Client Alert

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United Kingdom: UK Court of Appeal issues far-reaching judgment on scope of trade sanctions and financial assistance (Celestial Aviation v UniCredit)

In brief

On 11 June 2024, the UK Court of Appeal handed down its judgment in the case of *Celestial Aviation Services Limited v UniCredit Bank GmbH (London Branch)* [2024] EWCA Civ 628. In summary, the Court of Appeal determined that, in the context of payment obligations under standby letters of credit ("**LCs**"), sanctions measures relating to financing the supply of restricted items can apply retrospectively as well as prospectively, significantly widening the scope of application of such measures and creating uncertainty around the permissibility of payments where they have a degree of connection with restricted items, including where those items were lawfully supplied prior to the sanctions being introduced. The Court of Appeal overturned the 2023 High Court judgment that found UniCredit was not justified in refusing to make payment to aircraft lessors under LCs issued in connection with aircraft leases to Russian companies that were entered into prior to the relevant sanctions being introduced.

The Court of Appeal considered:

- the scope of Regulation 28 of the Russia (Sanctions) (EU Exit) Regulations 2019 ("**UK Russia Regulations**"), which prohibits the provision of financial services or funds in relation to the supply of certain restricted goods;
- the scope of Section 44 of the Sanctions and Anti-Money Laundering Act 2018 (SAMLA), which provides that a party shall have a defence in civil proceedings in respect of acts done in reasonable belief that the acts are in compliance with UK sanctions; and
- the relevance of US sanctions where a payment obligation is denominated in US dollars.

The Court of Appeal concluded that UniCredit was entitled to withhold payment on the basis the arrangement fell within the applicable sanctions regime. Furthermore, the Court found that even if the relevant sanctions restrictions did not apply, UniCredit would have been able to avail itself of a "reasonable belief" defence in support of withholding payment.

The Court of Appeal's decision has far-reaching implications for any parties involved in trade finance transactions (either banks or beneficiaries), or other financing activities connected to trade in goods that are (or have become) subject to sanctions. The case is also significant in highlighting the extent to which UK courts may take differing views of key elements of the UK sanctions framework.

Background

Celestial Aviation Services Limited ("**Celestial Aviation**") and two Constitution Aircraft Leasing entities ("**Constitution**") were Irish-incorporated entities involved in aircraft leasing to two Russian airlines. The relevant leases were entered into between 2005 and 2014. Between 2017 and 2020, twelve USD-denominated LCs were issued to guarantee payments under these aircraft leases. UniCredit Bank GmbH ("**UniCredit**") was the confirming bank under the standby LCs, which were issued by the Russian bank, Sberbank.

On 1 March 2022 (i.e., after the relevant leases and LC arrangements had been entered into), the UK Russia Regulations were amended such that civilian aircraft were categorised as "restricted goods" and subject to trade sanctions measures, including a prohibition (under Regulation 28) on providing financial services and funds in relation to the export / supply / making available of such civilian aircraft. As a result of the expansion of the sanctions to civilian aircraft, Celestial Aviation immediately terminated the leasing of their aircraft and subsequently issued demands for payment under the LCs as their beneficiary, asserting default under the leases.

On 6 April 2022, Sberbank was also designated for the purpose of UK asset freezing measures under Regulations 11 to 15 of the UK Russia Regulations. The asset freeze measures targeting Sberbank broadly prohibit dealings in funds or economic resources owned, held or controlled by a designated person, or making funds or economic resources available to or for the benefit of such a person.

UniCredit refused to pay Celestial Aviation and Constitution (i.e., the beneficiaries under the LCs) on account of sanctions, including on the basis that such payment would be unlawful under Regulation 28, as it would constitute the provision of funds "in connection with" the supply of civilian aircraft, a restricted good under the UK Russia Regulations. In the meantime, UniCredit applied for licences from relevant sanctions authorities in the UK, EU and US.

High Court

In the first instance, the High Court asserted that UniCredit's payment obligation did not engage Regulation 28 because the aircraft were provided to the Russian companies under leases, and the LCs were issued, long before March 2022, when the relevant prohibition under Regulation 28 regarding the supply of aircraft came into force. The High Court therefore took the view that UniCredit making payment to the beneficiaries under the LCs would not be "in connection with" an arrangement the object or effect of which was the supply of aircraft to or for use in Russia, or to a Russian person.

On this basis, the High Court took the more purposive position that the prohibition on providing financial services and funds in connection with the export / supply / making available of restricted goods under Regulation 28 is forward-looking and prospective in nature, and would not apply where there is a subsequent payment obligation in connection with goods that have already been lawfully supplied prior to the relevant sanctions coming into force. The High Court's position also supported the "autonomy principle," under which an LC is treated as a separate transaction from the underlying contract on which it is based.

The High Court added that even if payment in USD would have breached US sanctions, payment would have been possible in another currency or by other means, such as cash.

The High Court also concluded that the UK asset freeze provisions relating to Sberbank were not engaged, on the basis that payment by UniCredit to the beneficiaries would not involve any dealings in Sberbank's funds and would not confer any benefit on Sberbank.

Additionally, UniCredit sought to argue that in any event it had a defence under s.44 SAMLA, which provides that a party will not be liable in civil proceedings in respect of acts done in the reasonable belief that the act is in compliance with UK sanctions. UniCredit sought to argue that its belief that it was complying with the UK Russia Regulations by not making the payments to the beneficiaries was reasonable. The High Court disagreed with this, and determined that UniCredit believing that it was acting in compliance with sanctions was not objectively reasonable, thereby extinguishing the s.44 defence under SAMLA.

UniCredit subsequently appealed to the Court of Appeal.

Court of Appeal

Regulation 28: Provision of financial services or funds in relation to the supply of restricted goods

The Court of Appeal applied a much more literal interpretation of Regulation 28, finding that it can apply retrospectively as well as prospectively. In summary, the Court of Appeal found that payment by UniCredit to the beneficiaries would be prohibited under Regulation 28 of the UK Russia Regulations, as the LCs were factually "in connection with" a lease for supply of restricted aircraft to Russia (notwithstanding that the aircraft had been lawfully supplied to Russia prior to the relevant sanctions coming into effect). The Court of Appeal also noted that "with an ongoing arrangement such as a lease there is a continued "making available" during the currency of the lease".

The Court of Appeal described Regulation 28 as a "relatively blunt instrument … intended to cast the net sufficiently wide to ensure that all objectionable arrangements are caught". In reaching this view, the Court of Appeal also emphasised the wider purpose of applying pressure on Russia and the provision of licensing grounds as a way to mitigate the impact on any unintentionally captured activities as a result of casting such a wide net.

In further justifying this position, the Court of Appeal suggested that the High Court's interpretation of Regulation 28 would mean that parties could wait until the completion of an export or supply of goods before transferring funds. Furthermore, the Court of Appeal noted that fund providers like UniCredit would not have first-hand knowledge as to whether a lease has been terminated, or whether the lessee could acquire the aircraft in the case of termination.

s.44 SAMLA defence: Reasonable belief of acting in compliance with UK sanctions

The Court of Appeal also offered a more favourable interpretation of the s.44 SAMLA defence. In light of its findings regarding Regulation 28 (as discussed above), it was not strictly necessary for the Court of Appeal to consider the applicability of s.44. However, the Court of Appeal acknowledged that UniCredit was under commercial pressure and had to form a view about new legislation at short notice without the benefit of hindsight. Therefore, even if the Court of Appeal had reached a different view in relation to Regulation 28, it would still have disagreed with the High Court "about whether UniCredit's belief was a reasonable one".

The Court of Appeal's judgment also considered the application of the s.44 defence in relation to claims for interest and costs, as compared with an action solely to recover a debt which is otherwise lawfully due (but which has not been paid in the reasonable belief that payment would constitute a breach of sanctions).

In summary, the Court of Appeal took the position that s.44 does not provide a defence for claims to recover a debt, as this is "an amount which is owed irrespective of any action or inaction in purported compliance with sanctions".

Where a claim for interest is not independent of the claim for the underlying debt (e.g. statutory interest to be applied by the Court), the Court of Appeal took the view that the s.44 defence should also not be applicable: "On the basis that proceedings for recovery of the debt itself are not barred by s.44 (as to which see above) it logically follows that a claim which is no more than an adjunct of that, and has no independent foundation, should also not be barred."

However, the Court of Appeal noted that claims for interest at a default rate as provided in a contract would "give rise to different issues", and would be "much closer both to the mischief at which s.44 is aimed and the language, because the claim is for an amount due as a result of ("in respect of") the failure to pay".

Ralli Bros principle and relevance of US sanctions

The Court also considered the application of the *Ralli Bros* principle - a limited exception to the general principle that the enforceability of an English-law governed contract is determined without reference to illegality under any other law – in relation to UniCredit's argument that it could not transfer USD to a specified bank account as the LCs expressly required, as such payment would be in violation of US sanctions. The Court of Appeal confirmed that the *Ralli Bros* exception applies where contractual performance requires an act to be done in a place where it would be unlawful to carry it out. However, a party will not be excused if performance would be legal if a licence was obtained (unless that party "shows that they either made reasonable efforts to obtain a licence or that any such efforts would have been in vain because a licence would have been refused").

The Court of Appeal considered whether payment in USD would involve a US correspondent bank, and therefore involve performance in the US contrary to US sanctions. Notwithstanding, the Court concluded that even if the *Ralli Bros* principle was engaged so as to make US sanctions relevant, UniCredit could not rely on US sanctions because "it did not make reasonable efforts to obtain a licence from the US authorities". The Court emphasised that UniCredit's application to the US Department of the Treasury's Office of Foreign Assets Control ("**OFAC**") was overly focused on requesting authorisation for receipt of payment from Sberbank (which by the time of the US licence application had been listed as a US Specially Designated National (SDN)), as opposed to making payment to the LC beneficiaries.

Lord Justice Males, Lord Justice Snowden and Lady Justice Falk unanimously agreed with the decision.

Key Considerations

The Court of Appeal's judgment will have significant and far-reaching implications for parties involved in providing or benefitting from any trade finance arrangements in relation to controlled goods, or that are otherwise involved in any trade in controlled goods. On the basis of this judgment, there may now be significant uncertainty as to the permissibility of any payments that have some degree of connection to trade in restricted items.

Whilst the Court of Appeal indicates that the broad interpretation of Regulation 28 set out in the judgment is offset by the ability for companies to apply for UK sanctions licences, this does not take into account the practical and timing challenges for many companies in seeking to apply for sanctions licences.

The judgment recognises that there will be circumstances where US sanctions apply to English law-governed contracts (notably where USD payments involve a US correspondent bank), whilst recognising that the ability to rely on those US sanctions is premised on having taken all relevant steps to mitigate their impact, as is the case where parties are seeking to rely on UK sanctions.

The case also raises questions around the availability of the s.44 SAMLA defence. The Court's judgment indicates that in order for a party to avail itself of the defence, there is a two-stage test that must be met. The first stage is a subjective test where the party must satisfy the court that they held a certain belief on the position in question. The second stage is an objective test which requires a party to prove that the belief they held was reasonable. The Court of Appeal found that UniCredit met both these tests on the basis that there was sufficient evidence, including documentary evidence, to support its position. In order to make use of the s.44 SAMLA defence, it is therefore prudent to ensure adequate documentary evidence is maintained that actions have been taken in the reasonable belief that they are in compliance with sanctions.

The complexities in the case also highlight the need for market participants to consider including fallback language in their trade finance instruments to mitigate the risk of sanctions. For example, beneficiaries under LC arrangements may wish to consider including an obligation for the issuing bank to pay in EUR or GBP, in the event that sanctions prevent payment in USD.

Finally, the case also illustrates the significant complexity of UK and other sanctions regimes, and the potential for different courts and authorities to effectively reach opposite views on the scope and application of key aspects of the regimes.

Given the nature of the issues in question and the divergent positions taken by the High Court and the Court of Appeal, it is possible that the case will be appealed to the Supreme Court.

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