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Contract law and Ukraine's \$3 billion debt to Russia

W. Mark C. Weidemaier*

Key points

- Russia has announced that it will initiate proceedings by the end of January 2016 to recover the \$3 billion debt owed by Ukraine.
- The Russia–Ukraine dispute is unique in the annals of sovereign debt litigation. It is a politically and militarily fraught conflict wrapped in a garden-variety, English-law contract dispute.
- If the dispute settles, its resolution will depend largely on political and economic considerations.
- Yet the resolution will occur in the shadow of basic contract law, which is surprisingly relevant. Indeed, there are a number of plausible arguments available to Ukraine, which, despite the unusual facts, may excuse (or allow it to defer) its obligations to Russia.

In December 2015, Ukraine defaulted on \$3 billion worth of bonds owned or controlled by the Russian government [The bonds were purchased by Russia's National Wealth Fund (NWF), but the Russian government has made clear that it is running the show.] Russia has announced that it will initiate proceedings by the end of January 2016 to recover the debt. At the time of this writing, the tribunal for these proceedings is unknown. The bonds provide a choice between litigation in English courts and arbitration before three arbitrators under the rules of the London Court of International Arbitration (LCIA).¹

The dispute is remarkable in many respects. In one sense, it is a garden-variety debt enforcement case. True, the debtor is a sovereign government, but courts and arbitration tribunals often hear disputes arising out of sovereign debt.² In other respects, however, the dispute is unique in the annals of sovereign debt litigation. To begin with, the lender is also a sovereign government. Governments lend to each other all the time, but they usually make direct loans and resolve debt disputes through diplomatic channels or under the auspices of organizations such as the Paris Club. Russia, by contrast, structured its loan as an ordinary bond deal, seemingly in an effort to claim the benefits of both official and private creditor status.³ For example, it did not report the debt to the Paris Club of official creditors but also claimed an official creditor's right to veto IMF debt

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1 Technically the choice is the trustee's, but Russia controls 100 per cent of the debt and the trustee will presumably follow its wishes.

2 See, eg Julian Schumacher and others, 'Sovereign Defaults in Court' (draft dated 6 May 2014) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2189997> accessed 22 February 2016.

3 See, Anna Gelper, 'Russia's Bond: It's Official! (. . . and Private . . . and Anything Else it Wants to Be . . .)' <<http://www.creditslips.org/creditslips/2015/04/russias-ukraine-bond-its-official-and-private-and-anything-else-it-wants-to-be.html>> accessed 22 February 2016.

relief.⁴ Most notably, Russia has annexed the Ukrainian territory of Crimea, and the two governments are engaged in armed conflict in Ukraine's east. The conflict and the annexation have caused substantial harm to Ukraine's economy.

Thus, the Russia–Ukraine dispute involves a politically and militarily fraught conflict wrapped in a garden-variety contract dispute governed by English law. The resolution will depend primarily on political, economic and military considerations, rather than legal ones. Moreover, because the parties may ultimately settle this dispute—which is, after all, only one of many points of contention between them—there may never be a definitive resolution to the underlying legal issues. Yet those issues merit some attention. The dispute will be resolved in the shadow of basic contract law, which, as it turns out, is surprisingly relevant even to such a novel dispute. Indeed, Ukraine has a number of plausible arguments, which, if successful, might relieve it of the obligation to pay some or all of the debt.

The bonds are governed by English law, which overlaps in many respects with US contract law. Thus, the following discussion draws on both English and US legal materials. I do not argue that Ukraine's arguments will succeed, only that, given certain plausible findings of fact, Ukraine's contract-based arguments must be taken seriously. The following discussion focuses on the doctrines of prevention and frustration (impracticability). Note that Ukraine also must show that these doctrines can be applied against claimants other than Russia itself. I will not discuss that issue in detail, but readers should bear in mind that Russia has publicly conceded that it controls the bonds and the NWF's actions in buying and enforcing them. For that reason, any defence good against Russia should prove good against the NWF. Likewise, because of the publicity attending the dispute, any subsequent purchaser from the NWF would be on notice that Ukraine disputes the enforceability of the bonds.

1. Operative facts

Virtually every fact relevant to the Russian loan is disputed and politically charged. The loan was made on concessional terms (interest of 5 per cent rather than around 12 per cent) during a time of political and economic instability near the end of Viktor Yanukovich's tenure as President of Ukraine. Russia's apparent motivation was to support a relatively friendly regime and to prevent Ukraine from deepening its ties to the rest of Europe. Beyond this, accounts diverge. There are conflicting and politically inflected accounts about Yanukovich's downfall in early 2014, whether the people of Ukraine received any benefit from the loan, the legitimacy of Russia's annexation of Crimea and the extent of its involvement in Ukraine's east and other matters.

Some facts, however, are not seriously in dispute. These include (i) that Russia has annexed Crimea; (ii) that Ukrainian troops and pro-Russian insurgents are engaged in

4 This insistence recently prompted the IMF to change its policies to allow for lending into arrears to official creditors. See generally Mark Weidemaier, 'IMF Reverses Policy on Lending into Official Arrears' <<http://www.creditslips.org/creditslips/2015/12/imf-reverses-policy-on-lending-into-official-arrears.html>>; Mark Weidemaier, 'Negating Russia's Veto of Ukraine's IMF Package' <<http://www.creditslips.org/creditslips/2015/04/negating-russias-veto-over-ukraines-imf-package.html>> accessed 22 February 2016.

armed conflict in the east of Ukraine, with the Russian government providing at least indirect support to the insurgents;⁵ and (iii) that the combined effect of these developments has been to severely hamstring Ukraine's economy. The damage is such that it would be exceedingly difficult if not impossible for Ukraine to pay the \$3 billion in full while continuing to satisfy the conditions of its IMF support programme.

2. Contract defences

As noted, the following discussion emphasizes the doctrines of prevention and impracticability. Under certain circumstances, other defences might also become relevant. For example, if Russia made the loan with the undisclosed intent to annex Crimea and/or foment conflict in the east if the Yanukovich regime were to fall, this would arguably constitute fraud. At least conceivably, a tribunal also might invoke the doctrine of odious debt to treat non-payment as justified (although the doctrine is controversial and not widely recognized). Because it seems unlikely that a tribunal would make the necessary findings, I do not discuss such defences. Nor do I discuss doctrines that might entitle Ukraine to damages or other affirmative relief, whether arising under English or international law. It is conceivable, for example, that Ukraine might seek compensation under international law for Russia's annexation of Crimea.⁶ Finally, note that, if Ukraine were to attempt to set-off a claim for damages against its bond debt, it would have to contend with the bonds' 'No Set-Off' provision: 'All payment obligations ... shall be made in full ... and the Issuer undertakes not to claim or exercise any right of set-off in respect of such payments.'

3. Prevention

'It is a general principle of contract law that if one party to a contract hinders, prevents or makes impossible performance by the other party, the latter's failure to perform will be excused.'⁷ The doctrine—embraced by both English and US contract law—both excuses the party's non-performance and provides a basis for affirmative relief.⁸ The doctrine is uncontroversial and bears an obvious resemblance to the duty of good faith and fair dealing.⁹ As one might expect, however, few of the published cases involve facts analogous to the dispute between Russia and Ukraine.

A one-sided telling of those facts goes something like this: Russia lent \$3 billion to Ukraine with the understanding that, if already-unstable political and economic conditions worsened, the loan could not be repaid. When shortly thereafter the pro-

5 Reports also indicate that Russian troops are present. See, eg 'Putin's Secret Warriors: Russian Soldiers Sent to Fight in Ukraine' *Newsweek* (6 June 2015); North Atlantic Treaty Organization, 'NATO Releases Satellite Imagery Showing Russian Combat Troops inside Ukraine' (26 November 2014) <http://www.nato.int/cps/en/natohq/news_112193.htm> accessed 22 February 2016.

6 See, eg Joseph Blocher and Mitu Gulati, 'The Borders of Sovereignty' (draft dated 14 January 2016) <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2557830>.

7 13 Richard A. Lord, *Williston on Contracts* (4th edn) s 39:3 (1993).

8 See also Michael Furmston, *Cheshire, Fifoot, and Furmston's Law of Contract* (16th edn) 671 (2012); GH Treitel, *The Law of Contract* (9th edn) (1995).

9 See (n 7) s 39:6. The doctrine applies in lending relationships. See, *Diversified Foods, Inc v First Nat'l Bank of Boston*, 605 A 2d 609, 616 (Me 1992) (recognizing the doctrine though rejecting the borrower's argument).

Russian government was ousted and replaced by a pro-European one, Russia embarked on a programme to destabilize Ukraine, using economic and military means. Conflict in the east deepened the recession impacting Ukraine's economy, effectively rendering Ukraine unable to repay and exacerbating its need for official sector support.¹⁰

Russia, of course, contests this version of the facts and pins much of the blame for the conflict on Ukraine. For now, let us indulge the assumption that the tribunal will agree to resolve this factual dispute. In that event, there is a more-than-trivial chance that Ukraine could persuade the tribunal that its version of events is correct. If this were to happen, it is almost beyond dispute that the doctrine of prevention would excuse the country's failure to pay.¹¹ To be a bit tendentious: assume Lender lends a large sum of money to Borrower, a commercial enterprise that makes widgets. Lender thereafter hires a private army to destroy several of Borrower's factories, rendering Borrower insolvent. Beyond the other obvious legal consequences—such as criminal and civil liability—it cannot seriously be disputed that Lender's conduct excuses Borrower's duty to repay. Like other doctrines that excuse non-performance of contractual obligations, the doctrine of prevention cannot trump a clear allocation of risk in the contract.¹² But it is implausible to suggest that the bonds allocate to Ukraine the risk that Russia's geopolitical interests will prompt that country to destroy much of the Ukrainian economy. The only clause that even arguably implies such a bizarre allocation of risk is the concessional interest rate.

The difficulty with Ukraine's prevention argument has nothing to do with its legal merit. Again, given certain plausible findings of fact, the defence is patently meritorious. The real problem is that the argument depends on the tribunal's willingness to take sides in politically charged disputes over the nature and legitimacy of Russia's involvement in the east of Ukraine and annexation of Crimea.¹³ This seems rather unlikely. Yet it is possible that implicit views on such matters will make the tribunal receptive to Ukraine's other arguments, especially arguments that turn on less sensitive questions of fact. To that end, Ukraine would be well-advised to look for additional arguments. The doctrine of impracticability is one possibility.

4. Impracticability

The doctrine of impracticability provides an excuse for non-performance in certain circumstances when events after the formation of the contract make performance

10 For example, IMF Country Report No 15/69 (March 2015).

11 As a doctrinal matter, there might be a question whether the causal relationship between Russia's conduct and Ukraine's inability to repay was sufficiently strong. See, eg (n 7) s 39:8. But on this version of the facts, Russia would not be in a particularly good position to dispute causation.

12 See, eg *Security Nat Life Ins Co v Pre-Need Camelback Plan, Inc*, 509 P 2d 652, 654 (Az Ct App 1973); *Iron Trade Prods v Wilkoff Co*, 272 Pa 172 (1922).

13 For a discussion of the issues raised by the annexation, see Thomas D Grant, 'Current Developments: Annexation of Crimea' (2015) 109 Am J Int'l L 68. Note that other tribunals might be asked to decide whether Russia violated international law. For example, Ukraine might commence a separate arbitration alleging violations of the United Nations Convention on the Law of the Sea. The tribunal overseeing Russia's debt enforcement case might defer to findings made in such a proceeding (thus avoiding the need to make such politically charged findings itself.)

impossible (or nearly so).¹⁴ In some cases, a party whose performance has been rendered impracticable is permanently excused from the obligation to perform. In others, the party is excused only temporarily. Either outcome should prove acceptable to Ukraine; delay effectively amounts to a re-profiling of the debt. In our context, the doctrine requires three primary inquiries.

First, the change in circumstances must conflict with a fundamental assumption on which the parties made the contract. Here, it is important to be clear about the nature of the assumption: at least arguably, Russia would not have lent \$3 billion, and the Yanukovych government would not have borrowed that sum, unless the parties had assumed that hostilities between the two governments would remain muted. Importantly, a tribunal might find that the parties held this assumption (and, ultimately, that subsequent events proved the assumption false) without assigning blame to either side. Put differently, the tribunal must only conclude that the loan would not have happened had the parties known hostilities would escalate in this fashion.

Such a finding would be entirely plausible. As noted, the seeming intent of the loan was to support a government with which Russia had established friendly relations. Russia also insisted the loan include certain provisions that are hard to square with the expectation of increased hostilities, at least if the insistence was in good faith. In particular, the loan includes an unusual clause providing that it will be an event of default for Ukraine's debt-to-GDP ratio to exceed 60 per cent. Perhaps that clause can be justified as a mechanism for ensuring that an economically fragile borrower did not jeopardize repayment prospects by going deeper and deeper into debt. But if the parties had envisioned the ongoing conflict in the east, the clause would be much harder to justify, for its practical effect is to trigger an almost automatic default in that case. Taking a cynical view of the contract, this may have been precisely the intent. But the tribunal need not adopt such a cynical view in determining the assumptions underlying the loan.

Secondly, Ukraine cannot be at fault for the change in circumstances.¹⁵ Again, the reported cases do not involve facts analogous to those here. However, the inquiry is subtly but importantly different from the inquiry required by the doctrine of prevention. The tribunal need not rule directly on the propriety of Russian conduct, nor must it allocate blame for the conflict between the parties. It must only conclude that this is not a case in which Ukraine seeks to benefit from its 'self-induced frustration'.¹⁶ There is some authority—indirect, to be sure—for the proposition that a breakdown in diplomatic relations can excuse performance between state-controlled enterprises.¹⁷

14 See Treitel (n 8) 778, 792; Michael H Whincup, *Contract Law and Practice: The English System with Scottish, Commonwealth and Continental Comparisons* (5th edn, 2006) 339–45. English courts may be somewhat less receptive to the impracticability standard than US courts, preferring something closer to impossibility. See Treitel (n 8) 794–7. But see Whincup 341–5 (seemingly taking a somewhat broader view).

15 See, eg *Paal Wilson v Partenreederei* [1983] 1 All ER 34. Technically the doctrine applies when neither party is at fault. Other doctrines, including prevention, encompass situations where the promisee's conduct makes the promisor's performance impossible or impracticable.

16 Whincup (n 14) 340.

17 See, 'The Playa Larga' [1983] 2 Lloyd's Rep 171.

Thirdly, the contract cannot have assigned to Ukraine the risk that increased hostilities would make payment impracticable. At first glance, this requirement is most problematic. In general, a party whose primary duty is to pay cannot excuse its performance by asserting that it has run out of money.¹⁸ This is because, in a typical transaction, it is unlikely that a payee would agree to assume that risk.¹⁹ In the context of sovereign loans, the presumption that the borrower assumes the risk of its inability to pay may be somewhat weaker. As a historical matter, sovereigns have occasionally succeeded in arguing that financial necessity justifies non-payment, although the cases are few and there are important exceptions.²⁰ Still, under ordinary circumstances, it is sensible to presume that sovereign borrowers bear the risk of *most* future events that might make payment impracticable.

But there is nothing typical about the Russia–Ukraine loan or the events that followed it, and a finding that Ukraine may excuse or delay performance on impracticability grounds need not have implications for other sovereign loans. If the reasons Ukraine cannot pay are common to sovereign borrowers in distress and unrelated to the conflict with Russia (eg poor fiscal policy, weak tax collection, currency fluctuation, etc), then its impracticability argument will probably fail. Borrowers should presumptively bear such risks, because borrowers are in the best position to prevent them from materializing. However, if the armed conflict with Russian-backed rebels and annexation of Ukrainian territory substantially contributed to its inability to pay, then Ukraine's situation is unique. It makes little sense to say that Ukraine was better able to prevent these risks from materializing. On the contrary, given the inevitable political and economic disruption, Ukraine already had ample incentive to avoid exacerbating the conflict. The same cannot be said for Russia, which would predictably view a pro-European Ukraine as contrary to its geopolitical interests and have incentives to destabilize such a government. At least arguably, then, the presumption that payors cannot assert impracticability—though strong in a typical loan transaction—should not apply in this unique context.

Nor does anything in the contract suggest the intent to allocate this risk to Ukraine. To be sure, an escalation in conflict may have been foreseeable (although probably not the annexation of Crimea). The risk factors section of the prospectus warns that 'Ukraine may become subject to heightened volatility due to regional economic, political or military conflicts.' But the fact that a risk was foreseeable does not always prevent the use of impracticability.²¹ As for the contract itself, the most relevant provision makes it an event of default for Ukraine to 'contest the validity' of the debt, or for there to be a

18 Whincup (n 14) 342; *Northern Indiana Pub Serv Co v Carbon County Coal Co*, 799 F 2d 265 (7th Cir 1986).

19 Courts have generally rejected efforts by private borrowers to argue impracticability. See, eg *Bank of N.Y. v Tri Polyta Fin BV*, 2003 WL 1960587 (SDNY, 25 April 2003); *Bank of America v Shelbourne Dev Group Inc*, 2011 WL 829390 (N D Ill 3 March 2011).

20 See generally, Michael Waibel, *Sovereign Defaults before International Courts and Tribunals* (Cambridge 2011) Ch 5.

21 See Whincup (n 14) 340. To be sure, the fact that a risk was foreseeable may justify imposing that risk on the borrower. See, eg *Shelbourne Dev Group* (n 19). The point is simply that this result is not required in all cases. All risks are foreseeable to a degree. Changed circumstances doctrines exist precisely because some foreseeable risks are not assumed by the adversely affected party. The (foreseeable) risk of financial downturn is sensibly assigned to the borrower in most cases, but that is because borrowers usually can better prevent or insure against the type of risk that materialized. Not so here.

determination that Ukraine's obligations are 'unenforceable or invalid'.²² This is standard boilerplate in sovereign bonds; I am aware of no legal authority for the proposition that such a clause negates any defences the borrower might assert to the loan.

5. Conclusion

Once again, I do not mean to argue that these arguments must be resolved in Ukraine's favour. The point is simply that the defences are plausible. Having chosen to structure its loan as a private bond deal enforceable through litigation or arbitration, Russia must take the good with the bad. The good includes the normal judicial (or arbitral) tendency to enforce contracts. The bad, from Russia's vantage point, includes conventional legal doctrines that sometimes result in non-enforcement. It would be understandable for judges and arbitrators to hesitate before weighing in on such a politically charged dispute, but Russia's insistence on acting like a private creditor leaves little choice.

²² Prospectus dated 17 February 2014, s 8(g).