on the LoCs. UniCredit's position was that it was unable to make payment due to sanctions and so Celestial and Constitution issued proceedings in March and April 2022 respectively, claiming the amount owed in debt (or alternatively in damages), interest, a declaration in relation to the sanctions position and costs.

In the meantime, UniCredit applied for and obtained licences from the EU and UK authorities. Following this, the principal amounts due under the LoCs were settled. Liability for costs and interest however remained in dispute between the parties.

An application for a licence in respect of US sanctions remained outstanding as of the Court of Appeal's decision.

High Court decision

The High Court held that UniCredit's payment obligations were not suspended or excused by virtue of sanctions imposed under the UK and US sanctions regimes. Our blog post considering the first instance decision in more detail can be found here.

In relation to UK sanctions, the court held as follows:

- **Regulation 28**: Regulation 28(3)(c) provides that: "*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… directly or indirectly making restricted goods… available… to a person connected with Russia, or…for use in Russia*".

- The High Court found that financial assistance in this case was provided at the point in time when the LoCs were issued, which was before Regulation 28 came into effect. As the provision does not have retrospective effect, UniCredit was not relieved of its payment obligations. Although fulfilment of UniCredit's payment obligation owed to the claimants may have discharged the independent obligations of the lessees and Sberbank towards the claimants, that was a wholly collateral matter.

- **Regulation 11**: Regulation 11(1) provides that: "*A person ('P') must not deal with funds or economic resources owned, held or controlled by a designated person if P knows, or has reasonable cause to suspect, that P is dealing with such funds or economic resources*."

  - The High Court held that Regulation 11 did not come into force until after payment was due on the LoCs. It in any event did not prohibit payment, because UniCredit would not deal with Sberbank's property when making payment. UniCredit would satisfy its own independent contractual obligations and Sberbank's property was not in any way interfered with.

- **Regulation 13**: Regulation 13(1) provides that "*A person ('P') must not make funds available to any person for the benefit of a designated person if P knows, or has reasonable cause to suspect, that P is making the funds so available*".

  - The High Court similarly held that Regulation 13 did not come into force until after the relevant obligations under the LoCs matured. In addition, whilst UniCredit's payment may have meant that Sberbank's independent obligation to make payment would be satisfied, Sberbank remained under an equal obligation to reimburse UniCredit and there would be no reduction in its overall liability.

As for US sanctions, the High Court held that at the time that at least some of the payment obligations accrued, there was no relevant prohibition under US law. UniCredit had also sought to rely on the well-recognised foreign illegality principle under *Ralli Bros*, which provides that the English court will not enforce an obligation which requires a party to do something which is unlawful by the law of the country in which the act has to be done. UniCredit submitted that payment (which was to be made in USD, via a US correspondent bank) would trigger US sanctions. However, the High Court said that any impediment to payment presented by US sanctions was capable of being avoided by making payment in cash.

At a subsequent consequentials hearing, the High Court held that the claimants were entitled to interest and costs. It also found that UniCredit was not entitled to rely on s.44 of SAMLA, because UniCredit's belief that payment was prohibited by sanctions was not a reasonable one. It should have been clear that no sanctions breach would arise from payment.

Court of Appeal decision

The Court of Appeal considered four issues on appeal: (1) whether payment under the LoCs was prohibited by Regulation 28; (2) if that prohibition did not apply, whether UniCredit nonetheless had a defence under s.44 SAMLA; (3) whether the foreign illegality principle under *Ralli Bros* was engaged in respect of US sanctions; and (4) if the US sanctions regime was engaged, whether payment in accordance with the demands would have been illegal under that regime. The Court of Appeal did not

consider the first instance rulings on Regulations 11 and 13; it is to be hoped that there is a case which also enables these points to be further considered in the future.

The Court of Appeal allowed the appeal in part. Each of the key issues under appeal is considered in further detail below.

(1) Regulation 28

The Court of Appeal overturned the High Court's decision on Regulation 28(3)(c), finding that UniCredit was excused from making payment to the claimants by virtue of the regulation.

The original provision of the LoCs was not caught by Regulation 28 at the time of their issue. However, the Court of Appeal observed that making a payment under them was "obviously" the provision of “funds”, and it was clear from the scheme of the regulation that it did not matter that the claimants were unconnected with Russia; it was enough if the funds were to be provided "in connection" with a relevant arrangement. It was not in dispute that the object or effect of the arrangements comprising the leases was to make aircraft available either to persons connected with Russia or for use in Russia.

The Court of Appeal considered that payment under the LoCs would be “in connection with” the leases. That was, in the Court of Appeal's view, obviously the case in fact, as the LoCs provided security for performance of the lessees’ obligations under the leases, and it could readily be inferred that the leases required either the LoCs or some other acceptable security to be in place. It was not relevant that the planes had already been supplied (and therefore that payment under the LoC was not causally connected to the supply).

The Court of Appeal observed that the purpose of Regulation 28 is not simply to prevent further aircraft going to Russia. Instead, it is a relatively blunt instrument, intended to cast the net sufficiently wide to ensure that all objectionable arrangements are caught. Whilst it might therefore catch some arrangements that might not be seen to be objectionable, this risk is addressed by exceptions and the availability of licences.

(2) Section 44 SAMLA

The Court of Appeal's conclusion on Regulation 28 meant that it was not strictly necessary to address s.44 SAMLA, but it nonetheless did so because it raised points of significance.

The Court of Appeal accepted the High Court's conclusion that UniCredit had the requisite subjective belief – there was evidence on which it could legitimately base that conclusion. As to the objective question of whether that belief was reasonable, the Court of Appeal said that it clearly was. UniCredit was required to form a view about new legislation at short notice and there was no doubt that the literal words appeared to catch payments under the LoCs. This will provide reassurance to other financial firms which have been forced to take a view in the face of the same challenges, and have comforted themselves that s.44 SAMLA will provide protection in the event that their view is incorrect.

However, if the Court of Appeal had reached the contrary conclusion on Regulation 28 (and decided that it did not apply), it would have held that s.44 SAMLA did not protect UniCredit against an award of costs and interest. The Court of Appeal said that the evident purpose of s.44 is to ensure that a person is not pressurised into doing something that risks breaching sanctions by a fear of being exposed to civil claims.

The section is concerned to protect against a liability created because of something done (or not done) in the reasonable belief that it is in compliance with sanctions regulations. The provision is not concerned to protect against pre-existing liabilities. Absent sanctions, a debtor would expect to pay its debt in the normal course. Exposure to a claim to recover the debt is not a new financial exposure which might pressurise payment. It is a pre-existing liability and the mischief at which s.44 is aimed therefore was not present in this case. It followed that s.44 SAMLA did not prevent an award for interest and costs on a claim for debt.

(3) UniCredit's reliance on the *Ralli Bros* principle of foreign illegality

The Court of Appeal rejected the finding that any impediment to payment presented by US sanctions was capable of being avoided by making payment in cash, and also disagreed with Celestial and Constitution's submissions in the alternative that payment could have been made in sterling or euros.

Importantly, the Court of Appeal accepted that the foreign illegality principle in *Ralli Bros* could be engaged if the act of performance, in this case effecting payment in USD to the specified account, would have required the involvement of a correspondent bank in the United States. This will be helpful to financial firms who are faced with similar demands for payments in USD which may violate US sanctions only.

The Court of Appeal was critical of the High Court's application of *Libyan Arab Foreign Bank v Bankers Trust Co* [1989] 1 QB 728 to this case, which the High Court had said was authority for the proposition that where a USD payment is required under the contract, the customer is entitled to demand such payment in cash. The Court of Appeal concluded that that principle was only applicable where there was no express or implied contractual term to the contrary effect. The High Court was wrong to apply this case without reference to the terms of the contract and without taking account of the fact that in *Libyan Bank*, payment in cash was both contractually permitted and in fact demanded.

In the present case, by contrast, no demand for payment in cash or in a different currency had been made, and neither proposition reflected the terms of the LoCs. Rather, the LoCs expressly required that a demand for payment was presented in "strict conformity" with the terms of the LoCs, and that a demand would be for a transfer of USD, to a specified bank account. Accordingly, a demand for payment in cash, or in sterling or euros, could not be a conforming demand.

(4) US sanctions: reasonable efforts

However, notwithstanding that the *Ralli Bros* principle could apply in this case, on the facts, the Court of Appeal held that UniCredit was precluded from relying on the principle because it had not made reasonable efforts to obtain a licence from OFAC. This is because a party seeking to rely on the *Ralli Bros* doctrine may be precluded from doing so if they could have done something to avoid illegality in the place of performance.

UniCredit's licence application to OFAC had, in the opinion of the Court of Appeal, very much focused on processing receipts from Sberbank (which, by that time, had been added to the US's Specially Designated Nationals list), so that the funds could be passed on, rather than the performance actually required under the LoCs, i.e. payment to Celestial and Constitution (which were neither Russian persons nor sanctioned parties). While it was commercially understandable to link the payments under the LoCs

to payment by Sberbank, UniCredit's characterisation did not satisfy the requirement to use reasonable efforts to obtain a licence to pay Celestial and Constitution.

Having reached that conclusion, the Court of Appeal said it would be disproportionate to consider the final issue for appeal, regarding UniCredit's challenges to the judge's factual conclusions on the expert evidence about US law.