



*Ukraine: a brief primer on  
sanctions, expropriations and  
state break-ups*

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# Ukraine: a brief primer on sanctions, expropriations, and state break-ups

## What this note is about

The purpose of this brief note is to help market participants make contingency plans where the political crisis involving Ukraine results in sanctions and embargoes, exchange controls, expropriations and the break up of Ukraine.

We are focusing in particular on the legal impact these events might have on financial contracts, such as bond issues, bank loan agreements, deposits and investments. We do not deal with wider political and economic consequences, such as the impact on a country's economy and its banking system.

We sketch in the private law and the public international law background without applying them to the particular circumstances of Ukraine from day to day. The situation is moving quickly. What is needed is a steady framework which is not subject to daily change.

We look at the following main topics:

- the impact of sanctions and embargoes by one country on another
- the legal impact of expropriations
- the legal impact of a break-away from a state, notably international recognition of the break-away state and the general rules about state succession to assets and debts.

All of these things historically tend to happen together and so one has to try and unravel the strands.

## Sanctions and embargoes

Sanctions and embargoes were historically most prominent in times of war and were intended to deprive the enemy of armaments, supplies and finance. They were blockades. More recently they have been used against sovereigns thought to be a security threat or to express extreme disapproval.

In most countries, the executive government has the power to impose sanctions if there is considered to be an emergency or security threat.

The sanctions may be directed against specific individuals or corporations (as in the case of the sanctions imposed by the West in relation to Ukraine) or they may prohibit all dealings with the nationals and residents of the sanctioned country. For example, the sanctions may prohibit loans to nationals and residents of the sanctioned country, the repayment of loans, deposits or dividends to them (thereby imposing a freeze or moratorium), payments under letters of credit to sanctioned

beneficiaries, direct investments and the like. The sanctions may sequester assets. Or they may be targeted at specific transactions. You have to study the detail.

The U.S. can prevent foreign banks from using the U.S. dollar payment system directly or through correspondent banks and thereby freeze them out of the U.S. dollar market. This could have a serious impact on foreign banks from a sanctioned country, such as Russia, which are members of a bank syndicate lending U.S. dollars. Attention would have to be given as to whether standard clauses in syndicated bank credits, such as an illegality clause, are wide enough to cover the situation. Those clauses are primarily intended to cover sanctions against a borrower, not a lending bank.

In the past, the U.S. has imposed embargoes on Cuba, Vietnam, Libya, Iran, Iraq and other countries. U.S. sanctions are often tougher than those imposed by the EU which, in turn, tend to be tougher than those imposed by the UN.

A further typical example of where problems might arise is where the U.S. imposes sanctions on, for example, Russian entities, and a foreign branch of a U.S. bank in London either has deposits owing to the sanctioned Russian entities or has agreed to make loans or to roll over a loan in favour of the Russian entity in circumstances where the UK has not imposed similar sanctions.

The risk for a U.S. bank in this scenario is that it would be unlawful under U.S. law to make a payment but the sanctions are not recognised by the law of the branch, eg if the branch was located in Britain. This type of situation has been very common in the past and so there is quite an accumulation of case law.

The general rule, in the English courts at least, is that the courts will give effect to the foreign embargo if it arises under the governing law of the contract, such as a New York-governed deposit or loan agreement, or if (in the case of a contract governed by English law), the U.S. embargo makes payments illegal at the place where payment must be made. Therefore in the famous Libyan case of 1988, Bankers Trust was ordered by the English courts to pay a deposit to the Libyan Arab Foreign Bank, notwithstanding that this was illegal under U.S. law where the bank was domiciled. The deposit was payable in London and the bank was not required mandatorily to pay via Chips in New York, but could hand over a sack full of notes. It would have been otherwise if the deposit agreement had required payment through Chips because that would have involved doing something illegal at the compulsory place of performance.

Deposit contracts typically do not specify the governing law and may be vague on the details of place of payment. International bond issues typically require payment through the payment system in New York.

Note that sanctions do not normally prevent a sanctioned resident from repaying principal and interest owing by it to residents of the country imposing the sanctions.

If one gets into a situation where, for example, an obligation to make a loan is enforceable under English law, but is a criminal offence under U.S. law, the terms of the contract may come to the relief of the bank caught in the middle, eg the typical illegality clause in a syndicated credit or corresponding clauses in a derivatives master agreement. A material adverse change event of default or draw-stop may be relevant.

## Exchange controls

Countries typically impose exchange controls when they are in trouble – as a moratorium to prevent capital flight, to preserve foreign currency reserves and to protect the value of the local currency.

You apply roughly the same rules as the above in the case of exchange controls. Thus exchange controls imposed by one state, such as Ukraine, preventing Ukrainian borrowers from repaying their loans, would not be recognised under an English law agreement except in certain special cases, such as illegality under the law at the place of payment, but would be recognised by the English courts if the loan agreement is governed by Ukraine law. So the foreign law of the loan agreement or bond insulates the contract from Ukraine exchange controls, but a domestic governing law does not. This situation is somewhat theoretical if a Ukraine corporate borrower becomes bankrupt in which event the creditors would typically end up having to recover in Ukraine and hence be subject to the exchange controls.

Nearly all of Ukraine's foreign bonds are governed by English law and so would be insulated from Ukraine exchange controls. This would include the bonds governing Russia's very recent loans of USD5 billion to Ukraine just before the departure of [Mr Yanukovich]. See the [Intelligence Unit](#) paper on the [Allen & Overy](#) website, "[How protective are Ukraine's foreign law bonds?](#)" 5 March 2014.

The U.S. rule on recognition of exchange controls is slightly different, since it depends, not on governing law, but on the location of the claim. But you often get the same result.

There is a special regime governing exchange controls under article VIII 2b of the IMF Agreement which overrides the insulation of foreign governing law in the case of exchange controls prejudicing "exchange contracts". This article matters a great deal in such countries as Luxembourg, France and Germany but is generally not dangerous in the U.S. and English courts in the case of loans, bonds and deposits. In all IMF member countries, the article could override the insulation of the foreign governing law in the case of foreign exchange contracts.

There may be remedies available under bilateral investment treaties if exchange controls prevent a qualifying foreign investor from repatriating capital.

## Expropriations

Expropriations of foreign-owned assets are a familiar feature of the conduct of sovereign states. Expropriations may be driven by population, or a sense of injustice, or by war or a political tit-for-tat. The expropriation may be outright or partial, creeping, a nibble here, a nibble there.

The legal consensus adopted by the national courts of developed countries is that, subject to exceptions, they will recognise or refuse to adjudicate upon a foreign expropriation if the expropriated asset is located within the territory of the expropriating state at the time of the expropriation, but not if it is external. For example, if a bank deposit is expropriated in Russia and the deposit is payable by a bank in Moscow, generally the courts of other countries will recognise this forcible transfer. But they would not do so if the deposit were payable by, say, the London branch of the Russian bank. A Russian law cannot transfer a foreign asset.

The basic idea is that national courts do not interfere with acts carried out by a government relating to assets within its territorial domain because to do so would be pointless and give rise to endless litigation in all states. This is called the act of state doctrine.

There are exceptions to this proposition, eg where the expropriation is discriminatory on the grounds of race and creed or (in England) the expropriation was by an illegal government, such as the expropriation by Iraqi legislation of Kuwaiti aircraft in Iraqi-occupied Kuwait around 1990.

But the most important exception is where the expropriating state does not pay prompt, adequate and effective compensation. There have been decisions in many developed countries, eg France, the Netherlands and others, declining to recognise an expropriation in the absence of compensation, and indeed the mainstream view is that under public international law, an expropriation is unlawful unless the state pays proper compensation. But courts in England, Germany and Italy have recognised international takings, even though no compensation was paid. The U.S. position is complex.

The case law has been built up on successive waves of expropriation, eg the Russian revolution, the Cuban revolution, Indonesian tobacco, Chilean copper, expropriations by newly independent states – the list is endless. One of the most interesting cases involved the seizure by Russian revolutionaries of pictures from the palace of Princess Paley Olga after the Russian Revolution in 1917.

There can be arguments about where the property is located for the purpose of the act of state rule. This is simple in the case of goods, eg Princess Olga's pictures were located in Russia and therefore the English courts could not intervene, but on the other hand, a decree of the Netherlands government could not requisition gold held in London.

As regards the expropriation of claims, bank deposits are generally held to be located at the location of the branch where the deposit is payable. Similar rules would apply to loans. The governing law of the contract or the jurisdiction of the courts is not relevant, but sometimes U.S. case law has located a debt at the place of payment so that if the debt is payable in New York in U.S. dollars, then it is outside the territory of the foreign expropriating state.

Shares are normally located where the company is incorporated, but there have been unusual cases in Switzerland and Germany where the courts have looked through the corporate veil to the location of the assets so that the foreign assets of the company concerned could not be touched. The UK and the U.S. courts do not adopt this view if the shares of a local company are expropriated; it is irrelevant that it has foreign assets: the foreign assets, including foreign subsidiaries, go with the company. The principles are relevant to project finance special purpose vehicles incorporated to build and operate a local project.

Apart from actions in foreign domestic courts, it is generally useless to proceed in the courts of the expropriating state, whatever their constitution says about the need for compensation. Pursuing a remedy in international courts under customary international law is also generally so hindered by obstacles as to be of little value, eg the state of the investor must bring the claim.

On the other hand, if there is a bilateral investment treaty in usual form between the expropriating state and an investor who is a national of the other party to the treaty, then generally an expropriation will allow the investor to bring an arbitration claim in an arbitral tribunal. If the arbitral tribunal is international, like ICSID, then an award may have diplomatic value, but, again, remains of little

practical value if the expropriating country chooses to ignore the award. One reason is that it is often hard to find the external assets of a foreign sovereign state because their main foreign reserves are held by the central bank and other state assets are held via state-owned companies which are not responsible as debtors in respect of the award.

## Impact on bank deposits

The above principles are particularly relevant to bank deposits. If, say, Russia, expropriates deposits owed by Moscow branches of U.S. or UK banks, then the disappointed depositor could seek to claim from the head office of the foreign bank in the U.S. or UK. If the bank had to pay through its head office, then it would not have the benefit of the local assets to cover the deposits, such as local loans.

The situation is illustrated by a case where Arab Bank had placed a deposit with the Jerusalem branch of Barclays Bank. When the Arab-Israeli War of 1948 broke out, the Israelis expropriated the deposit by requiring that Barclays Jerusalem pay it to an Israeli custodian. Arab Bank sued Barclays in London to recover the deposit. The court held that Barclays was not liable to pay because the deposit was at the time situated in Jerusalem and therefore subject to the legislation in Israel. A U.S. case came to the same conclusion in the case of a deposit payable in Cuba. But in another case involving the flight from Vietnam, a U.S. court held that Chase was liable to pay in New York a deposit with its Saigon branch which was expropriated.

This risk has led banks to debate whether to mitigate the foreign branch political risk by providing specifically in the deposit agreement between the foreign branch and the depositor (1) that the deposit is payable only at the local branch so that the legal location of the deposit is local with the result that the depositor takes the local expropriation risk, (2) that the deposit is governed by local law at the branch so as absorb any exchange control or moratorium legislation, and (3) that the depositor agrees to the exclusive jurisdiction of the local courts. These contracts are rather unusual, perhaps because they have a discouraging effect on depositors who are thereby alerted to risks they had not thought of before.

These problems do not affect subsidiaries since the parent is not normally liable for the debts of its subsidiary unless it has specifically guaranteed them. Often local regulators require foreign banks to form local subsidiaries so as to give the local jurisdiction more control and for other reasons. This also technically insulates the foreign parent from liability for deposits.

## Recognition of states and governments

Legal issues of recognition arise when a new sovereign state claims that it has come into existence or when a new government of an existing state assumes power by a revolution or other unconstitutional means. Other states and their courts then have to decide whether the new state exists as a matter of law and who represents it.

For example, if there is a new country or competing regimes, who is entitled to borrow under a loan agreement? Which borrowing state can be sued? Who owns what assets? Is the new state entitled to sovereign immunity?

Issues of recognition would arise if, say, Crimea declared independence or if a competing government purported to take control of eastern Ukraine. Similar historical examples include the Rhodesian declaration of independence in 1965, the establishment of the Turkish Republic of North Cyprus in 1977 and the Iraqi annexation of Kuwait in 1999. None were recognised by other states, with very limited exceptions.

The courts of most developed countries will often decide whether the new state has *de facto* authority over the population and territory showing a stability and effectiveness essential for a state to exist. But their courts also often take into account the views of their own government since, in matters of foreign relations, the courts and the government should speak with one voice. The degree of influence on the courts of a declaration by the executive as to whether or not it recognises the state or otherwise deals with the state as if it were recognised varies from country to country. In the U.S. and the UK the views of the executive are usually binding on the courts.

The recognition of governments is different from the recognition of states. So there are two forms of recognition. A country may recognise a state, but not its government, eg because the new government was unconstitutional or there is a competing government. The issue arises if the new government, for example, borrows money or grants a concession. In 1980 the UK dropped formal recognition of governments. This view is widespread, eg in Australia, Canada, Belgium, France, the Netherlands, New Zealand the U.S. (since 1977), and the EU. Most courts decide according to the realities, eg who has effective control.

In a 1993 case involving Somalia, an English court held that the factors are to be taken into account as to whether a foreign government was the government of the state included (1) whether it was the constitutional government, (2) the degree, nature and stability of administrative control that it exercises over the state's territory, (3) whether the UK government had any dealings with it, and (4) in marginal cases, its degree of international recognition. In that case, the interim government of Somalia did not qualify as a government.

If a state is not recognised, then generally the courts will not give effect to its acts, such as the grant of concessions, or allow the unrecognised government to sue or to be sued.

If a state is not recognised, then the basic rule is that the unrecognised state cannot sue or be sued in the courts of the country which refuses recognition. The lonely state is treated as not being there at all. Nevertheless, this fiction has limits, though these are hard to define precisely. For example, UK and U.S. courts will often give effect to private transactions which are not inconsistent with foreign policy objectives, eg marriages, private transfers of property and the like.

Under the UK Foreign Corporations Act 1991, a body having corporate status under the laws of a non-recognised state will be treated as if the state were recognised, ie the body has legal personality and if there is a "settled court system". There is similar legislation in Australia and Hong Kong.

Non-recognition can continue for considerable periods, such as the non-recognition by the U.S. of the Peoples Republic of China and then Taiwan, notwithstanding that the state clearly exists in fact.

## State succession

Questions of state recognition are typically interwoven with the law of state succession, ie where there is the replacement of one state by another in the responsibility for the international relations of territory. Examples are partitions, reunifications and the break away of part of a state.

Again, these situations affect the position of lenders and other financial counterparties eg which state is entitled to borrow, which state is liable for the debt, which state owns the foreign reserves, what happens to any collateral, how one decides any new currency, how one determines the governing law if it was local and so on.

These questions might arise if the Crimea or the eastern Ukraine were to break away or declare independence or to unify with Russia.

Questions of state succession do not arise if all that happens is there has been a change in the government. Most developed countries hold that mere political changes of government do not affect the state's obligations. The binding nature of a state's obligations is independent of changes of regime, constitutional or otherwise. This proposition was upheld in the famous Tinoco arbitration of 1923 where concessions granted to British companies by Tinoco, who had seized dictatorial powers in Costa Rica, were held to be binding even after a change of government which declared the concessions invalid.

It is extremely difficult for a sovereign debtor to claim that any of its public debt is odious debt and therefore invalid on the grounds that the government which contracted the debt was unconstitutional or wicked. A loan may be fraudulent if, say, the lender knew that the head of state would steal the money.

There are a vast number of historical precedents as to the effects of state break-ups. One does not have to go back to the dissolution of Great Colombia in 1829 to 1831, or the dissolution of the Union of Norway and Sweden in 1905, or the disappearance of the Austria-Hungarian Empire in 1919, or the dissolution of the United Arab Republic in 1961 or indeed the whole process of decolonisation in the mid-20th century. In relatively recent times, we are presented with the dissolution of the USSR (including the declaration of independence by the Baltic states in 1991), Yugoslavia, Czechoslovakia and the independence of East Timor (2002) and Montenegro (2006). Sudan and Kosovo are other recent examples.

Notwithstanding that sovereign splintering and fragmentation seems rather routine, there is nevertheless a dearth of case law in domestic courts and much disagreement as to the rules of public international law. Apart from the succession of states in respect of treaties under the Vienna Convention of 1978, we do have another Vienna Convention on the Succession of States in respect of State Property, Archives and Debts adopted in 1978. This never came into force because the approach of that convention on the position of newly independent states was dominated by the views of newly decolonised states which were contrary to the views of the industrialised states. Still, the unfulfilled convention is quite a useful summary of state practice in general.

Broadly speaking, debt which is contracted by a territorial public authority which has a separate legal personality, such as a province, city or public enterprise, should go with the local authority. Very often debt contracted by the state itself but which is linked to a particular territory, eg where it is secured on

assets or fiscal resources there, or is earmarked for territorial use there, goes with the territory as localised debt.

Those principles would be relevant to project finance, but clearly there could be obscure questions, such as liability under the host government concession.

When we get to the national debt of a state which is not related to any particular territory or asset and is charged to general revenue account, we get problems.

In practice, if there is a breakaway of a small part of a territory and the surviving state remains substantially intact, there is probably a presumption that the surviving state is responsible for the national debt even though its economic ability to service its foreign debt may be reduced. On the other hand, if a state completely breaks up, then state practice is to arrive at an equitable apportionment of the debt, based upon such matters as tax ratio, productivity, extent of territory, population, value of assets and the like. It is hard to find any firm domestic case law and so one has to fall back on state practice and common sense principles of fairness and reason.

In the case of the Czech and Slovak republics, the two successor states agreed to divide the assets and liabilities of the predecessor state, Czechoslovakia, in the ratio of 2:1 which was the rough population ratio of the two new states.

In the case of the former USSR, Russia and the successor states agreed in 1991 and 1992 to apportion the assets and liabilities of the USSR. Russia had a share of 61.34% and Ukraine 16.37%. The criteria used included the participation of the republics in the imports and exports of the former USSR, the proportion of GNP and the proportion of populations. But the agreement never came into effect and in 1993 Russia claimed all the assets and liabilities of the former USSR.

In the case of former Yugoslavia, an agreement in 2001 provided for the distribution of assets on the basis of agreed proportions. India on independence was responsible for all the public debt of British India, but Pakistan agreed to make a contribution to India. On the break-away of the Irish Free State from the UK in 1921, it was agreed that the UK public debt would be apportioned equitably.

## Change of currency

If Crimea or the eastern Ukraine were to break away and establish a new currency, such as the Russian rouble, there would be issues as to impact of the change of currency, eg on local project loans. Some of principles were exhaustively thrashed out with relation to speculation that Greece would exit the euro and we have papers on the subject. The same issue is currently being debated in relation to Scotland.

## Conclusion

Banks and corporates – and sovereign states – are rightly interested in how predictable the legal rules are, where they stand and what the risks are in these highly charged situations.

Often the situations are resolved by events or negotiations. But negotiations take place against the background of the law so that the law determines the strength of bargaining positions.

The law in developed countries is reasonably well settled in the case of the recognition and legal impact of sanctions, exchange controls and expropriations. This is not the case with state succession to public debt, probably because in most cases a legal resolution has been trumped by agreement between the states concerned and the political realities of the situation. State recognition remains mainly political, so that dealings with an unrecognised state take the risk of legal unenforceability.

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