Dangerous Liaisons – With Whom Do You Trade?

Essential Elements for Compliance with the Russia Sanctions

By Michelle Schulz and Elsa Manzanares

In response to the ongoing crisis in Ukraine, the U.S. and other countries have imposed sanctions against Russian individuals and entities. With each new round of sanctions announced by the Obama administration and the Office of Foreign Assets Control (OFAC), U.S. companies with business operations involving Russia are continually assessing how these sanctions affect them. Below are a few essential elements to keep in mind amidst this dynamic sanctions landscape.

1. Carefully assess the impact of the “50 Percent Rule”

The first step is to know the parties to the transaction. Who is your customer? Who owns them? Persons on the U.S. sanctions lists are designated as Specially Designated Nationals (SDNs). U.S. persons are generally prohibited from dealing with SDNs or with entities owned 50% or more by an SDN, either directly or indirectly. If an SDN owns 50% or more of another entity, that entity is blocked as well, even if that entity is not on the SDN list. In its most recent guidance, OFAC clarified that any entity owned in the aggregate 50% or more by one or more SDNs is itself considered an SDN.

To add to the complexity, OFAC advises companies to exercise caution when entities are under control of SDNs by means other than 50% or more ownership or when one or more SDN has a significant ownership interest that is less than 50% because those entities may be designated in the future.

2. Tune in to the activities of your foreign subsidiaries

With whom do your foreign subsidiaries do business? Although foreign subsidiaries are not currently restricted by the Russia sanctions, this could change at any time. U.S. persons cannot enter into transactions where they know a product is intended for onward sale to an SDN. Take care to identify if an SDN is involved anywhere in the chain of transactions. For example, if you sell a product to your Russian subsidiary and you know your subsidiary intends to sell your product to an SDN or use it in a project involving an SDN, your participation in that transaction is likely prohibited by U.S. law. A contractual provision with your subsidiary prohibiting sales to SDNs is one option for mitigating risk in this situation.

3. Adopt a formal trade compliance program (or enhance your existing one)

A robust trade compliance program already requires comprehensive due diligence procedures for vetting prospective and existing business partners. That due diligence is a critical tool in dealing with the rapid developments in the Russia sanctions.

To comply, companies must trace the ownership of their business partners. For example, prior to the execution of a distribution or supply agreement, many companies require prospective business partners to complete a questionnaire detailing the owners and shareholders of the company, as well as all principal officers, directors and employees. In a company with numerous owners, this becomes a time-consuming task, especially in light of the recent clarification that the 50 Percent Rule applies to entities owned 50 percent or more in the aggregate by one or more blocked persons. It may even mean hiring a third-party service to assist you in identifying such ownership information as it may not be publicly available. Regardless, your due diligence efforts must be thorough and well documented.

If you do not have a contractual provision requiring your business partners to provide you such ownership information, now is the time to amend your contracts. It is also a good time to add an escape provision in your agreements allowing you to exit the relationship if a party to the transaction is designated as an SDN in the future.

Even if your company decides not to adopt a compliance program, consider that your shipping partners and other third parties may adopt procedures that will impact you. As part of enhanced compliance procedures, for example, freight forwarders are requesting indemnification provisions from their clients for items they ship to Russia.

A compliance program is critical if you uncover a potential violation of the sanctions laws or any other trade regulation. The existence of a robust trade compliance program is a significant mitigating factor in any U.S. Government investigation.

Michelle Schulz and Elsa Manzanares are co-chairs of the International Trade Practice at Gardere Wynne Sewell, LLP in Dallas.