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Credit Agreement Considerations for Borrowers after Russian Invasion of Ukraine

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Promptly after Russian forces invaded Ukraine in late February 2022, the United States, the European Union, the United Kingdom, Canada and an increasing number of other countries enacted a broad (and growing) set of sanctions on Russian and Belarusian banks, businesses, government sectors and individuals. Such sanctions have been described in a recent Paul Hastings client alert as the "most draconian and punitive set of sanctions ever imposed on a large economy." In addition, many Western businesses have announced that they are willingly ceasing operations in Russia and/or Belarus until the war ends, even if such cessation is not required by applicable law at this time.

As the legal and moral considerations evolve, companies should familiarize themselves with the applicable provisions in their credit agreements governing sanctions, anti-money laundering and anti-terrorism rules. In this alert, we have summarized at a high level common Sanctions-related representations, warranties and covenants contained in credit agreements. Next, we consider common commercial scenarios and set forth, among other things, potential breaches of those common representations, warranties and covenants contained in credit agreements. Finally, we discuss other scenarios that may arise based on other related business decisions, like suspending operations, replacing suppliers or selling business units, because these actions may have unintended consequences.

What are the common restrictions and provisions in credit agreements relating to Sanctions?

Nearly all credit agreements contain representations and covenants that a company and its subsidiaries are in compliance with all applicable laws, subject to varying degrees of materiality. Most credit agreements contain specific representations and covenants regarding compliance with government sanctions which have much more limited materiality standards. Indeed, the scope of such Sanctions provisions may vary and should be reviewed for compliance.

Directors, Employees, Officers, Owners, Agents, Etc.

Such sanctions may include a representation regarding officers, directors, owners or agents being subject to Sanctions or located in a sanctioned jurisdiction.

> No Group Member, nor, to the knowledge of any Group Member, any director, officer, employee, agent, affiliate or representative thereof, is an individual or an entity that is, or is owned or controlled by an individual or entity that is (a) currently the subject of any Sanctions, or (b) located, organized or resident in a Designated Jurisdiction.[1]

In order to maintain the accuracy of this representation, companies should consider, among other things, where their agents and representatives are domiciled and whether any of them are included on a sanctions list. Indeed, such representation may not be broad enough to apply to a company's customers but it is broad enough to apply to a company's traveling sales agent, as discussed further below. If a company is aware that it has employees, contractors, agents or other representatives located or resident in a sanctioned territory, as discussed below, it is critical that the company seek advice of outside counsel before further transacting in such regions.

Locations of Collateral

Credit agreements (especially asset based credit agreements) may restrict any collateral from even being located in a sanctioned jurisdiction.

> No Collateral is Embargoed Property. "Embargoed Property" means any property (a) in which a Sanctioned Person holds an interest; (b) beneficially owned, directly or indirectly, by a Sanctioned Person; (c) that is due to or from a Sanctioned Person; (d) that is located in a Sanctioned Jurisdiction;[2] or (e) that would otherwise cause any actual or possible violation by the Bank of any applicable Anti-Terrorism Law if the Bank were to obtain an encumbrance on, lien on, pledge of or security interest in such property or provide services in consideration of such property.

Maintaining the location of all company collateral at all times is a daunting task, given, among other things, global shipping of goods and the mobility of employees. Companies may wish to consider the likelihood of immaterial foot faults (i.e., an employee brings a company laptop or mobile phone to visit family during the holidays) as well as more significant defaults (i.e., locations of warehouse or barges and ports), as further discussed below. As noted above, if a company is aware that it has assets located in a sanctioned territory, as discussed below, it is critical that the company seek advice of outside counsel before further transacting in such regions.

Use of Proceeds

Nearly all credit agreements will bar, without any materiality standard, the use of loan proceeds or other extension of credit in violation of Sanctions provisions, whether direct or indirect, or knowingly or unknowingly, because the lenders themselves become strictly liable for any violations of the laws in which their loan proceeds are used.

> Use the proceeds of any Loan or extension of credit hereunder, whether directly or indirectly, and whether immediately, incidentally or ultimately, to fund any activities of or business with any individual or entity, or in any Designated Jurisdiction, that, at the time of such funding, is the subject of Sanctions, or in any other manner that will result in a violation by any individual or entity (including any individual or entity participating in the transaction, whether as Lender, Arranger, Administrative Agent, Issuing Lender, Swingline Lender, or otherwise) of Sanctions (or lend, contribute or otherwise make available such proceeds to any Subsidiary, joint venture partner or other individual or entity in violation of the foregoing).

Given that financing sources face strict liability for violations of Sanctions utilizing the proceeds of their capital, financing sources will have very little or no flexibility to accommodate any such breaches. As discussed below, this poses operational complexity for companies to consider that may operate in or conduct business in Russia or Belarus or with Russian or Belarusian individuals, banks and other businesses.

Compliance Programs

More recent credit agreements may contain a covenant or representation regarding the existence and enforcement of a Sanctions compliance program.

> The Borrowers will maintain in effect and enforce policies and procedures designed to promote and achieve compliance by Holdings, its Subsidiaries and their respective directors, officers, employees and agents, in all material respects, with Anti-Corruption Laws and applicable Sanctions.

While such covenants or representations should not require strict compliance with the compliance program itself, the covenant or representation likely requires companies to review and update their programs from time to time in order to comply. Given the number of recently enacted sanctions, companies would be well suited to review their compliance programs with outside counsel to ensure they are up to date.

How may the Sanctions that have been enacted affect a company's business?

While the Russian sanctions package developed in February/March of 2022 has some of the most far-reaching measures ever enacted, it does not prohibit all U.S. transactions with Russia and Belarus. Broadly, as of the time of posting this article on March 10, 2022, the U.S. government has designated as sanctioned several Russian and Belarusian elites and a number of key Russian financial institutions. In addition, the U.S. has imposed debt and equity prohibitions concerning certain Russian entities, expanded restrictions on dealings in Russia's sovereign debt, imposed restrictive measures on the Russian Central Bank and committed to removing select Russian banks from the SWIFT international messaging system. Finally, the U.S. has placed prohibitions on U.S. correspondent and payable-through access for Sberbank and its subsidiaries, and enacted significantly more restrictive trade control measures. The result is that U.S. company dealings with Russia have become considerably more complex, requiring careful consideration and analysis of current operations.[3]

While the impact of sanctions laws and trade controls on each business is necessarily fact-dependent, Paul Hastings thought it would be useful to examine at a high level how the new U.S. sanctions[4] on Russia could affect some common commercial scenarios, especially in the context of credit agreement compliance. Below, we have presented hypothetical situations based on some common fact patterns[5] and worked to classify them as either (1) prohibited under sanctions laws, (2) permitted under sanctions laws, but in potential breach of a credit agreement, or (3) neither prohibited nor a breach, but presenting practical difficulties that could make a company's business unduly difficult to operate.

Operating Locations

Example: Company R, a United States company, owns and operates a retail store[6] in Russia.

<u>Sanctions Laws</u>: Generally, U.S. sanctions would not prohibit a U.S. company from owning and operating a retail store in Russia, provided that the Russian operations did not involve transacting with sanctioned persons or engaging in certain transactions with certain Russian energy and defense companies and financial institutions in violation of "sectoral" sanctions regimes.

<u>Credit Agreement</u>: While operating a retail store in Russia does not violate current U.S. sanctions laws, it exposes Company R to potential breaches of its credit agreement. If during the course of its business, Company R unknowingly transacts with someone on the List of Specially Designated Nationals and Blocked Persons ("SDN List"),[7] the transaction could be a violation of sanctions laws and could be a

breach of, among other things, representations regarding "Use of Proceeds" in a credit agreement. Company R would presumably be using the proceeds of the loan to fund its retail store, and by doing business with a sanctioned individual would be using the loan to fund a transaction in violation of U.S. sanctions laws. Additionally, if Company R's credit agreement restricts the location of collateral in a sanctioned jurisdiction, the location of the retail store and the inventory located therein could be a violation of such covenant.

Practical Considerations: Even if not illegal or a breach, new sanctions on Russia will cause considerable operational difficulties. Practical considerations include, among others, paying employees, processing payments from Russian customers, screening customers, exporting supplies to a location in Russia, and reputational damage. The U.S. has sanctioned a number of prominent Russian banks, and plans to disconnect others from the international SWIFT messaging system, which could make it difficult for Company R to pay its employees or receive payment from Russian customers if such transactions require interacting with accounts at sanctioned/disconnected banks. In addition, if a Russian customer needs financing to purchase goods from Company R, the customer could not do so through a sanctioned bank. Furthermore, a number of credit card companies have pulled out of Russia,[8] meaning that it could be more difficult, if not impossible, for retail stores to screen customers and see if they are on the SDN list (as customers may be forced to pay with cash). This opens the company up to unknowingly transacting with an SDN.

What's more, increased restrictions on the export of sensitive technology to Russia, detailed further below, could make it more difficult, if not impossible, for a U.S. company to export the necessary goods to its retail store in Russia.

Finally, a company risks reputational damages by continuing to operate in Russia. As a growing number of international companies cut ties, at least temporarily, with Russia, continuing to operate a location in Russia could be viewed as insensitive to the suffering of millions of Ukrainians.[9]

Engaging Sales Agents

Example: Company U, a United States company, hires a sales agent in Russia. The sales agent is also a Russian national.

Sanctions Laws: Generally, U.S. sanctions would not prohibit a U.S. company from hiring a Russian national as a sales agent, provided that the agent was not on the SDN List or otherwise sanctioned and that the sales agent did not transact with any sanctioned person or entity.

Credit Agreement: While companies may not breach their credit agreements by having a sales agent in Russia, they make themselves more vulnerable to such violations. If Company U did happen to hire an SDN, it could be in violation of the "Locations of Collateral", "Use of Proceeds," "Compliance Programs," and "Directors, Employees, Officers, Agents, Etc." representations and covenants of a credit agreement. If Company U received a loan to help operate its business and used such funds to hire a sales agent, and that person was an SDN, Company U could be funding the activities of a sanctioned person. What's more, hiring an SDN would show a clear breakdown in Company U's compliance program, demonstrating that the borrowers were in fact not enforcing policies and procedures promoting compliance with applicable sanctions laws.

Practical Considerations: Practical considerations would largely mirror those above. Company U might currently use a sanctioned institution to process its payroll, and the traveling sales agent might only have a bank account with a sanctioned bank, begging the question of how Company U would pay the agent. In addition, hiring a sales agent in Russia increases the likelihood that Company U will transact with an SDN or otherwise sanctioned person and creates what the company might find to be an unjustifiable risk of a sanctions violation.

Exports to Customers

Example: Company S, a United States company located in Washington, D.C., exports widgets to Russia. Sanctions Laws: The U.S. Department of Commerce's Bureau of Industry and Security ("BIS")[10] has implemented trade control laws[11] severely restricting the export, re-export or transfer in country of U.S. origin technology that could assist Russian defense, aviation and maritime sectors. Consequently, if Company S's business involves sensitive technology, such as semiconductors or encryption software, it may not be able to export those materials to its Russian customers. What's more, BIS is implementing a series of "Foreign Direct Product Rules" that will allow the U.S. government to place limits on foreign produced items being sent to Russia that are either: (i) the direct product of U.S.-origin technology or software; or (ii) produced by certain plants or with major components of plants that are themselves direct products of U.S. origin software or technology. This rule provides the U.S. government with more control over foreign produced goods and could further restrict exports to Russia. BIS has also placed a de facto trade embargo on exports intended for Russian military end users or for Russian military end uses.

Even if Company S is allowed to export its widgets under applicable trade control laws, it would be prohibited from exporting or re-exporting goods to a person or entity who is on the SDN list or otherwise sanctioned.

Credit Agreement: If the export is permissible under U.S. export and sanctions laws, it generally should not be a breach of a credit agreement, so long as the export does not go to someone on the SDN list or who is otherwise sanctioned, and payment for the widgets is received in compliance with applicable sanction laws.

Practical Considerations: Practical considerations include, among others, how Company S will receive payment for its products, how Russian customers will finance such transactions, and whether Company S will have to breach its contracts with Russian customers. If Company S exports goods subject to the new export controls laws, it will likely be unable to comply with its obligations to its Russian customers, possibly making the company liable for breach of contract. In addition, reputational risks remain prominent as exporting goods to Russia, outside of humanitarian aid, could be viewed as supporting Russian military action.

Imports from Suppliers

Example: Company I, a United States company located in Seattle, Washington, imports widgets from Russia.

Sanctions Laws: Except for the U.S. government's recent decision to ban Russian oil imports[12], U.S. sanctions have generally not affected the import of goods from Russia, so long as the transaction is not with an SDN. Company I would need to ensure, however, that it was in compliance with all existing laws and regulations surrounding the import of goods to the United States. These regulations are typically enforced by the Department of Homeland Security and U.S. Customs and Border Protection ("CBP").

Credit Agreement: If the import is permissible under U.S. import laws, it should generally not be a breach of the credit agreement, provided that the supplier is not an SDN and the payment for such widgets will be made in accordance with applicable sanctions laws. If importation involved an SDN, that could be a violation of the "Use of Proceeds" and "Compliance Programs" provisions of a credit agreement. If Company I received a loan to purchase inventory, for example, and they did so from an SDN, that would be using a loan/extension of credit to fund business with a sanctioned individual. Further, if Company I was transacting with a sanctioned supplier, that could be a result of a failure to effect and enforce proper compliance mechanisms.

Practical Considerations: Importing from a Russian supplier could make payment complicated. If they are involved in international business, they may have accounts with major Russian financial institutions, many of whom have been sanctioned. As a result, Company I would need to find another supplier or another method of payment without attempting to "evade or avoid" U.S. sanctions laws.

Banking/Treasury Management

Example: Company F, a United States company, has a retail store in Russia. As a result, Company F has corporate funds in a Russian bank account, which it uses to pay employees.

Sanctions Laws: As mentioned previously, certain Russian banks have been sanctioned, meaning that U.S. companies cannot transact with them. Consequently, Company F's corporate funds could be frozen, and Company F would be unable to repatriate its money back to the United States, if such funds are currently located in a sanctioned bank. Fortunately, there are a number of general licenses that grant U.S. persons a **limited** time period to wind down business transactions with certain sanctioned entities.

Credit Agreement: As noted above, if Company F's credit agreement restricts collateral from being located in a sanctioned jurisdiction, the location of the retail store, the inventory located therein and the cash held in a sanctioned bank could result in a violation of such covenant. Additionally, this could result in a covenant breach under Company F's credit agreement if such credit agreement includes a covenant limiting the amount of cash that Company F and/or its subsidiaries may hold outside of the United States. Further, if a company engages in a prohibited transaction with a sanctioned entity, it could result in a violation of the "Use of Proceeds," "Compliance Program" or similar covenants.

Practical Considerations: Even if Company F is storing its funds in the accounts of a non-sanctioned Russian bank, it is risky to continue doing so. As Russia continues its invasion of Ukraine, the U.S. will continue to ramp up sanctions in an attempt to cripple Russia's financial system. Interacting with almost any Russian bank as the branch of a U.S. business, therefore, attracts considerable risk.

The Crimea, Luhansk, or Donetsk Regions of Ukraine

Sanctions Laws: The Crimea, Luhansk and Donetsk Regions of Ukraine are all sanctioned territories and targets of a de-facto trade embargo. All new investment by U.S. persons in those regions and the import and/or export of goods, services and technology by U.S. persons is prohibited.[13]

Credit Agreement: If the activity violates an applicable sanction law, such activity could result in a violation of the "Use of Proceeds" and/or "Compliance Programs" provisions in a credit agreement.

Practical Considerations: Although there are licenses permitting certain transactions with these regions, given the breadth of the sanctions, U.S. companies are advised to avoid doing business in these regions until they can seek the advice of outside counsel.[14]

What other consequences may arise under credit agreements as companies react to newly enacted Sanctions?

Companies may find themselves making decisions to, among other things, cede operations, sell business units or abandon proposed acquisitions transactions. Such decisions may be a direct consequence of complying with Sanctions legal regimes. In some circumstances, such decisions may be driven by employee desire, investor pressure or other stakeholder considerations. In addition, companies may become subject to additional licensing requirements or other costs in order to maintain business units. Any of these decisions or consequences may have credit agreement implications.

EBITDA

Companies should review their EBITDA definitions to consider what, if any, expenses, losses or other items may impact their net income from actions taken in response to sanctions implementation and compliance. Some of these expenses or losses may be added back to EBITDA or net income. For example, losses from discontinued operations or abandoned acquisitions are often common addbacks to EBITDA. In addition, if companies incur expenses to comply with additional licensing requirements or to source new suppliers or vendors, companies may be permitted to add back such expenses under a non-recurring expense addback. Additionally, net income of any subsidiaries subject to sanctions may be legally restricted from repatriating income into the U.S. and as a result any income from such subsidiaries may be excluded from consolidated net income for purposes of determining EBITDA. Finally, companies may struggle to support an addback for lost revenue or bad debts, generally. So, companies may need to forecast such consequences and consider whether to solicit any consents or amendments to account for such losses.

Dispositions/Sale of Assets and Lien Releases

If a company has direct or indirect operations in a designated jurisdiction, it may consider selling such operations or ceasing operations and transferring assets to another subsidiary. Nearly all credit agreements will restrict disposition/sales of assets, including among subsidiaries. Companies will need to review what, if any, caps are applicable to making dispositions in any fiscal year. In addition, if the transfer may be to another subsidiary, such transfer may be subject to its own cap as an investment.

In addition, most third parties will require that any assets are transferred free and clear of any liens. Some credit agreements include automatic release provisions in the event such disposition is permitted by the existing terms of credit agreement. However, third parties may still want a letter acknowledging such release, even if automatic. If no automatic release exists, the company may need to solicit the consent of the required lenders (or, in some cases, all lenders) to permit the lien release.

Mandatory Prepayments

Yet again, nearly all term loan credit agreements will require that asset sale cash proceeds above a certain threshold are applied to prepay the term loans, unless reinvested in specific assets within a certain period of time. Companies should proactively consider whether to solicit a waiver of such mandatory prepayment. A failure to prepay in the required timeframe is typically an immediate Event of Default and payment defaults are generally viewed as serious breaches of credit agreements, even if unintentional.

Business Cessation Events of Default

Credit agreements may contain an Event of Default on the basis of a business cessation, whether voluntary or required by law. Such events of default are more common in businesses which are location based (i.e., healthcare surgery centers, franchise locations, etc.) and may be tied to a reduction in revenue or EBITDA. Franchise business, retailers, healthcare service providers and other "location based" companies, in particular, should review their credit agreements to confirm if such events of default are present before taking voluntary cessation actions.

To the extent clients have any questions regarding compliance with their loan documents or sanctions regimes, clients are encouraged to contact their debt finance and sanctions regulatory team to discuss.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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1 For purposes of this representation, "Designated Jurisdiction" means any country or territory to the extent that such country or territory is the subject of any countrywide or territory-wide Sanctions (e.g., Crimea, the so-called Donetsk People's Republic and the so-called Luhansk People's Republic regions of Ukraine).

2 For purposes of this representation, see the definition of "Designated Jurisdiction" in footnote 1 above.

3 It is worth noting that there are a number of general licenses that dictate when these sanctions come into effect and what interactions with sanctioned parties are still permitted. For the sake of simplicity, we have not included those here. Please see our prior alert, linked above, or contact outside counsel to understand whether these licenses are required.

4 As of March 10, 2022.

5 Analysis is subject to change, as the situation in Russia is fluid and rapidly changing.

6 It is important to reiterate that under the Russian sanctions, a separately incorporated non-U.S. subsidiary of a U.S. company is *not* considered a U.S. person. For the purposes of this hypothetical, we are assuming that this is a Russian branch of a U.S. company. The analysis would change if this was a foreign incorporated subsidiary of a U.S. company.

7 The list is created by the Department of Treasury's Office of Foreign Assets Control ("OFAC"). Any property that is 50 percent or more owned, directly or indirectly, by one or more SDNs in the aggregate is blocked property. This includes entities; thus, a company owned 50 percent or more by one or more SDNs is also considered sanctioned, regardless of whether the company itself is placed on the SDN List.

8 Ramishah Maruf, *American Express becomes the latest credit card company to suspend operations in Russia*, CNN (Mar. 6, 2022), https://www.cnn.com/europe/live-news/ukraine-russia-putin-news-03-06-22/h_e0512c49d922f17cfd6d543eb52a3e3f.

9 Rishi Iyengar, et al., *Here are the companies pulling back from Russia*, CNN (Mar. 7, 2022), https://www.cnn.com/2022/03/02/business/companies-pulling-back-russia-ukraine-war-intl-hnk/index.html (listing companies including Apple, Disney, and Ford).

[10] The BIS implements and enforces the Export Administration Regulations ("EAR"). The EAR regulates most commercial items, as well as "dual use" and certain military items. The U.S. State Department, the U.S. Department of Energy, and the U.S. Nuclear Regulatory Commission have jurisdictional authority over other U.S. control regimes covering defense articles/services and certain nuclear-related technology/equipment.

[11] What impact these trade control laws have on a business is a fact-intensive inquiry and Paul Hastings recommends that Company S seek the advice of outside counsel.

[12] Notably, the new prohibition includes crude oil, petroleum fuels, oils, and products of their distillation; liquefied natural gas; coal; and coal products. In addition, U.S. persons are now prohibited from making new investments in the energy sector of Russia after March 8, 2022.

[13] Press Release: U.S. Treasury Imposes Immediate Economic Costs in Response to Actions in the Donetsk and Luhansk Regions, U.S. Department of the Treasury (Feb. 22, 2022), https://home.treasury.gov/news/press-releases/jy0602.

[14] It is worth noting that U.S. sanctions do not block the entire Donetsk and Luhansk oblasts. They only block those regions determined by the Secretary of the Treasury, which are the so-called Donetsk People's Republic and Luhansk People's Republic regions of Ukraine.