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In this Issue:

Insurance Protections for the Transactional Impact of Sanctions Compliance

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The Burden of Sanctions Compliance

In recent years much column space has been taken up with trade and economic sanction measures and their effectiveness as a strategy for bringing about desired political change. To stand a chance of succeeding in any such objective, even if that desired outcome is only to get people to engage in meaningful dialogue, they need to have significant economic impact on the territory they are targeted at. That can only be achieved if there is robust surveillance of adherence and regulatory bodies who are prepared to bare their teeth when commercial entities step out of line.

In no country is this demonstrated more highly than in the United States, with the tenacious stance adopted by the Office of Foreign Asset Control (OFAC) to police compliance with sanctions regulations. The significant fines meted out to corporations and financial institutions, headlining to figures in the hundreds of millions of dollars, primarily related to breaches of US sanctions on Iran, have more than succeeded in creating a meaningful deterrent,

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Documentation Risk Issues in PRI, TCI, ECA Guarantees and Similar Transactions, Part II

***Frederick E. Jenney** is a partner at Morrison & Foerster LLP in Washington, D.C. This article, the second half of a two-part series, discusses assessing, quantifying, mitigating and shifting enforceability risk. Part I of the article, published in the November 2015 edition of the Newsletter, focused on an overview of documentation risk issues and on identifying enforceability issues.*

ASSESSING AND QUANTIFYING ENFORCEABILITY RISK

How Can Enforceability Risk Change After it is Determined Initially?

So a key question is: what evidence regarding enforceability at an **earlier stage** is the best predictor that an obligation will be enforceable later, when it counts?

To put it another way, given a typical transaction, what are the chances of a documentation risk arising that impairs recovery by the underwriter against the obligor?

The good news is that, in general under most established legal systems, enforceability can be determined at the outset (i.e., at signing) and is highly likely not to change over time.

Of course, this sort of good news is of limited comfort to most risk-takers, because "highly likely" means that enforceability could change upon certain events or if the status of the obligor changes, and that it might change if the law regarding enforceability of certain obligations changes.

Unfortunately, there is no precise way to quantify the likelihood that a given obligation will become unenforceable. However, there are some warning signals.

Specific Elements that Might Increase Enforceability Risk

Here are some of the elements of a transaction that are likely to increase documentation risk and impair enforceability. In most cases, there are ways to mitigate the risk. (On the other hand, contracts and obligations free from these sorts of elements are very likely to be enforceable—*see box on page 4.*)

Obligor is a Governmental Entity. If the obligor is a sovereign, sub-sovereign or other government entity, it may have sovereign

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Middle East and North Africa Political Risk Assessment: Implications of Sustained Low Oil Prices

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The US energy resurgence since 2005 has dramatically changed the geopolitics of global energy, particularly with respect to the Middle East and North Africa (MENA). The political risks in the MENA region are as high as they have ever been, just as oil supplies are abundant and inflation-adjusted prices are lower than they have been for decades.

The effects of lower oil prices (trading under USD 30.00 per barrel in mid-January 2016) on the MENA region are serious and complex. Three of the five countries labeled by RBC Capital Markets Ltd. as the “Fragile Five”—countries whose economies are undiversified and deeply dependent on oil revenues—are located in the MENA region: Algeria, Libya and Iraq (Nigeria and Venezuela round out the constituents of the group). For nations like these that produce and export large volumes of oil and depend on oil export sales for most of their revenue, sustained low oil prices present serious economic stability issues and the prospect of continuing budget deficits and diminished investment. Compounded by the volatile regional political and military situation, sustained low oil prices will increase the political security risks in the MENA countries.

Almost all oil exporters in the region, particularly the Gulf Cooperation Council (GCC) members, are facing steep declines in fiscal revenues as oil prices are now less than one-third of those needed to balance their budgets. Saudi Arabia’s 2015 fiscal revenues were about half of those in 2014. Iraq’s revenues are estimated to decline by USD 40 billion in 2015 and 2016, while government spending remains high as large parts of the population work for the government or are dependent on public sector spending. Iran is hampered by the combination of previous and current sanctions and low oil and gas prices. The wealthy oil exporters in the region—Saudi Arabia, Qatar, Kuwait and UAE—have large financial reserves that will enable them to run deficits over the coming years, but Iraq, Libya and Algeria have very limited foreign asset reserves.

It is becoming more and more difficult for the oil rich countries to mediate conflicts or maintain regional financial stability. As noted by Jon Alterman, after the "Arab Spring," tens of billions of dollars have flowed into Egypt from the Gulf states, first as Qatari support for Mohammed Morsi’s Muslim Brotherhood-led government, and then as UAE, Saudi, and Kuwaiti support for the secular nationalist government of Abdel Fattah al-Sisi. The Gulf states’ approach to the Arab Spring was to treat the dislocations as an economic phenomenon. They spent huge amounts of money in the region in an attempt to stifle any contagion of regional instability, but with declining oil prices the implementation of their aid projects in neighboring states has slowed. Many MENA governments subsidize domestic energy prices and, in that respect, lower global oil prices have benefitted countries such as Egypt, Lebanon, Jordan, and Morocco. On the other hand, many (like Egypt and Morocco) are also labor-exporting countries, heavily dependent on worker remittances from wealthier neighboring countries. Moreover, regional oil importers are suffering the effects of regional conflicts and terrorism. Jordan, Lebanon and Turkey are burdened by the influx of Syrian refugees or migrants and the accompanying fiscal consequences. Jordan hosts more than 630,000 registered Syrian refugees. In Lebanon, refugees account for one-quarter of the population. Unemployment rates in Jordan increased to 12.5 percent in the first half of 2015. The World Bank has attributed increased insecurity and uncertainty to lowered foreign and domestic investment in both countries.

It is becoming more and more difficult for the oil rich countries to mediate conflicts or maintain regional financial stability.

Security implications

It has been evident for a decade that growing population pressure (the so-called "Youth Bulge"), failed economic development, a lack of employment for the younger generation, and failed and corrupt governance increased the potential for political upheaval in the MENA region. Even before the "Arab Spring," many oil-rich countries had been trying to address people's dissatisfactions by distributing oil revenues rather than by introducing political and economic reforms. Many of other countries in the region have similarly avoided reforms by depending on outside aid from neighboring petroleum-rich states. Alterman points out that as their wealthier neighbors become less able or willing to provide such support, countries like Yemen, Iraq, Syria and Libya have greater difficulty combatting domestic political instability. This in turn renders them more vulnerable to insurgent or terrorist groups such as the Islamic State, Ansar al Shari‘a, al-Qaeda in the Arabian Peninsula (AQAP), and al-Qaeda in the Islamic Maghreb (AQIM). Five years of civil war in Syria and the escalating conflict with ISIS in Iraq after 2014 have

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Middle East and North Africa Political Risk Assessment: Implications of Sustained Low Oil Prices (*cont'd*)

gravely damaged these countries' stock of physical capital. Absent a (unlikely) prompt resolution of these conflicts, the economies of these countries have little prospect for recovery, and they continue to run high current account fiscal deficits.

The recent Saudi-Iran confrontation in Yemen adds to ongoing political uncertainty in the region. Iran's potential to add oil supplies to the market now that P5+1 sanctions are eased could put further downward pressure on oil prices in 2016 and 2017. The confrontation, if escalated, could require both countries and their allies to assume still greater military spending burdens, worsening their fiscal difficulties. Moreover, the confrontation adds to regional geopolitical risks, affecting investment, tourism, and trade.

Libya as a Microcosm

Since the civil war began in 2011 in Libya, attacks on key facilities have resulted in significantly diminished oil production and the shutdown of some oilfields. Libya had produced around 1.6 million barrels/day (B/D) before the civil war; current oil production stands at 360,000-370,000 B/D. Furthermore, oil sales are yielding almost US $160 per barrel (/B) less than what Libya needs to meet its annual budget requirements. In their *Financial Times* article in January 2016, Anjli Raval and Heba Saleh highlight that with the 10th largest oil reserves in the world, Libya is estimated to have forgone more than US $68 billion in potential oil revenues since 2013.

The head of the Libyan National Oil Company (NOC) estimates that if recent UN-backed peace plans succeeded, oil production could rise to 1.2 million B/D. But the actions of ISIS in Libya (believed to have 2,000-3,000 fighters as of December 2015) aim to destroy or damage infrastructure and to reduce state revenues and to undermine peace efforts.

ISIS activity in Libya poses a huge threat to the country's political stability and energy sector, already burdened by a multitude of political and economic factors including a dysfunctional and fragmented state-owned oil company and the activities of local militias. The defeat of ISIS alone will not provide a solution. Without stable and profitable oil revenues, Libya will remain vulnerable politically and economically, and will be a growing threat to regional security.

Future Prospects

The World Bank forecasts oil prices to average US $37/B this year and to increase to US $48/B in 2017. Even if the price increases to around US $50/B, it is still much lower than the price before 2010, when the MENA countries were relatively stable. Sustained low oil prices discourage economic development and investments in security and diversity of supply. In his report on the implications of sustained low oil prices, Frank Verrastro emphasizes that global oil market security hinges heavily on having a diverse and robust global market, strategic stocks to draw on quickly in times of significant shortfalls, and policies that balance prudent and timely development of indigenous energy resources with environmental stewardship, economic improvement, strong trade ties, and a future-oriented outlook as the energy landscape continues to change.

Without stable and profitable oil revenues, Libya will remain vulnerable politically and economically, and will be a growing threat to regional stability.

The World Bank expects average growth in MENA to be 4.1 and 4.4 percent in 2016 and 2017, about one-percentage point higher than in the past three years. Much of this additional growth is contingent on Iran's re-entry into global markets and sufficient security for Libya and Iraq to increase oil exports. Meanwhile, regional expert Anthony Cordesman notes that the same problems that drove the upheavals in 2011 remain in place even in the stable MENA states, and are far worse in others, particularly the fragile states such as Libya, Iraq, Syria, and Yemen. As most projections indicate continued oil supply abundance in 2016 and 2017, political and economic risks in the MENA region will continue to be vulnerable to volatility in the global oil market. It is necessary to continue paying close attention to the future trends of oil prices and their implications for the MENA countries. ■

Documentation Risk Issues in PRI, TCI, ECA Guarantees and Similar Transactions, Part II (*cont'd*)

immunity from suit, or from attachment of its assets. This can be mitigated by getting an express written waiver of immunity.

<u>Obligation is a Guarantee</u>. If the obligor is guarantor that is guaranteeing the underlying obligor's payment, the guarantor may have defenses to payment that are separate from (and in addition to) the underlying obligor's defenses. For example, if key terms of a loan are changed without notice to the guarantor, it may release the guarantor from its obligations. This can be mitigated by confirming that the guarantee includes standard waivers of guarantor defenses.

<u>Sensitive Subject Matter in Contract</u>. Some types of contract provisions are not reliably enforceable for host country public policy or other reasons. For example, a big interest rate increase upon a

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Documentation Risk Issues in PRI, TCI, ECA Guarantees and Similar Transactions, Part II (*cont'd*)

payment default may run into usury limits, or a high pre-set liquidated damages amount may be viewed as an impermissible penalty. Mitigating these problems requires a case-by-case review.

Sensitive Industries. Host country courts and arbitral panels may be more reluctant to enforce agreements relating to certain industries, such as arms sales to foreign governments, gambling, or international adoptions. Mitigating these problems requires a case-by-case review and an understanding of the public policy of the applicable country.

Sensitive Countries. The enforceability of obligations against obligors in certain countries may be limited by international sanctions against that country. Recent sanctions regimes against Iran and Cuba are good examples.

Impact of Local Law of Host Country. Host country law (1) may impact obligor organizational (e.g., corporate) formalities, and (2) if elected as governing law, may limit the enforceability of obligations. This can be mitigated by legal due diligence and consultations with local counsel regarding specific issues.

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Is There a Safe Harbor?

While no contract is entirely free of enforceability risk, a hypothetical transaction with the following characteristics would likely not pose significant enforceability risk or problems:

The Contract

- **Standard type** of contract, such as:
  - Repayment by borrower of **loans** disbursed (indebtedness for borrowed money)
  - Payment by buyer for **goods** and **services** received (ordinary trade)
- Contract is governed by **established commercial law** (e.g., New York or English law)
- Dispute resolution mechanism is adjudication in courts of a designated country, **not arbitration**
- Language **translation not required** for documents to be enforced

The Context

- Not for use in a **sensitive country**
  - Not a country **sanctioned** by the UN or another block of countries
  - Not a country that has **withdrawn** from **international recognition & enforcement treaties**
- Not for use in a **sensitive industry** (e.g., military aircraft sales, international adoptions)

The Obligor

- Obligor is a **private** party (not a governmental or quasi-governmental entity)
- Obligor is **primary obligor** (not a guarantor or a pledger of security)

The Obligation

- Obligation in question is a fundamental obligation, typically a **payment** obligation (for goods actually received) or a **repayment** obligation (for a loan actually made)
- Obligation not related to **sensitive subject matter** (e.g., penalty amounts)
- (MOST IMPORTANTLY) Standard **legal opinions** have been obtained that cover basic enforceability issues with respect to the obligation in question, including:
  - Host country organizational formalities (typically a legal opinion from obligor's counsel)
  - Third-country governing law issues, e.g., New York law, English law (typically a legal opinion from lender's counsel)

Documentation Risk Issues in PRI, TCI, ECA Guarantees and Similar Transactions, Part II (*cont'd*)

Dispute Resolution By Arbitration. Arbitration is notorious for producing less predictable results than litigation because, among other reasons, there is no appellate review system or principle of stare decisis. If a dispute regarding enforcement of an obligation is subject to arbitration, the arbitrators may consider factors (such as fairness and equity) that would not be part of a judicial review of enforceability. This is why loans and other purely financial transactions are rarely subject to arbitration.

Translation Required. If contract enforcement requires that documents be translated, for example from English into the local language in the host country, important contractual concepts can be literally lost in translation. This can be partially mitigated by drafting documents in the local language and then translating them into English—and mitigated even further by an agreement that the local language version is the binding translation from the English.

Legal Opinion as Risk Identifier

Given the consequences of unenforceability, it sure would be handy to have a list of documentation risk issues for the key obligations in a transaction.

Actually, such a list often exists. The standard legal opinion regarding the enforceability of key obligations of a key obligor, called an "enforceability opinion," invariably has a long list of exceptions and qualifications to enforceability of those obligations.

Some of those exceptions are well-known and untroubling to most readers, such as the common bankruptcy exception:

- "[This opinion is qualified by] the effect of bankruptcy, insolvency, reorganization, arrangement, moratorium or other similar laws relating to or affecting the rights of creditors generally."

Other enforceability opinion exceptions—typically regarding developing countries with developing laws and legal systems—are more hair-raising:

- "In many cases, applicable laws, decrees, regulations, orders, and other governmental pronouncements are often vague, inconsistent, or unclear. In addition, applicable laws and regulations undergo frequent change, as do governmental interpretations thereof. We express no advice regarding future changes or interpretations of such laws and regulations."
- "In common with other emerging markets the exercise of the courts may result in decisions or circumstances which are inconsistent with decisions which may reasonably have been expected to be made. We express no opinion as to the observance and compliance by host country authorities with their respective legal obligation."
- "So far as we are aware host country courts have not had to consider any commercial agreements similar to the Agreement. We express no opinion as to how those courts would interpret or enforce the Agreement."

Parties are well advised to work with their lawyers to understand what these exceptions and qualifications really mean.

However, note that legal opinions speak only as of the date they are issued; most opinions expressly disclaim anything to do with future law.

MITIGATING AND SHIFTING ENFORCEABILITY RISK

A review of documentation risk also raises the broader questions inherent in any risk analysis: How can the risk, once identified and quantified, be effectively **mitigated** or **shifted**?

Relative Benefits of Shifting vs. Mitigation

Too often the parties dealing with documentation risk focus only on ways to **shift** the risk. As noted above, typical methods include:

- Representations in a political risk insurance policy that the documents are "legal, valid and binding and enforceable in accordance with its terms" ("LVBE") (at some point in time), coupled with provisions that bar a claim if any representations are untrue.
- Covenants in an ECA guarantee to maintain documents as LVBE (over some period), together with provisions that negate coverage if a covenant is breached.
- Exclusions or conditions to a claim in a trade credit policy that at the time of the claim the documents be LVBE.

As always, a better approach than arguing about who should take a risk is to reduce the risk itself. Happily, most of the typical mechanisms for **mitigation** work well for parties dealing with documentation risk.

For example, a political risk insurance policy of an investment agreement may require that the insured provide a copy of the host government decree authorizing it. Similarly, a trade credit insurer may conduct its own due diligence on the trade rules of the host country.

Surprisingly, though, one of the best mitigants for documentation risk is often overlooked. Legal opinions are not only one of the best methods for identifying documentation risks, as discussed above, but they also indirectly reduce those risks.

Many of the issues identified during due diligence process for a legal opinion are small errors that can be readily fixed, and thereby can materially lower documentation risk. ■

Insurance Protections for the Transactional Impact of Sanctions Compliance (*cont'd*)

striking fear into the heart of Wall Street and reverberating around the walls of corporate board rooms.

Legal and compliance departments are swarming all over the risks, particularly in banks where the regulatory burden has, in recent years, become all-consuming. This is bringing about significant change in corporate culture. The entrepreneurial spirit has arguably been stifled under the sheer weight of fear and desperate need to conform and comply. The consequence of being found to be in breach is not limited to the headline grabbing fines that jeopardize the balance sheet; the associated reputational hit and brand devaluation can have less direct but equally costly results.

Transactional due diligence is multi-faceted, extremely detailed and time consuming to complete, resulting in every deal taking much longer to reach closure. More nimble operators outside of the banking sector, such as commodity traders, are stepping into the breach and leveraging their balance sheets to steal a march on the more lumbering financial institutions. It is not an easy time to be a banker and there is little prospect of a relaxation of regulation anytime soon; the momentum is only heading one way.

Though Iranian sanctions have all but been lifted in Europe as of January 2016, in the US the relaxation has only curtailed the "extra-territorial" application of sanctions with the general trade embargo on Iran remaining in place. Where Russia is concerned, after initial inertia while everyone scratched their heads and grappled with interpreting the new sanctions regulations, it has swiftly become the established norm in the business environment. It seems that where the change in sanctions regulations once (and fairly recently) created uncertainty and unquantifiable risk, it is now almost the acknowledged status quo with the risks being accepted and measured, and the business opportunities slowly resurfacing. Sanctions regulations are now, more than ever before, a prominent fixture on the business landscape and companies are spending considerable time and effort to ensure that they comply with it.

[Compliance] can … have significant financial impact at the transaction level when new regulations are introduced during the life of an overseas investment or midway through performance of a trade contract or financing.

The Cost of Compliance

However, the cost of compliance is not only felt in the form of the wage bill for the swelling cohorts needed internally to implement and police the endless checks and balances. It can also have significant financial impact at the transaction level when new regulations are introduced during the life of an overseas investment or midway through performance of a trade contract or financing.

Timing is everything. If the measures are introduced before you enter into a venture that would be impacted, the solution is fairly straight forward: you don't proceed. If the signs are there of deteriorating international relations, you form a view and the prudent likely shy away, whereas the more cavalier choose to proceed. It all comes down to your corporate risk barometer and appetite but if the situation escalates without warning and measures are rushed through, even the most cautious may find themselves in a position where to comply with the sanctions regulation they have to beat a swift and financially painful retreat.

[T]here is always a risk that relations between an insured's home nation and the host nation could deteriorate to the extent that the insured's own government legislates that it must divest itself of its interest in the host country.

How does an organization—be that a bank, commodity trader, exporter or corporate investor—protect itself from the financial consequences at the transactional level of adhering to unanticipated sanctions? In such circumstances, what insurance products could or would provide protection?

The private Credit and Political Risk Insurance (CPRI) market has an extensive history, in excess of 40 years, of providing insurance policies that respond in such circumstances.

Insuring Corporate Investors operating Overseas

Some of the earliest insurance products that provided coverage for loss arising from the application of sanctions appeared in the form of "Forced Divestiture" protection. This is epitomized in the early Lloyd's standard wordings for investment covers (originating in the late 1970s/early 1980s) and remains a fixture of such policies today. A fairly typical clause reads as follows:

> ***Forced Divestiture*** *means the operation of a law, order, decree or regulation by the government of the Insured's Country that forbids the Insured from owning shares in the Foreign Enterprise or Assets in the Foreign Country and/or requires the Insured to sell or dispose of such shares or Assets.*

Such cover acknowledges that for corporate investors seeking to truly globalize their operations and shift investment overseas on a long term basis, be that in the form of manufacturing capabilities,

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Insurance Protections for the Transactional Impact of Sanctions Compliance (*cont'd*)

establishing foreign subsidiaries or investing in infrastructure projects, there is always a risk that relations between an insured's home nation and the host nation could deteriorate to the extent that the insured's own government legislates that it must divest itself of its interest in the host country. The insured gets squarely caught in the political crossfire, particularly if it is in a strategic industry, and the impact on the balance sheet could be considerable. Such was the fate of numerous US oil companies over the prior century.

Insurance covering Forced Divestiture is designed to compensate an insured on the basis of either their Net Book Value or Net Investment Value providing the necessary balance sheet protection. In addition, it is also possible to protect the Profit and Loss Account by purchasing Business Interruption following Forced Divestiture. This would then provide compensation for loss of profit, on typically a 6 or 12 month basis, while a business relocates its operations elsewhere.

Though claims activity under such perils has been relatively dormant over the last few decades, in the 1990s it was widely acknowledged (with a wry smile) that the government responsible for generating the largest historic monetary losses to the CPRI market was the United States, largely due to forced divestiture and other impacts of sanctions regulations (though, I would hasten to add, in recent years they are likely to have been overtaken).

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Trade Embargo and Export License Cancellation

Where investments are wholly reliant on overseas inputs to be productive, or overseas sales markets to be profitable, any introduction of regulatory barriers to trade can result in an equity investor's overseas operation ceasing to function. These barriers can take the form of new trade embargoes or the cancellation or non-renewal of existing export/import licenses. Protection for these events can be provided under fairly traditional private investment insurance policies and have been regular features of market template policy wordings for decades.

Bank Investment Insurance

Those same insurance covers of Embargo and Export/Import License Cancellation are also available to lenders particularly in relation to project finance risks in the extractive industries where revenue from exports is paid into off-shore collection accounts primarily to provide debt service. If those trade flows are interrupted due to the aforementioned named perils resulting in default in scheduled payments under the project loans, then these lenders' policies are structured to respond. Indemnity is provided on the basis of the value of the resultant outstanding loan repayments, typically on a principle plus contractual interest basis.

Contract Frustration Insurance

In addition to political risk insurance for overseas investments, the CPRI market provides policies covering cross-border trade contracts against frustration due to named political and commercial perils.

Where the Insured is the seller under the contract: These covers indemnify on the basis of "costs incurred" if the frustration occurs before the insured has delivered the goods and services to meet their contractual obligations, typically referred in the market as "Pre-shipment" cover. Should the frustration occur due to the failure of the counter-party to meet its payment obligations after the insured has performed, then indemnity under the policy is simply based on amounts contractually due to the insured under the contract. This latter cover has traditionally been referred to as "Post-shipment."

Protection against the impact of sanctions regulations is provided under both of these sections, just more overtly in the former. Pre-shipment cover, in line with investment insurance policies discussed previously, includes named perils of "Embargo" and "Export License Cancellation or Non-renewal" and responds when the sales contract is frustrated due to the fact the Insured is unable to deliver the goods or services in accordance with the contract. Typically this will fall within the force majeure provisions of the contract and if regulation remains in place the contract will likely be terminated. The insurance policy will step in and compensate the insured for its costs, including those of obligations to third party suppliers and a small element of lost profit (typically 10%).

On the "Post-shipment" side, cover responds when the buyer defaults in payment in accordance with the contract terms. The policy doesn't typically seek to limit the causation of that non-payment. Therefore, if sanctions restrict the buyer's access to markets or finance resulting in liquidity crises this wouldn't normally be excluded from cover.

Where the Insured is the purchaser under the contract: Contract frustration policies in these circumstances indemnify to the value of any prepayment made by the insured to a supplier in advance of delivery. If sanctions regulations prevent the supplier from delivering under the contract or the insured from taking delivery under the terms of the contract, then this should trigger the contract force majeure clause. As long as the contract is drafted so that force majeure situations lead to termination, and upon that termination

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Insurance Protections for the Transactional Impact of Sanctions Compliance (*cont'd*)

the supplier is under a contractual obligation to return the advance payment to the insured, then the policy will respond if the supplier fails to make that repayment.

Comprehensive Non-Payment Insurance for Banks

Much time has been devoted recently in the CPRI market to developing a clause for banks that determines the treatment of the policy if the parties to the insurance, or the transaction being insured, become subject to sanctions during the life of the policy. This has been a long drawn out and, at times, surprisingly heated debate. By way of explanation, as comprehensive non-payment insurance policies can be utilized for capital relief (if drafted to meet the definition of a guarantee under the Basel II/III banking regulations), any clause that adds conditionality which is outside the bank's control jeopardizes that treatment. Therefore, drafting a clause to recognize the positions of both insured and insurer, while retaining the benefits of capital relief from the policy, requires treading a very careful and considered line.

…[D]rafting a clause to recognize the positions of both insured and insurer, while retaining the benefits of capital relief from the policy, requires treading a very careful and considered line.

Given the focus of this section is on coverage for sanctions as opposed to compliance with them, you could be forgiven for querying the relevance of the preceding paragraph. However, during the process of reaching a landing on the market sanctions clause (LMA 1865), it served to highlight the fact that in complying with sanctions regulations, an insured may well exacerbate the probability of a default under a loan and increase the likelihood of a claim under the policy. This would arise if, in fear of being found guilty of "facilitating" trade with a sanctioned entity and breaching regulations, the banks activated the sanctions provisions in the loan agreement, giving them the right to terminate the loan agreement. At that point, any amounts drawn down under the loan would become immediately due and payable. If the obligor couldn't meet the requirements to pay the accelerated amount, the obligor would be in default and any insurance policy providing non-payment cover would be in line to respond.

What the market sanctions clause recognized contractually in the policy was that an insured taking action to abide by sanctions could increase the likelihood of a loss but that action should not in itself prejudice the insured's rights to claim under the policy. Insurance policies have always contained obligations on an insured to "minimize loss" and act with "due diligence." The market sanctions clause recognised the potential contractual conflict that sanctions compliance could create with the other terms of the policy and made it clear that in such circumstances, coverage would be preserved. Therefore, inclusion of the clause in any comprehensive non-payment policy for a bank removes any possibility for alternate interpretation by insurers and potential for dispute on the issue at point of claim.

As I hope this piece has demonstrated, many insurance products are available to provide protection for entities financially caught out when sanctions regulations get unexpectedly implemented. Many of these products have been available for decades and merit dusting down and re-highlighting. Others are more subtle and less obvious in the scope of protection they afford in such circumstances and are worthy of a little explanation. What is clear, for the prudent overseas investor or entity involved in cross-border trade, is that insurance products exist to ensure adherence to sanctions won't leave compliant entities exposed to financial loss. ■

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