Shipping & International Trade

Can Confirming Banks Rely on a Sanctions Clause in a Confirmation to Refuse to Honour a Complying Presentation?

Introduction

The commercial purpose of a confirmed documentary letter of credit is to provide assurance to the beneficiary that it will receive payment against presentation of complying documents. The addition of the confirming bank in the letter of credit transaction is often due to the beneficiary's discomfort with the issuing bank, whether for reasons of creditworthiness or otherwise. Where a confirming bank seeks to rely on a sanctions clause to refuse to honour a complying presentation, what is the standard of proof it must meet in order to discharge its burden to invoke such a clause? The recent Singapore Court of Appeal ("**CA**") in *Kuvera Resources Pte Ltd v JPMorgan Chase Bank, N.A.* [2023] SGCA 28 (*"**Kuvera**"*) sheds light on this important issue.

In *Kuvera*, the confirming bank relied on a sanctions clause in its confirmations to refuse to honour an otherwise complying presentation on the basis that the goods had been shipped onboard a vessel which was allegedly subject to US sanctions laws. Before the High Court, the bank successfully argued that it was entitled to rely on the sanctions clause by applying a risk-based approach, which on the facts of *Kuvera* meant that it would suffice for the confirming bank to establish *inter alia* that the relevant authority (in this instance, the US Office of Foreign Assets Control ("**OFAC**")) would have found the bank to be in breach of the relevant US sanctions had it made payment to the beneficiary under the letters of credit.

On appeal, however, the CA found that the confirming bank could not bring itself within the operation of the sanctions clause. The CA emphasised that the issue of whether the vessel was subject to sanctions was to be determined objectively, rather than by reference to speculative elements under the bank's risk-based approach, for instance a determination by a third party such as OFAC.

Below, we cover the background of the dispute, the key points made by the High Court and the CA, and the implications *Kuvera* has for banks and beneficiaries of confirmed letters of credit.

Background

The respondent ("**JPMorgan**") was the confirming bank under two letters of credit (**"LCs"**) issued in favour of the appellant ("**Kuvera**"). JPMorgan added its confirmation and advised both LCs to Kuvera under cover of its confirmations ("**Confirmations**"). The underlying goods, which were cargoes of coal, were shipped on board the performing vessel, "*Omnia*" (the "**Vessel**").

JPMorgan's Confirmations contained a sanctions clause which provided *inter alia* that JPMorgan must comply with US sanctions laws and regulations ("**Sanctions Clause**"). Specifically, the Sanctions Clause provided that in the event where documents presented involved any vessel "*listed in or otherwise subject to any applicable restriction*", JPMorgan would not be liable for any failure to pay under the LCs.

JPMorgan maintained an *internal* list of entities and vessels that it had determined to have a sanctions nexus and/or concern ("**Master List**"). The Master List was not accessible to the public, and it was more extensive than OFAC's publicly accessible list of entities sanctioned under US law ("**OFAC List**").

After Kuvera made a complying presentation of documents to JPMorgan under the LCs, JPMorgan discovered that the Vessel was included on its Master List. JPMorgan invoked the Sanctions Clause and refused to honour Kuvera's presentation of complying documents under the LCs.

High Court Decision

Kuvera commenced proceedings in the High Court against JPMorgan, asserting that JPMorgan had acted unlawfully in not paying Kuvera the sum due under the LCs pursuant to Kuvera's complying presentation. The High Court Judge found *inter alia* that:

1. A letter of credit issued by an issuing bank and a confirmation issued by a confirming bank to the beneficiary each function as an offer of a separate and autonomous unilateral contract, with one *sui generis* exception, namely that an issuing or confirming bank (as the case may be) has a contractual obligation to the beneficiary not to revoke its offer (for which no consideration has to be provided or supplied). This was endorsed by the CA (see below).

2. There was no legal impediment to a confirming bank adding a term to its confirmation that was set out not in the letter of credit issued by the issuing bank, as long as the term was not fundamentally inconsistent with the commercial purpose of the confirmation.

Accordingly, the High Court Judge found that:

1. the Sanctions Clause had been duly incorporated as a contractual term of JPMorgan's Confirmations, and the Sanctions Clause was not fundamentally inconsistent with the commercial purpose of a confirmation.

2. For JPMorgan to avail itself of the Sanctions Clause, it would suffice for JPMorgan to prove that (i) OFAC would have held that paying Kuvera against a complying presentation would be a breach of the relevant regulations; and (ii) it was unnecessary for JPMorgan to prove that the Vessel was in fact owned by a sanctioned entity. JPMorgan's risk-based approach – i.e., relying on its Master List, and in deciding that it would rather be sued by Kuvera than be found by OFAC to have breached US sanctions – was a "*rational and contractually justified approach*" which entitled JPMorgan to invoke the Sanctions Clause.

Court of Appeal Decision

The CA allowed Kuvera's appeal, and arrived at a different conclusion from the High Court on the following:

1. The CA held that JPMorgan's risk-based approach, while perhaps rational from a risk management perspective, was not "*contractually justified*".

2. In that regard, the CA held that the Sanctions Clause must be construed (as any other contractual provision) objectively. On the facts of *Kuvera*, the Sanctions Clause permitted the bank to refuse to honour a complying presentation if the performing vessel was "*listed in or otherwise subject to any applicable restriction*". In applying the objective approach and bearing in mind OFAC's regulations against Syria, the CA held that in order to invoke the Sanctions Clause, JPMorgan had to prove, on a balance of probabilities, that the Vessel had been Syrian-owned at all material times.

3. The standard of a balance of probabilities, and placing the burden of proof on JPMorgan to meet that evidential threshold, was a function of how JPMorgan had drafted the Sanctions Clause, and was in accordance with how Singapore courts would interpret any other contractual provision. Accordingly, the CA rejected the risk-based approach in meeting that evidential threshold. Such an approach did not determine the matter objectively, but instead relied on circumstantial evidence which introduced an element of speculation and arbitrariness – e.g., by referring to its Master List and the subjective views of third parties such as OFAC. The CA noted that adopting a risk-based approach towards contractual interpretation would practically render it impossible for a beneficiary under a letter of credit to be certain whether it would be paid, notwithstanding full compliance with the documentary requirements.

Applying the objective approach, the CA found that the evidence did not prove that the Vessel was under Syrian beneficial ownership, and as such JPMorgan could not bring itself within the operation of the Sanctions Clause.

In that regard, while the Vessel had previously been under Syrian beneficial ownership, she had been the subject of a sale to a non-Syrian registered owner. JPMorgan had not displaced the well-established *prima facie* inference of beneficial ownership arising from the current registered non-Syrian owner of the Vessel, and it was insufficient to suggest that there was some masking or concealment of the Vessel's beneficial ownership merely because such information on the Vessel's beneficial owner was not available.

Compatibility of the Sanctions Clause with the commercial purpose of the Confirmations

Although it was not necessary to consider whether the Sanctions Clause was compatible with the commercial purpose of the Confirmations, the CA set out in *obiter* its provisional views on the issue, albeit restricted to the context of where the allegedly sanctioned entity is the owner of a vessel.

The commercial purpose of a letter of credit is to provide security to the beneficiary that it will receive payment so long as it is able to present the requisite complying documents to the issuing / confirming bank (as the case may be). A sanctions clause which can be invoked by a bank to withhold payment on a mere suspicion that the vessel may be subject to sanctions, or on any other arbitrary or speculative element, would serve to undermine that commercial purpose. The CA noted that banks "*cannot have it both ways by representing to a beneficiary that payment is conditioned only on a complying demand, but reserving [the] right to dishonour where it is unsure of its legal liabilities*".

The CA observed that in the present context, if JPMorgan was to be justified in denying payment as long as it determined that it would prefer to be sued by Kuvera rather than risk being penalised by OFAC, significant unpredictability would be introduced into the Confirmations. Such unpredictability would most likely render the Sanctions Clause incompatible with the Confirmations' commercial purpose.

Concluding Remarks

Economic sanctions have become a powerful and frequent political instrument for governments to achieve foreign policy objectives. However, such political considerations take a back seat in contractual interpretation. The CA's decision in *Kuvera* emphasises that principles governing contractual interpretation take precedence notwithstanding the geopolitical significance of sanctions. The CA's decision is a welcome reminder that banks' approach to sanctions compliance cannot be undertaken in a vacuum, and must be compatible with applicable legal principles. It underscores the importance of banks' compliance staff having an understanding of how sanctions clauses will be construed and applied as a matter of law.

The CA's provisional views on the impact of sanctions clauses on the commercial purpose of letters of credit also reinforces the predictability and certainty of payment that letters of credit offer, as a lynchpin in international trade. Sanctions clauses which introduce uncertainty by relying on subjective or arbitrary elements may not necessarily be to banks' advantage: such clauses may potentially be found to run contrary to the commercial purpose of the letter of credit. The CA's provisional views in this respect are likely to reinforce market views that sanctions clauses may not have a place in letters of credit.

The CA's decision in Kuvera underscores the need for banks to obtain comprehensive and reliable data, especially concerning vessel ownership and proper screening of entities and vessels, as part of banks' suite of sanctions compliance tools. In particular, banks should not expect that they will be able to refuse to honour an otherwise complying presentation merely by reason of vessel ownership or control being

listed by a third party data aggregator as "unknown", as that will not suffice to discharge the bank's burden of proof to objectively prove vessel ownership.

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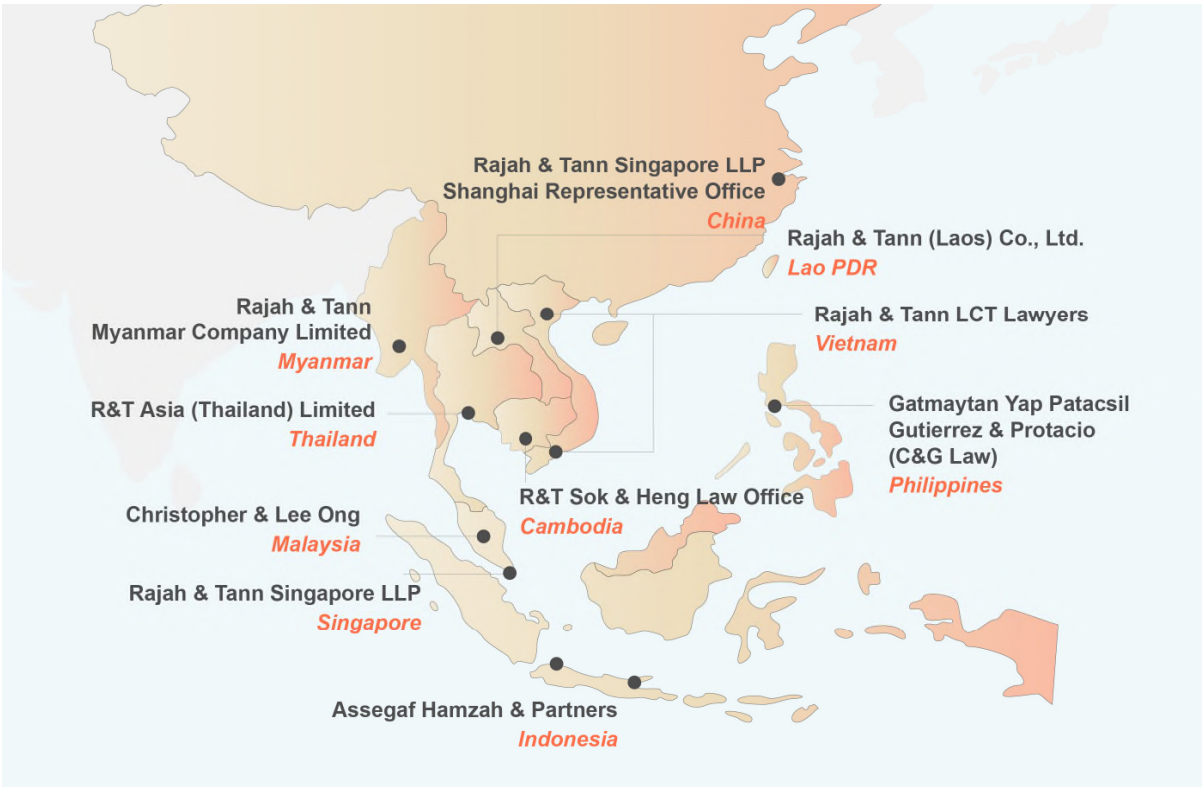

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