To: LSTA Membership
Re: U.S. Sanctions Issues in Lending Transactions

Background

The Office of Foreign Assets Control ("OFAC") of the U.S. Department of the Treasury is the primary federal agency administering and enforcing economic sanctions programs against countries, governments, groups and individuals. The purpose of U.S. economic sanctions is to achieve U.S. national security, foreign policy, or economic goals. Sanctions may be imposed against geographical areas and all persons within those areas, or against designated governments, organizations, individuals, and entities ("Persons") wherever located.

Under regulations administered by OFAC, U.S. Persons are generally prohibited from engaging in transactions, directly or indirectly, with Persons and countries targeted by U.S. sanctions (referred to herein as "Target Persons" and "Target Countries," respectively, or collectively as "Sanctions Targets"), unless the transactions are exempt or licensed by OFAC. U.S. Persons are also generally prohibited from “facilitating” actions of non-U.S. Persons, which – although entirely legal for a non-U.S. Person – could not be directly performed by U.S. Persons due to U.S. sanctions restrictions.

Currently, the following countries are targets of U.S. territorial sanctions: Cuba, Iran, Sudan, Syria, and for certain transactions, North Korea. The governments of Cuba, Iran, Sudan and Syria are sanctioned, including their political subdivisions, agencies and instrumentalities, and entities they own or control directly or indirectly. In most cases, Persons located, organized, or resident in a Target Country are also considered Target Persons. These countries and Persons are the targets of various trade embargoes that ban imports and/or exports of goods and services (including financial services) and technology.

OFAC also administers “list-based” sanctions that are imposed on Persons designated under various programs for certain acts. These parties’ names are generally placed on OFAC’s List of Specially Designated Nationals and Blocked Persons (the “SDN List”). Designated Persons include:

- Persons involved in narcotics trafficking, terrorism and terrorist financing, transnational crime, proliferation of weapons of mass destruction, and piracy;

---

1 The U.S. State Department administers certain “secondary” sanctions targeting parties that engage in certain activities in Iran, discussed below.

2 U.S. Persons include: United States citizens, wherever located; permanent resident aliens, wherever located; all entities organized in the United States (including their foreign branches); and all individuals, entities and organizations actually located in the United States. For the U.S. sanctions against Cuba and Iran, all entities owned or controlled by U.S. Persons, wherever organized or doing business (including foreign subsidiaries of U.S. firms), are also generally required by U.S. law to comply.

3 For example, many sanctions programs contain exemptions for transactions in information or informational materials.

4 Territorial sanctions on Burma/Myanmar have been suspended.
Persons in, or related to, former regimes in the Balkans, Côte d’Ivoire, Iraq, Liberia and Libya and current regimes in Belarus, Burma, the Democratic Republic of the Congo, and Zimbabwe; and specific acts in Darfur, Lebanon, Somalia, Ukraine, and Yemen.

U.S. Persons are prohibited from conducting financial or commercial transactions with SDNs, and any assets the SDNs may have within the United States or within the possession or control of any U.S. Person (“U.S. jurisdiction”) are “frozen” or “blocked.” In addition, any property that is 50% or more owned by an SDN is blocked property. This includes entities; thus, a subsidiary owned 50% or more by an SDN is also a Target Person, regardless of whether the entity is placed on the SDN List.

The penalties for violations of OFAC sanctions can be substantial. Depending on the program:

- Criminal penalties for willful violations can include fines ranging from $50,000 to $10,000,000 and imprisonment ranging from 10 to 30 years
- Civil penalties can range from a maximum of $65,000 to $1,075,000 per violation

Most cases are covered by the International Emergency Economic Powers Act, as amended, authorizing a civil penalty that is the greater of $250,000 per violation or twice the value of the violative transaction.

Given the aggressive enforcement posture of OFAC, as evidenced by a number of very large settlements between OFAC and financial institutions in recent years, U.S. and non-U.S. financial institutions have become increasingly conservative in managing their sanctions risks. In addition, lenders want to protect themselves against franchise and reputational risks resulting from sanctions violations and, in some cases, lawful transactions that have some nexus to Sanctions Targets.

**Primary OFAC Risks in Lending Transactions**

The main prohibitions of concern for U.S. lenders are the prohibition on the exportation of services to a Target Country or Target Person, and the prohibition on the “facilitation” by U.S. Persons of non-U.S. persons’ activities that the U.S. Person could not perform directly due to sanctions. Lenders that are U.S. Persons must ensure that they do not provide any benefit, directly or indirectly, to Sanctions Targets by, for example, making loans to Sanctions Targets, or to borrowers that use the loans to finance business with Sanctions Targets. With respect to Iran, there is the added risk that a non-U.S. borrower that engages in certain transactions involving Iran could be subject to secondary U.S. sanctions (discussed below).

**De Minimis “Rule”**

Despite the various sanctions prohibitions, in order to allow U.S. businesses to remain competitive in a global economy, OFAC does not require lenders to refuse to participate in transactions merely because the borrower does a small amount of business with Sanctions Targets. It is generally understood that U.S. Person lenders may make loans to third country companies or parties that engage in business involving Sanctions Targets, provided that: (i) the lender has verified through due diligence that the financing does not involve or relate to the borrower’s business with the Sanctions Target; and (ii) due diligence confirms that the borrower’s activities involving Sanctions Targets are de minimis. Due diligence is discussed further below. There is no official OFAC de

---

5 Services are "exported" to a Sanctions Target if any foreseeable direct or indirect benefit of the services is received in or by such Sanctions Target.
Sanctions Risk Mitigation: Due Diligence

Lenders use various tools to mitigate their sanctions-related risks. First, as noted, it is prudent for lenders to conduct sanctions due diligence. Although it will vary depending on the deal, due diligence should generally address the following issues:

- Whether a transaction directly or indirectly involves or relates to a Target Country or Target Person
- Whether a transaction directly or indirectly involves or relates to a non-sanctioned entity with substantial business interests with Target Countries or Target Persons
- Whether U.S. citizens, permanent residents, or individuals located in the United States will be involved in or supervise the transaction
- Details about the borrower’s and its affiliates’ business with Sanctions Targets, including the percentage of their assets, revenues, and net profits attributable to business with Sanctions Targets and a description of any such business activities

If the borrower or one of its affiliates conducts business with or related to Iran, it is important to obtain additional information to help determine whether these activities could make them targets of secondary U.S. sanctions under the Iran Sanctions Act, the Comprehensive Iran Sanctions, Accountability, and Divestment Act of 2010, the Iran Freedom and Counter-Proliferation Act of 2012 (part of the National Defense Authorization Act for FY 2013), the Iran Threat Reduction and Syria Human Rights Act of 2012, or related Executive Orders. Secondary sanctions can trigger a range of potential penalties, including the most extreme sanction, the blocking of property within U.S. jurisdiction. If blocking sanctions were imposed on a borrower, then U.S. banks would be unable to conduct business with the borrower and could not receive repayment for any loans (because repayment funds would have to be frozen). Lenders should therefore conduct additional due diligence if there is an indication that the borrower conducts any business with Iran.

Sanctions Risk Mitigation: Representations and Covenants in Credit Agreements

Lenders should also protect themselves by preserving the understandings reached in due diligence via contractual undertakings. Many credit agreements contain borrower representations and covenants intended to ensure compliance with U.S. sanctions by U.S. Person lenders and other U.S. Persons participating in the loan. However, the OFAC clauses in many precedent agreements contain certain deficiencies. Several of the most frequently seen provisions are listed below. Following these examples are suggested representations and covenants.

OFAC loan agreement provisions can be complicated. If a bank has any indication that a transaction party does business in or with Sanctions Targets, it would be prudent to involve sanctions/compliance personnel and lawyers early in the transaction. As discussed below, subtle word changes can make a big difference in the meaning of, and the protection afforded by, sanctions representations and covenants.

Status Under Sanctions Representation. Lenders should obtain assurance that neither the non-U.S. borrower nor any of its group members that may receive loan proceeds is a Sanctions Target or located in a Target Country. A credible representation that the borrower is not a Sanctions
Target is important to ensure that U.S. financial institutions do not violate prohibitions against dealing in blocked property or engaging in transactions with Sanctions Targets.

The following are two common representations that have certain deficiencies:

**Example (a):** “The Borrower, its subsidiaries, and its and their directors, officers, employees, agents, and representatives are not Persons described or designated in [OFAC’s] Specially Designated Nationals and Blocked Persons List.”

**Example (b):** “None of the Borrower, its subsidiaries, or its or their directors, officers, employees, agents, or representatives is subject to U.S. economic sanctions administered by [OFAC].”

Example (a) is too narrow. The SDN List provides only minor coverage of the Target Countries. For example, programs targeting governments typically have some entries on the SDN List, but often also require the blocking of government-owned or -controlled entities, whether or not listed. In addition, as noted, typically Persons located in countries that are covered by territorial U.S. sanctions are themselves Sanctions Targets. Further, as discussed above, a number of U.S. laws authorize the imposition of secondary sanctions on non-U.S. Persons that engage in specified dealings with Iran. These Persons are not covered by Example (a).

Example (b) can be misconstrued. The phrase “is not subject to U.S. sanctions” could be interpreted as a representation that the borrower is not subject to the jurisdiction of OFAC or required to comply with OFAC sanctions, which will be true of a non-U.S. Person in most cases. Instead, the representation should provide that the borrower is not “the subject of U.S. sanctions” or “a target of U.S. sanctions.”

**Use of Proceeds Covenant.** Lenders should also obtain an undertaking that the borrower will not use loan proceeds to finance business with Sanctions Targets. A use of proceeds covenant is important if the offering proceeds are not fully dedicated to particular, non-sanctions-related uses, and is particularly important if due diligence indicates that the borrower has operations in or with Sanctions Targets. A use of proceeds clause is essential if those operations are material or have significant capital needs (particularly current or impending needs) that are not expressly funded from a source other than the loans. The covenant protects against U.S. Persons’ “exporting” financial, legal or other services to or for the benefit of a Sanctions Target, or facilitating a transaction that they are prohibited by sanctions from engaging in directly.

The following are two common covenants that also have deficiencies:

**Example (c):** “The Borrower, its subsidiaries, and its and their directors, officers, employees, agents, and representatives are not Persons described or designated in [OFAC’s] Specially Designated Nationals and Blocked Persons List, and will not knowingly engage in any dealings or transactions with any such Person.”

---

6 As noted above, non-U.S. subsidiaries of U.S. companies are generally required to comply with U.S. sanctions on Cuba and most sanctions on Iran.

7 If the activities with or in Sanctions Targets are the predominant business of the Company, before proceeding, seek advice from sanctions/compliance personnel or counsel. It might not be lawful for U.S. Persons to participate the transaction.
Example (d): “None of the Borrower, its subsidiaries, or its or their directors, officers, employees, agents, or representatives is subject to U.S. economic sanctions administered by [OFAC], and will not directly or indirectly use the proceeds of the offering … for the purpose of financing the activities of any person currently subject to any U.S. sanctions administered by OFAC.”

Example (c) is too narrow. It is limited to the list-based sanctions portion of a U.S. Person's compliance obligations (i) not to deal with SDNs and (ii) not to facilitate the financing of others’ business with SDNs.

Example (d) above raises two issues: First, as noted with respect to Example (b) above, the term “subject to any U.S. sanctions” is ambiguous, and can be interpreted to mean a Person subject to the jurisdiction of OFAC, rather than a Person who is the target of sanctions. Second, “currently” appears to freeze the covenant as of the closing date – the wrong point in time. OFAC's SDN List changes frequently, often weekly, and programmatic changes can occur at any time. To prevent impermissible facilitation, the covenant must prohibit the financing of Persons or in places that, at the time of the financing, are targets of sanctions.

Moreover, both Example (c) and Example (d) are limited to any “Person” that is a Sanctions Target, thus improperly excluding Target Countries from the scope of the covenant.

Suggested Sanctions Representations and Covenants

Below are suggested sanctions representations and covenants that we believe more effectively protect lenders. Please note, however, that your due diligence findings and the nature of the transaction are critical to a determination of the provisions that will best protect U.S. financial institutions from OFAC risk in a particular situation. You should contact sanctions/compliance personnel or counsel early in a transaction for OFAC due diligence questions and guidance on precise contractual language.

(a) None of the Borrower, any of its Subsidiaries or[, to the knowledge of the Borrower,] any director, officer, [employee, agent, or affiliate] of the Borrower or any of its Subsidiaries is an individual or entity (“Person”) that is, or is owned or controlled by Persons that are: (i) the [subject/target] of any sanctions administered or enforced by the U.S. Department of the Treasury’s Office of Foreign Assets Control (“OFAC”), the U.S. Department of State,6 [the United Nations Security Council, the European Union, Her Majesty’s Treasury, or other relevant sanctions authority]9 (collectively, “Sanctions”), or (ii) located, organized or resident in a country or territory that is, or whose government is, the subject of Sanctions, [including, without limitation] [currently,] Cuba, Iran, North Korea, Sudan and Syria);10 and

(b) The Borrower will not, directly or indirectly, use the proceeds of the Loans, or lend, contribute or otherwise make available such proceeds to any subsidiary, joint venture partner or other Person, (i) to fund any activities or business of or with any Person, or in

---

6 The State Department should be included because certain secondary U.S. sanctions on Iran are administered by the U.S. Department of State, rather than by OFAC.

9 Focus on and include those non-U.S. sanctions with which the borrower or any lender must comply.

10 Instead of separating the list-based and territorial sanctions, paragraph (a)(i) could be modified to read “… the subject of any list-based or territorial Sanctions …” and eliminate paragraph (a)(ii). But note before doing so that the list of countries may help clarify the scope of the representation.
any country or territory, that, at the time of such funding, is, or whose government is, the subject of Sanctions, or (ii) in any other manner that would result in a violation of Sanctions by any Person (including any Person participating in the Loans, whether as underwriter, advisor, investor, or otherwise).\footnote{The phrase in clause (ii) is a “catch-all” provision that is sometimes excluded.}

Some borrowers insist on adding a knowledge qualifier (borrower will not “knowingly,” directly or indirectly, use the proceeds . . .) to the use of proceeds covenant. They do not want to be in default if this language is read too broadly and is deemed to cover activities by a party several transactions removed from the borrower. This is frequently a point of negotiations with U.S. lenders, who worry about adding such language because U.S. sanctions prohibitions, including facilitation prohibitions, typically have no knowledge qualifiers. Some agreements contain the compromise language “will not, directly, or to the Borrower’s knowledge, indirectly” in an attempt to protect the lenders without putting the borrower “on the hook” for downstream transactions of which it is unaware and does not control. There is no “one size fits all” answer as to what language should be included here, or in the sanctions representations and covenants more generally. The lenders should consider their risk tolerance in a particular transaction, given the identity of the borrower, its industry, and where it conducts business, among other factors.

\textbf{Less Common Sanctions Representations and Covenants}

Below are a few examples of the many other variations of sanctions representations and covenants that are included in credit agreements followed by our analysis of these provisions.

\textbf{Example (aa):} None of the Borrower’s funds that are used to repay any obligation under the Credit Agreement shall constitute property of, or shall be beneficially owned directly or indirectly by, any Person that is the subject of Sanctions.

Example (aa) is not common in credit agreements and we do not deem it essential. If the lenders obtain a representation that no group member is a Sanctions Target, they should be adequately protected without this representation.

\textbf{Example (bb):} The Borrower will not fund all or part of any payment under the Credit Agreement out of proceeds derived from transactions that violate Sanctions.

Example (bb) is similar to Example (aa), and is also not typical, especially where due diligence has identified no “red flags” indicating any involvement of Sanctions Targets. Here also, if the lenders obtain a status under sanctions representation, they should be adequately protected without this covenant.

\textbf{Example (cc):} The Borrower represents and covenants that for the past [5] years, neither the Borrower nor any of its Subsidiaries has knowingly engaged in, or is now knowingly engaged in, or will engage in, any dealings or transactions with any Person, or in any country or territory, that at the time of the dealing or transaction is or was, or whose government is or was, the subject of Sanctions.

Example (cc) is sometimes requested by lenders, although it is not necessary to protect them against sanctions violations. U.S. lenders are not prohibited from lending to a non-U.S. company that conducts a small amount of business with Sanctions Targets (as discussed above), and frequently, non-U.S. borrowers cannot make this representation, as they may conduct some
transactions with Sanctions Targets. Sometimes this language can be useful in a first draft to highlight diligence issues. In addition, it may alert the lenders to issues that could present reputational issues.

**Conclusion**

U.S. lenders should be cognizant of, and address in a risk-based fashion, sanctions risks that may arise in lending transactions. They can mitigate their risks through due diligence and contractual provisions in credit agreements. There is a range of effective contractual language that lenders may consider, bearing in mind the facts and circumstances of a particular transaction. The ultimate goal is to demonstrate to OFAC (in hindsight) that the lenders took appropriate steps to ensure that their participation in a lending transaction did not violate any U.S. sanctions.