

ALERT

Coping with Rapidly Expanding U.S. Sanctions on Russia

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HIGHLIGHTS:

- » The U.S. Office of Foreign Assets Control (OFAC) issues the fourth round of designations blocking the assets of seven additional Russian individuals as well as 13 Russian companies, including several Russian banks.
- » The White House has indicated that further actions by Russia could lead to a "ratcheting up" of sanctions to include broader sanctions on sectors of the Russian economy, including the Russian financial and energy sectors.
- » OFAC has issued initial regulations providing some guidance for U.S. companies regarding the blocking of assets under these Ukraine-related sanctions.

The rapid expansion and growing complexity of U.S. sanctions arising out of the crisis in Ukraine present real challenges for both U.S. and non-U.S. companies attempting to assess their legal obligations and future risks. In particular, the risk of broader "sectoral" sanctions could significantly impact companies doing business in Russia.

Fourth Round of Designations

On April 28, 2014, OFAC designated seven additional Russian/Ukrainian individuals and 17 companies as specially designated nationals (SDNs) under Ukraine-related sanctions. To date, the U.S. has designated 45 individuals and 19 companies as SDNs. These individuals are all either directly associated with events in Ukraine or are considered part of President Putin's inner circle. However, in many cases these Russian oligarchs own substantial assets. This has led to the designation of a number of companies owned by them as SDNs, including several banks – Bank Rossiya, SMI Bank, Investcapitalbank, and JSB Sobinbank. In addition, the U.S. Department of Commerce's Bureau of Industry and Security (BIS) has added all the designated companies (other than the designated banks) to the U.S. "Entity List," thereby precluding these companies from access to U.S. goods and technology.

What Are the Cumulative Sanctions?

To date there have been three Executive Orders (issued in March 2014) and legislation (the Support for Sovereignty, Integrity, Democracy and Economic Stability of Ukraine Act (the "Act")) signed into law April 3, 2014, providing authority to impose sanctions. In addition, on May 8, 2014, OFAC issued initial regulations detailing certain rules regarding blocking of assets under the above Executive Order. Certain administrative actions also were taken by U.S. export agencies and the U.S. Federal Aviation Administration (FAA).

Who May Be Sanctioned?

The Executive Orders and Act give broad authority for the U.S. government to designate persons or entities that, among other things:

- » are officials of the Russian government
- » operate in sectors of the Russian economy designated by the U.S. government, such as financial services, energy, metal and mining, engineering, and defense/arms or related materials
- » are involved in the destabilization of Ukraine, misappropriated state assets of Ukraine, or asserted authority over regions of Ukraine without authority of the Ukrainian government
- » contribute to corruption in the Russian Federation

Although the Executive Orders also authorize sanctioning of certain Russian industry sectors, no sectors have been designated to date. However, certain banks have been designated and the U.S. State Department has suspended the processing of defense exports to Russia.

What Are the Sanctions Against Persons Designated as SDNs

For the individuals and entities designated as SDNs under these sanctions:

- » U.S. persons are required to block the assets of any SDN designated under these sanctions (e.g., any USD transactions would be blocked by the U.S. bank through which the funds would normally clear).
- » U.S. persons may not provide goods, services or funds to SDNs (or receive goods, services, or funds from SDNs). Historically, OFAC has interpreted "services" more or less synonymous with "facilitation," and thus U.S. persons in general cannot engage directly or indirectly in business dealings with SDNs.
- » Individual SDNs are barred from entering the U.S. (Visa ban).
- » As a legal matter, any person (including a non-U.S. person) that materially assists a sanctioned entity by providing financial, material, or technological support or goods or services is also potentially subject to sanction. However, OFAC has downplayed the existence of secondary sanctions authority, focusing exclusively on the obligations of U.S. persons to block assets of designated entities.
- » For entities also designated on the BIS Entity List, no person (e.g., including non-U.S. persons) may export goods from the U.S. to such person or reexport U.S.-origin goods or technology to such person.

What About Companies That May Be "Owned or Controlled" by a Designated Individual?

Notwithstanding broad language in the relevant Executive Orders that include entities both "owned" or "controlled" by an SDN, in both presentations and in the new regulations issued May 8, OFAC focused on a "bright line" ownership test of 50 percent or more equity interest:

- » If an SDN owns 50 percent or more of the equity in a company, then the company is considered an asset of the SDN and U.S. persons are obligated to block the assets of the company in their possession and otherwise treat the company as if it were an SDN.
- » For an entity that does not meet this threshold, OFAC may still determine that an SDN effectively owns or controls the entity and designate the entity as an SDN. However, until OFAC so designates the entity, U.S. persons have no authority to block assets but should exercise caution in dealing with such entity as it may be designated in the future.
- » Certain individuals designated as SDNs either prior to or immediately after designation have sold

off all or a portion of their ownership in certain companies, presumably to avoid having their company's assets blocked. Over the last two months, OFAC has appeared to informally recognize the validity of these sell-offs. The new regulations formalize restrictions on transfers, which in part depend on the timing of the transfer (e.g., did a bona fide transfer occur prior to the date a U.S. person would have been obligated to block assets?).

Have There Been Any General Sanctions on Russia?

- » Both BIS (which processes licenses for sensitive civil technology) and the U.S. State Department (which processes arms export licenses) quietly ceased processing new export license applications to Russia in early March 2014. More recently it was announced that these agencies would deny pending license applications to Russia and occupied Crimea for "high technology items" with military applications, and would take action to revoke existing licenses for these items.
- » The FAA has prohibited U.S. air carriers, and U.S. registered aircraft (other than those operated by non-U.S. air carriers) from overflying Crimea. This is not a "no fly" zone, such as was established over Libya during the crisis there in 2011.

What Is the Likelihood of Expansion of U.S. Sanctions Against Russia?

As long as Russia continues to support efforts to destabilize Ukraine, economic sanctions remain the best, and perhaps only, foreign policy tool to try and restrain Russian action. Hence, the prospect of further rounds of designation of individuals and entities owned by such individuals is likely. Imposition of "sectoral" sanctions is less likely, as this would have economic costs to U.S. companies, and significant costs to European Union countries whose economies are more intertwined with Russia. It is likely that President Obama would be reluctant to impose unilateral sector sanctions if the European Union was not willing to follow suit. Notwithstanding this, in a recent press briefing the White House press secretary repeatedly threatened "sectoral sanctions," mentioning the Russian finance and energy sectors as potential targets.

What Steps Can Companies Take to Mitigate Risk?

The uncertainty regarding future designations and expansion of sanctions make compliance and risk management difficult. Nevertheless, companies doing business with Russian companies should be proactive:

- » For existing business relationships, a company can (i) revisit its due diligence to determine who owns the Russian company (e.g., is it indirectly owned by an individual who may be designated in the future?); (ii) develop contingency plans; and (iii) review contract provisions.
- » For potential new business, a company should (i) exercise additional diligence regarding Russian business partners; (ii) consider the length and terms of the contact (including in particular the sanctions/force majeure clauses); and (iii) consider whether there are ways to structure the transactions to reduce risk.

It is likely that the crisis and the sanctions will continue to change rapidly, and thus the information in this alert may become quickly outdated. Companies with potentially affected business operations should monitor events closely and develop contingency plans should there be a major escalation of sanctions.

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