Writing Contracts That Address Subsequent Russia Sanctions

By **John McIntyre and Cara Brack**

John McIntyre

Cara Brack

Following the February invasion of Ukraine, the U.S. and more than 30 other countries have applied an escalating set of economic sanctions on Russia and Belarus and prominent businesses and individuals associated with those governments.

The U.S. sanctions include both broad export restrictions and prohibitions on the import of numerous Russian goods, including diamonds, iron and steel.

These sanctions come in the wake of U.S. government restrictions limiting the import of certain products from China under, among other things, the recently enacted Uyghur Forced Labor Prevention Act.

This adds stress to supply chains already reeling from state and federal restrictions imposed in connection with the COVID-19 pandemic.

This article will:

- Explore the issues likely to influence the enforceability of commercial agreements that are directly and indirectly affected by the new restrictions;
- Briefly examine the common-law defenses of illegality, impossibility and impracticability, and frustration of purpose, which have been invoked by contracting parties following previous sanctions that were imposed against Iran and Yugoslavia;
- Touch on the potential impact of the United Nations Convention on Contracts for the International Sale of Goods; and
- Offer tips for parties negotiating agreements that could be affected by future government restrictions.

Illegality

The most direct impact of the sanctions will be to void contracts with prohibited parties and those involving proscribed products. A contract becomes void for subsequent illegality if the enactment of a new law or a change in existing law precludes performance of the contract.

For example, the sanctions against the Russian Federation announced by President Joe Biden on April 6 relied in part on his authority under the International Emergency Economic Powers Act.[1]

In Kashani v. Tsann Kuen China Enterprise Co., the California Court of Appeals, Second Appellate District, affirmed in 2004 the trial court's ruling that the parties' contract was unenforceable because it involved trade and commerce with Iran that was prohibited under the IEEPA.[2] According to the Kashani court, any

agreement in violation of trade restrictions promulgated for national security reasons and therefore for the purposes of protecting the public should be unenforceable.

Impossibility and Impracticability

In addition to illegality, courts will also excuse the nonperformance of contractual obligations under certain circumstances when a party's performance is made either impossible or impracticable — depending on the jurisdiction — by a subsequent change in foreign or domestic law. Section 264 of the Restatement (Second) of Contracts sets forth the impracticable standard as:

If the performance of a duty is made impracticable by having to comply with a domestic or foreign governmental regulation or order, that regulation or order is an event the non-occurrence of which was a basic assumption on which the contract was made.

In order to establish the defense, businesses will generally need to show that:

- The change in the law made performance either impossible or possible only with extreme and unreasonable difficulty, expense or loss;
- The risks associated with the change in the law were not assigned to either party; and
- The promisor was not responsible for the difficulties in performance.

A recent decision from New York addressing the defense highlights how strictly some courts construe the requirement that the risks associated with the change in the law must not have been allocated under the contract.

For example, the Feb. 22 Wang v. 44th Drive Owner LLC decision in the Supreme Court of New York, New York County, involved a buyer's claim for rescission of a real estate contract that was premised on restrictions that were subsequently enacted by the People's Republic of China.[3]

The buyer in Wang argued that restrictions on electronic fund transfers involving the sale of real estate imposed by the Chinese government rendered his performance impossible. Under the New York standard, however, nonperformance is only excused where performance is objectively impossible due to an unanticipated event that could not have been guarded against in the contract.

The court in Wang found that the parties had agreed that the buyer would remain obligated regardless of whether he could obtain sufficient financing, even if the parties could not have foreseen the actions of the Chinese government.

Because it found that the buyer had assumed the risk of obtaining sufficient financing to make the requisite payment at closing under the contract, the court in Wang rejected the buyer's rescission claim based on impossibility.

Globally, more than 90 countries — including the U.S. — have adopted the U.N. CISG, which includes a provision addressing impracticability in the sale of goods. The CISG governs contracts for the international sale of goods between parties whose places of business are in nations that are signatories to the treaty, absent an express choice-of-law provision to the

contrary.[4]

Echoing the requirements of the Restatement of Contracts, Article 79 of the CISG provides that a

party is not liable for a failure to perform any of his obligations if he proves that the failure was due to an impediment beyond his control and that he could not reasonably be expected to have taken the impediment into account at the time of the conclusion of the contract or to have avoided or overcome it or its consequences.

Thus, as with the restatement, the CISG requires any party asserting the defense based on a change in the law to show that the change was not reasonably foreseeable when the contract was executed.

Frustration of Purpose

Even where performance is possible, a party's nonperformance may be excused under the doctrine of frustration of purpose when an unanticipated change in circumstances has defeated the primary object of the contract. Generally, a party seeking to excuse its performance due to frustration of purpose must show:

- A total or near total destruction of the primary object of the agreement;
- That both parties understood that the transaction would make little sense without the object;
- The frustration cannot fairly be regarded as a risk that the party assumed under the contract; and
- The nonoccurrence of the frustrating event must have been a basic assumption on which the contract was made.

Section 265 of the Restatement (Second) of Contracts expresses the standard as:

Where, after a contract is made, a party's principal purpose is substantially frustrated without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his remaining duties to render performance are discharged, unless the language or the circumstances indicate the contrary.

In the 1998 Sage Realty Corp. v. Jugobanka decision, the U.S. District Court for the Southern District of New York rejected a Yugoslavian bank's assertion of a frustration-of-purpose defense in a commercial lease dispute, even after its banking license was revoked as a result of economic sanctions imposed against Yugoslavia by the U.S.[5]

The lease agreement at issue in Sage was signed in June 1991. In April 1993, pursuant to an executive order blocking all Yugoslavian entities from using or accessing any of their assets located in the U.S., the Office of Foreign Assets Control revoked the license of the tenant bank, Jugobanka, to conduct business in the U.S.

After Jugobanka subsequently ceased paying rent, the landlord brought suit to recover all amounts owed under the lease and Jugobanka asserted a frustration-of-purpose defense.

While the court in Sage agreed that the executive order frustrated the parties' purpose for entering into the lease, it declined to excuse the tenant's nonperformance based on its finding that the events in question were reasonably foreseeable.

The court stated that if a contingency is reasonably foreseeable and the agreement fails to provide for protection in the event of its occurrence, the defense of frustration of purpose is not available.

Relying on press reports and deposition testimony, the court found that Jugobanka's representatives were aware of the strained relations between the U.S. and Yugoslavia during the lease negotiations and the possibility that future sanctions could affect the parties' agreement. As such, the court rejected the tenant's frustration-of-purpose defense.

Summary

These decisions illustrate some of the challenges associated with establishing the common-law defenses of illegality, impossibility and impracticability, and frustration purpose.

Given those challenges, it is prudent for contracting parties whose prospective agreements could foreseeably be impacted by future economic sanctions — including supply chain contracts involving products that incorporate imported raw materials or subcomponents — to negotiate force majeure provisions that directly address the parties' respective rights and obligations in the event of subsequent sanctions.

Among other things, any such agreement should specify the types of restrictions that will trigger the application of the force majeure provision, the manner in which notice should be provided, and how risks will be allocated if performance is delayed or precluded entirely as a result of subsequent government action.

John M. McIntyre is a partner and Cara L. Brack is an associate at Porter Wright Morris & Arthur LLP.

The opinions expressed are those of the author(s) and do not necessarily reflect the views of the firm, its clients, or Portfolio Media Inc., or any of its or their respective affiliates. This article is for general information purposes and is not intended to be and should not be taken as legal advice.

[1] 50 U.S.C. § 1705.

[2] 13 Cal. Rptr. 3d 174, 118 Cal. App. 4th 531, 547 (2004).

[3] 2022 NYJL LEXIS 128 (N.Y. Sup. Ct. Feb. 23, 2022).

[4] Minh Dung Aluminum Co. v. Aluminum Alloys Mfg. LLC, 2021 U.S. Dist. LEXIS 143459, at *6 n. 3 (M.D. Pa. Aug. 2, 2021).

[5] 1998 U.S. Dist. LEXIS 15756, 1998 WL 702272 (S.D.N.Y. Oct. 8, 1998).