

A Russian sovereign debt default? No longer improbable

On 16 March 2022, the Russian Federation (**Russia**) was due to make its first coupon payments on its sovereign debt (totaling \$117m on two dollar-denominated bonds) after its invasion of Ukraine. It appears that some creditors have received the coupon payment, but whether all creditors will receive payment remains uncertain.¹

Following the sweeping economic sanctions by the US, Canada, EU, UK and Japan against Russia's key financial institutions, including the Central Bank of the Russian Federation (the **CBR**), a default by Russia on its sovereign debt is no longer 'improbable' according to the head of the IMF.²

Should Russia fail to make payment in dollars and attempt, as it has suggested, to make payment in roubles, that may also constitute a default depending on the terms of the relevant bonds. If payment is not made on the relevant coupon payment date, or indeed if repayments of principal are not made timely, Russia will typically have a 30 day grace period in which to make the payment at which point creditors may have few options but to resort to legal action to seek to recover their investments.

I. Immobilizing the assets of the Central Bank of Russia

The US, Canada, EU, UK and Japan have introduced sweeping economic sanctions that target Russia's key financial institutions including the CBR:

1. On 28 February 2022, the U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC) prohibited United States persons from engaging in transactions with the CBR, the National Wealth Fund of the Russian Federation, and the Ministry of Finance of the Russian Federation. This action effectively immobilized any assets of the CBR held in the United States or by US persons, wherever located.³
2. On the same day, similar restrictions were introduced by the EU and Canada.⁴
3. On 1 March 2022, the UK amended the Russian (Sanctions) (EU Exit) Regulations to restrict UK persons from undertaking financial transactions involving the CBR, the Russian National Wealth Fund, and the Ministry of Finance of the Russian Federation.⁵
4. On 1 March, Japan also introduced similar restrictions on assets of the CBR.⁶

The combined result of these sanctions is a severe curtailment of Russia's ability to access and utilize its foreign currency and gold reserves. According to the Russian finance minister, Anton Siluanov, the sanctions mean

¹ <https://www.reuters.com/world/europe/russia-says-its-order-pay-117-mln-eurobond-interest-fulfilled-2022-03-17/>

² <https://www.cbsnews.com/news/kristalina-georgieva-imf-face-the-nation-transcript-03-13-2022/>

³ <https://home.treasury.gov/news/press-releases/jy0612>

⁴ https://ec.europa.eu/info/strategy/priorities-2019-2024/stronger-europe-world/eu-solidarity-ukraine/eu-sanctions-against-russia-following-invasion-ukraine_en#financial-sector-sanctions, <https://www.canada.ca/en/department-finance/news/2022/02/canada-and-g7-partners-prohibit-russian-central-bank-transactions.html>, https://ec.europa.eu/commission/presscorner/detail/en/statement_22_1423,

⁵ <https://www.gov.uk/government/news/uk-statement-on-further-economic-sanctions-targeted-at-the-central-bank-of-the-russian-federation>

⁶ <https://www.channelnewsasia.com/asia/japan-freezes-russia-central-bank-assets-new-sanctions-2527646>

that Russia is now unable to access at least US\$ 300 bn of its gold and foreign currency reserves, which amount to approximately US\$ 640 bn in total.⁷

II. Potential Russian sovereign debt default

Russia has circa. US\$ 40 billion worth of USD or Euro denominated bonds (**Eurobonds**) outstanding, of which approximately half is held by foreign persons.⁸ On 16 March 2022, Russia was due to make two coupon payments in relation to Eurobonds maturing in 2023 and 2043 of US\$ 73.1 million and US\$ 44.1 million respectively, which were the first coupon payments to fall due following Russia's invasion of Ukraine. It appears that the coupon payments have been processed by the depositories but it is not yet clear whether all creditors have received payment.⁹

Due to the sanctions imposed following Russia's invasion of Ukraine, and in particular those that have targeted the CBR, the ability of Russia to make those (or future) coupon payments on time or within the 30 day grace period remains uncertain. If Russia is unable to make payment in dollars, according to the Russian finance minister, Anton Siluanov, it may do so in roubles.¹⁰ However, depending on the exact terms of the Eurobonds, Russia may well have no express contractual right to make coupon payments in roubles.

The payments due on 16 March 2022 are just the start of potential issues with Russia's sovereign debt. In the next few months, a further US\$ 485 million in coupon payments on Russian Eurobonds will fall due. Russia is also due to repay US\$ 2 bn worth of principal in relation to Eurobonds which mature on 4 April 2022.¹¹

If Russia does default on its sovereign debt, bondholders may have little choice but to resort to legal action to seek to recover their investments. The scope of existing sanctions, including prohibitions on dealing with securities issued by Russia on or after 1 March 2022, and the ongoing war in Ukraine, are likely to rule out the possibility of either of Russia raising fresh financing internationally in order to service existing debt or of a negotiated restructuring.

III. Governing law and jurisdiction of Russian Eurobonds

In general (although each issuance must be viewed on its own terms), Russian Eurobonds:

1. Are governed by English law; and
2. Do not contain a jurisdiction clause.

There is usually an express reservation in relation to jurisdiction which states that Russia has not: i) submitted to the jurisdiction of any court; ii) agreed that disputes may be resolved in any forum; or iii) appointed any agent for service of process in any jurisdiction in connection with any action or proceeding.

⁷ <https://www.bloomberg.com/news/articles/2022-03-13/russia-lost-access-to-half-its-reserves-finance-minister-says>

⁸ <https://www.reuters.com/markets/rates-bonds/russia-says-sovereign-bond-payments-will-depend-sanctions-2022-03-06/>, <https://www.ft.com/content/7a72d966-15ee-424a-bc62-1f46980827d4>

⁹ <https://www.ft.com/content/c381f620-1897-489a-81d1-956f01fb0bf0>

¹⁰ <https://www.ft.com/content/299c95ec-8c01-472e-99ec-feeb1a4b2c66>

¹¹ <https://fortune.com/2022/03/06/putin-aims-to-avert-defaults-with-ruble-payment-to-creditors/>

In the absence of an express jurisdiction clause, it will be for the court of the jurisdiction presented with a claim to determine whether it will accept jurisdiction to hear the case.

The US position

In the US, the Foreign Sovereign Immunities Act of 1976 (**FSIA**)¹² governs all litigation in both state and federal courts against foreign sovereigns. The FSIA provides the exclusive basis for obtaining jurisdiction over sovereigns and contains special rules for service of process.¹³ The basic position is that a foreign state is immune from suit and immune from execution of judgments and pre-judgment attachments in any US federal or state court unless, as discussed below, a statutory exception to immunity applies.¹⁴ To obtain both subject matter and personal jurisdiction, a US court must answer three threshold questions: (1) whether the defendant is a “foreign state or government,” (2) whether valid service has been made pursuant to the FSIA (i.e. in accordance with the specific provisions in FSIA, 28 U.S.C. § 1608), and, (3) whether a statutory exception to immunity applies (as to which see further below).

The UK position

In England, where jurisdiction is initially established by the process of service of the claim form, it would be necessary to obtain permission to serve Russia outside the jurisdiction¹⁵ and then serve the claim form through diplomatic channels, in accordance with the State Immunity Act 1978 (the **SIA**).¹⁶ A gateway issue to obtain permission to serve out would be whether Russia could rely on the default rule in Section 1 of the SIA that states are immune from suit. However, the issue of Eurobonds is likely to constitute a commercial transaction which is one of the exemptions to immunity under the SIA (on which see further below). Following service of the claim form, Russia may seek to challenge the jurisdiction of the English courts on *forum non conveniens* grounds.

When considering the question of *forum conveniens*, English courts consider a range of factors including the location of the parties, witnesses and documents, the law applicable to the dispute and any pending related proceedings. For Russian Eurobonds governed by English law, England would likely be considered an appropriate forum to determine the dispute particularly where there are few, if any, relevant witnesses or documents located abroad.

To successfully challenge the jurisdiction of the English courts, Russia would need to show that there is some other available forum, having competent jurisdiction, which is a clearly more appropriate forum for the trial of the action, i.e. in which the case may be tried more suitably for the interests of all the parties and the ends of justice. Russia may face difficulties persuading a court that there is a clearly more appropriate forum, particularly if the proposed alternative forum is Russia itself. Even if Russia is shown to be the natural forum, the English

¹² The Foreign Sovereign Immunities Act, 28 U.S.C §§ 1602 *et seq.*

¹³ FSIA, 28 U.S.C. § 1608.

¹⁴ *Ibid.* §1604.

¹⁵ Civil Procedure Rule 6.36 and PD36 paragraph (6)(b) provide a jurisdictional gateway where the dispute is made in respect of a contract which is governed by English law.

¹⁶ Section 12 of the SIA provides that any document for instituting proceedings against a State shall be served by being transmitted through the Foreign, Commonwealth and Development Office to the Ministry of Foreign Affairs of the State. Service shall be deemed to have been effected when the writ or document is received at the Ministry. The process for service out is described in further detail at CPR 6.44.

courts may retain jurisdiction to hear the claim where there is a real risk that justice will not be obtained in the foreign court by reason of incompetence, lack of independence or corruption.¹⁷

A BIT claim?

In some circumstances, sovereign debt has been recognized as an investment capable of being the subject of a bi-lateral investment treaty claim. A potential alternative to a claim before national courts, therefore, would be a claim under one of Russia's bi-lateral investment treaties.

IV. Sovereign immunity

Russian Eurobonds usually also contain a statement to the effect that Russia: i) has not waived any rights to sovereign immunity in any jurisdiction; ii) may be entitled to immunity from suit in any action or proceeding arising out of the Eurobonds; and iii) Russia and its assets, properties and revenues may be entitled to immunity in any enforcement action.

Since Russia has not waived any of its rights to sovereign immunity, in order to succeed any claim against Russia will need to engage with and overcome issues of sovereign immunity. Rules governing sovereign immunity differ from country to country, but there are, in general, two limbs to sovereign immunity:

1. Immunity from suit (i.e. from a claim even being brought against a foreign state); and
2. Immunity from enforcement or attachment of state-owned assets.

This means that, even if a judgment can be obtained from a court of competent jurisdiction against a foreign state such as Russia, the ability to enforce that judgment may nevertheless be curtailed by sovereign immunity.

The US position

In the US, the FSIA states that a foreign state is immune from suit in any US federal or state court unless one of the enumerated statutory exceptions to immunity applies.¹⁸ The second enumerated exception, the so called "commercial activity" exception, allows for suits to proceed where the action is "*based upon. . . an act outside the territory of the United States in connection with a commercial activity of the foreign state elsewhere and that act causes a direct effect in the United States.*"¹⁹ The issue of Eurobonds by Russia and their purchase by US citizens may trigger the commercial activity exception. To satisfy this exception, plaintiffs must show that an action is "based upon" commercial conduct that forms the "basis" or "foundation" of a claim such that the elements, if proven, would entitle the plaintiff to relief.²⁰

It is well established that a foreign sovereign's activities related to debt instruments constitutes "commercial activity" and that a suit brought for breach of bond instruments is based upon that commercial activity.²¹ Individual potential claims would have to be further analysed to determine if they satisfy the "direct effect" requirement of the commercial activity exception. It is not enough to show that a state's commercial activity

¹⁷ *AK Investment CJS C v Kyrgyz Mobil Tel Ltd* [2011] UKPC 7.

¹⁸ FSIA, 28 U.S.C. § 1605.

¹⁹ *Ibid.* §1605 (emphasis added).

²⁰ *MMA Consultants 1, Inc. v. Republic of Peru*, 719 F. App'x 47, 52 (2d Cir. 2017) (internal citations omitted).

²¹ *Republic of Argentina v. Weltover, Inc.*, 504 U.S. 614, 615-16 (1992).

outside of the United States caused financial injury to a US citizen.²² To find a “direct effect” in the United States caused by non-payment of a commercial obligation, US courts have generally required a showing that either the defaulting party was contractually obligated to make payment in the US,²³ or that a provision of the underlying documents permits the holder to designate a place of payment.²⁴ Courts also look to the language of the bonds to determine if they suggest “a reasonable understanding that the United States could be the place of performance.”²⁵

In the US, even if a plaintiff successfully brings a claim under the FSIA, execution of the judgment is not guaranteed. Under the FSIA, the property of a foreign state is immune from attachment and execution unless an exception applies,²⁶ for example, where the property is or was used for the commercial activity upon which the claim is based.²⁷ Since property of foreign central banks such as the CBR is immune from attachment and execution, and there are unlikely to be assets outside the CBR used for the repayment of the Eurobonds, a judgment based on Eurobonds is unlikely to be enforceable in the US.²⁸

The UK position

In England, the general rule under the SIA is that a state is immune from suit before the English courts.²⁹ Like the US, there are exceptions to that general immunity including where the state has entered into a “commercial transaction”. “Commercial transactions” are defined as including loans or other transactions for the provision of finance.³⁰ Russian Eurobonds would likely fall under this exception.

In relation to enforcement, there is a general rule that the property of a state is immune to any process for the enforcement of a judgment or in an action for its arrest, detention or sale.³¹ There are certain exceptions to that rule including where property of the state is for the time being in use or intended for use for commercial purposes.³² However, the property of central banks is afforded greater protection, and is expressly excluded from being in use or intended for use for commercial purposes.³³ That said, English law does not impose the same requirement as US law that enforcement may only take place against assets of a state used for commercial purposes if the assets in question are or were used for the commercial activity underpinning the claim, so in principle the scope for enforcement against commercial assets of Russia located within the UK (if any) would appear greater.

²² *Guirlando v. T.C. Ziraat Bankasi A.S.*, 602 F.3d 69, 74 (2d Cir. 2010).

²³ *Rogers v. Petroleo Brasileiro, S.A.*, 673 F.3d 131, 139 (2d Cir. 2012).

²⁴ *Ibid.* at 140.

²⁵ *Ibid.*, see also *Kensington Int'l Ltd. v. Itoua*, 505 F.3d 147, 157 (2d Cir. 2007) (holding that prepayment agreements had “no connection” to the United States where they “were negotiated in France, written in French, apply to foreign entities, and specify France as the exclusive jurisdiction to resolve disputes”).

²⁶ FSIA, 28 U.S.C. §1609.

²⁷ *Ibid.* §1610.

²⁸ *Ibid.* §1611.

²⁹ SIA Section 1.

³⁰ *Ibid.* Section 3(1) and 3(3)(b).

³¹ *Ibid.* Section 13(2).

³² *Ibid.* Section 13(4).

³³ *Ibid.* Section 14(4).

Enforcement elsewhere?

A judgment creditor of Russia may seek to enforce its judgment against assets of Russia located around the world. The scope in any jurisdiction for both the recognition and enforcement of a foreign judgment will depend on the local rules applicable in the enforcing jurisdiction.

V. Discovery in support of enforcement proceedings

Regardless of where a judgment against Russia is obtained, if that judgment were to be recognised in the US or UK, which would itself engage questions of sovereign immunity, the respective courts would have wide powers to make orders in support of enforcement proceedings.

In the US, the full array of discovery permissible under the Federal Rules of Civil Procedure is available to a judgment creditor of a sovereign state. Discovery into the assets of a judgment debtor is very broad but subject to a principle of proportionality. Available discovery includes the ability to request the production of documents and written responses to interrogatories, as well as sworn deposition testimony. This discovery can in principle be requested from not only from the judgment debtor, but also any other persons or entities believed to have information relevant to the enforcement efforts.

It should also be noted that the United States Supreme Court (in a case on which one of the authors represented the successful party) has ruled that the FSIA does not grant immunity to foreign governments from discovery proceedings in litigation over the enforcement of judgments.³⁴

In the UK, the courts have wide powers to makes orders, including asset disclosure orders, third party disclosure orders (Norwich Pharmacal) and orders for cross-examination in support of enforcement proceedings. However, the granting of such orders may also engage questions of sovereign immunity especially where they concern central banks and/or their agents.³⁵

VI. What Should Bondholders Do Next?

In the event that Russia fails to make payment of any of its Eurobond obligations, there is likely to be a 30 day grace period for Russia to comply with its obligations. Investors who hold Russian sovereign debt will likely want to organize themselves and seek advice on their options ahead of time, including preparing to issue a claim against Russia to seek to recover their investments.

If you have any questions about the issues addressed in this memorandum, please do not hesitate to reach out to:

Dennis Hranitzky

Email: dennishranitzky@quinnemanuel.com

Phone: +1 801 515 7333

³⁴ *Republic of Argentina v. NML Capital, Ltd.*, 573 U.S. 134 (2014).

³⁵ *KOO Golden East Mongolia v Bank of Nova Scotia* [2007] EWCA Civ 1443.

Richard East

Email: richardeast@quinnemanuel.com

Phone: +44 20 7653 2222

Alex Gerbi

Email: alexgerbi@quinnemanuel.com

Phone: +44 20 7653 2227

Epaminontas Triantafilou

Email: etriantafilou@quinnemanuel.com

Phone: +44 20 7653 2060

Liesl Fichardt

Email: lieslfichardt@quinnemanuel.com

Phone: +44 20 7653 2040

Yasseen Gailani

Email: yasseengailani@quinnemanuel.com

Phone: +44 20 7653 2021

Rupert Goodway

Email: rupertgoodway@quinnemanuel.com

Phone: +44 20 7653 2065

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