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Smooth Sailing into 2020!

Year in Review

MAKING WAVES

THE IMPACT OF INCREASINGLY COMPLEX SANCTIONS ON THE MARITIME INDUSTRY[1]

What maritime shipping companies, investors, insurers, and lenders need to know

Shipping companies and their executives, investors, insurance providers and lenders – regardless of their nationality or location – face increasingly draconian sanctions risks, notably from the U.S. and Europe, and soon from the United Kingdom. Particularly under the current U.S. administration, economic sanctions have increasingly become a favored instrument of foreign policy. The recent zealous application of sanctions to the shipping sector is by design. On November 6, 2019, a top U.S. official stated that the United States will target shipping companies that are in breach of U.S. sanctions, and aggressively enforce measures across the globe in the maritime sector, taking aim at an industry that, like the financial services industry, is critical to global commerce.

In just one example of the vigorous approach to sanctions enforcement, the U.S. government recently designated several major subsidiaries of COSCO, China's state-owned shipping company, as sanctioned entities on the Specially Designated Nationals (SDN) list due to their involvement in the transportation of Iranian crude oil to Asia. The SDN designation of the COSCO subsidiaries sent oil freight costs to record highs around the world, adding millions of dollars to the cost of every voyage, and sending a clear message that those involved in the transport of cargo in violation of sanctions do so at their peril.

For executives navigating these turbulent seas, it is important to understand the extraterritorial reach of varying and sometimes conflicting sanctions programs, so that they can proactively mitigate business and legal risks and respond quickly should an international crisis produce new sanctions. The potentially serious collateral consequences of a sanctions violation under commercial and financing commitments require companies to respond nimbly to this rapidly evolving landscape. This article explores the current focus of sanctions enforcement on the maritime industry, assesses the sanctions risk profile of players in this industry, and offers practical advice for mitigating those risks.

I. A GLOBAL PERSPECTIVE: THE LONG REACH OF SANCTIONS

Companies operating in a global industry like shipping must comply with all applicable laws, even if those laws appear to be in conflict. Non-U.S. entities may see technical possibilities to engage in certain activities that are prohibited for U.S. persons. At first sight, inconsistent laws would seem to suggest that non-U.S. persons may be relieved from compliance with U.S. sanctions programs. However, in practice, companies must find a way to comply with both U.S. and EU sanctions. To add to the complexity of the sanctions landscape, the United Kingdom will leave the European Union,

Exemplar Sanctions Triggers

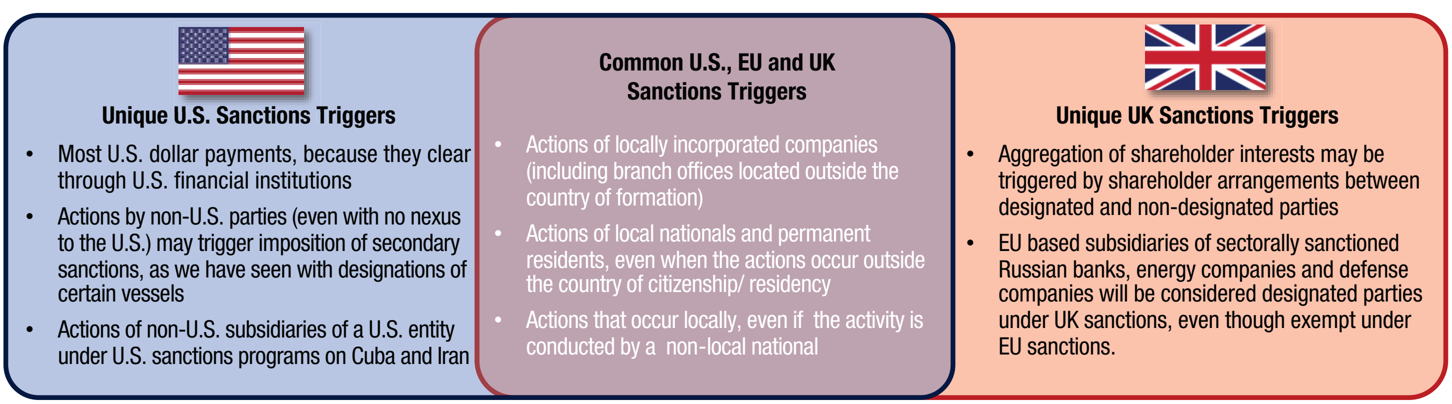

FIGURE 1

either with a deal at the end of 2020 or without a deal as early as January 31, 2020, and as the UK sanctions regulations published earlier this year confirm, the UK will adopt a position that differs from the EU position, for example on Russia. For examples of common and jurisdictionally unique sanctions triggers see Figure 1.

A. U.S. Sanctions Can Have Non-U.S. Targets

The U.S. Department of the Treasury's Office of Foreign Assets Control (OFAC) maintains sanctions that fall into two basic categories: (1) "Primary Sanctions" that directly prohibit U.S. persons, which are broadly defined under U.S. regulations, from engaging in prohibited activities; and (2) "Secondary Sanctions" used to dissuade non-U.S. persons from engaging in certain activities by threatening to impose measures (such as an SDN List designation) on non-U.S. persons engaging in such activities.

To be found to have violated primary sanctions, there must be some nexus to the United States but, importantly, liability for primary sanctions violations is not limited to U.S. companies. For example, many U.S. sanctions programs prohibit any transaction that evades, avoids, has the purpose of evading or avoiding, causes a violation of, or attempts to violate any of the prohibitions of the regulations. Non-U.S. companies can be liable for violations of primary sanctions on a derivative basis, most commonly where a non-U.S. person engages in a U.S. dollar transaction that transits a U.S. correspondent financial institution. Where these transactions relate to underlying conduct that violates U.S. sanctions, such as dealings with a blocked party, OFAC has asserted its jurisdiction over the otherwise non-U.S. transaction by virtue of the fact that a non-U.S. person caused a U.S. person (i.e., a U.S. correspondent financial institution) to violate primary sanctions. Persons that violate primary sanctions, including on a derivative basis, may be exposed to civil and/or criminal liability in the United States.

Secondary sanctions refer to a number of laws, regulations, and executive orders that impose extraterritorial sanctions on non-U.S. persons who engage in conduct that the United States deems contrary to its foreign policy or national security interests, and therefore sanctionable. Secondary sanctions are designed to dissuade non-U.S. persons from engaging in such activities, and they are often enforced where there is no U.S. jurisdictional hook in the transaction. While the U.S. may impose other measures depending on the sanctionable activity in question, the imposition of secondary sanctions is often by means of the designation of a non-U.S. person on the SDN List.

This was the case for COSCO, whose non-U.S. subsidiaries were designated as SDNs despite the lack of a U.S. nexus in the underlying transaction which, but for the lack of such nexus, would have been a violation of U.S. primary sanctions. Following the designations, global trading companies such as Exxon and Unipec have ceased activities involving 43 oil tankers owned by COSCO's non-U.S. subsidiaries. These companies have gone even further to protect themselves from the reach of U.S. sanctions, shunning 250 crude and oil product tankers that are known to have carried Venezuelan oil in the past year and which may therefore face a heightened risk of secondary sanctions.

In addition to sanctions issued at the Federal level, many U.S. states also maintain laws that prohibit public funds from investing in, and require them to divest from, companies that engage in certain types of business activities involving specified countries such as Iran and Sudan. While these state divestment laws vary significantly, the most common model generally requires public funds (e.g., state pension funds and endowments) to divest holdings and refrain from new investments in companies that engage in certain kinds of business activities associated with the specified country. More recently, we have seen states consider the application of similar restrictions with respect to other countries (e.g., Florida statute with respect to Venezuela). Accordingly, even if a shipment does not violate U.S. sanctions, perhaps because there is not a U.S. nexus, companies involved in the shipment should consider risks under these state laws as a result of their investor base. Similarly, another issue worthy of consideration by SEC-registered companies is whether conducting trade or business with certain of the comprehensively sanctioned countries which are also listed by the United States as State Sponsors of Terrorism (e.g., Iran, Syria, Sudan), will trigger a disclosure or reporting requirement.

B. Increasing Complexity: The Divergence of U.S. and EU Sanctions and New UK Sanctions Following Brexit

Some EU sanctions programs are aligned with U.S. sanctions, but there are also significant differences. For example, the EU tends to designate government actors of the targeted regime, rather than affiliated or private companies engaged in conduct that flies in the face of EU foreign policy objectives. In some regimes, the EU restrictions substantially differ from U.S. restrictions, such as in respect of Iran and Venezuela. Further, the EU has implemented a Blocking Regulation to counter-balance the extraterritorial effects of the U.S. sanctions against Cuba and Iran. Although this regulation, on its face, may appear to exempt EU persons from compliance with U.S. sanctions, the reality is that it complicates rather than simplifies compliance.

The Blocking Regulation does not absolve a non-U.S. entity from derivative U.S. primary or secondary sanctions risks. Rather, such parties are left in a Catch-22 where they are contractually obliged to comply with both U.S. sanctions laws and the EU Blocking Regulation, but are restricted from full compliance with U.S. law by the EU Blocking Regulation. As discussed below in Section II, to mitigate these risks, companies must properly scope compliance policies and procedures and carefully draft commercial and financial contracts.

Brexit, deal or no-deal, should have a limited but immediate impact on the EU sanctions landscape. This is because the UK has implemented the Sanction and Money Laundering Action of 2018 (SAMLA) and various implementing regulations. The UK regulations, as they have been published, confirm that, as a starting point, UK sanctions regimes generally are aligned with EU sanctions.

The UK sanctions against Russia are outliers. The UK subjects EU-based subsidiaries of sectorally designated Russian banks, energy companies, and defense companies to the same financial and capital market restrictions as their Russian parents, although these EU companies are excluded from EU sanctions. Likewise, the UK has a more expansive definition of ownership and control, which includes, for example, aggregation of parties with shareholder agreements. This complexity affects, among other issues, sanctions due diligence for commercial operators.

In addition, SAMLA provides broad authority to the UK government to impose additional sanctions measures. Historically, the UK has been a strong proponent of the use of sanctions as a foreign policy tool by the EU. It has seen its ambitions thwarted by the European unanimity requirement for the adoption of sanctions in several instances. On its own, the UK can act more swiftly in response to geopolitical developments and, with the significance of London's financial markets, has a significant instrument of power to yield. An independently evolving UK sanctions landscape is a complicating factor for global shipping, particularly where many contracts have traditionally been subject to English law and/or provide for dispute resolution in the UK.

II. MANAGING SANCTIONS RISKS

A. Common Sense Compliance: Decreasing the Likelihood of Enforcement and Mitigating Potential Penalty Amounts

The first step for industry participants is to re-familiarize themselves with their institution's sanctions obligations and, as necessary, update their sanctions compliance policies and procedures. As a starting point, in May 2019, OFAC recently issued "A Framework for OFAC Compliance Commitments," which highlights essential components for all sanctions compliance programs. Sanctions regulators are specifically targeting the maritime industry for sanctions enforcement, and a key question asked in the course of a review by OFAC of any potential sanctions violation will be the adequacy of the company's compliance policies and procedures.

It is critical to remember that compliance procedures should not be static. Board members and executive management teams in the shipping industry must stay abreast of developments and ensure their company has capable advisors who can provide timely insights on recent developments and forward-looking guidance regarding future developments. Given the serious direct and collateral consequences for lapses in this area, as a matter of fiduciary duties as well as best practices, the board of directors must ensure that there is a cross-disciplinary team of managers who are responsible for regularly reviewing sanctions developments, updating sanctions compliance policies and procedures and regularly updating the board on these measures.

B. Transaction-based Compliance: From Vessel Acquisitions to Voyages

Given the increasingly frequent application of extraterritorial sanctions, the intentionally aggressive enforcement of those sanctions, and the potentially direct and indirect debilitating impact of sanctions violations, conducting robust diligence in the context of all shipping transactions, from investment, vessel dispositions and acquisitions, insurance and chartering to individual voyages, is vital. OFAC's recent shipping advisories have highlighted deceptive shipping practices that aim to circumvent traditional due diligence measures, including ship-to-ship (STS) transfers, disabling of Automatic Identification Systems (AIS), as well as vessel name and ownership changes. OFAC has put the industry on notice that heightened diligence addressing deceptive practices is required. As a result, new service providers offer both historical and real-time vessel tracking, and provide information regarding whether and when a vessel's AIS was turned off. Importantly, this information is based on a vessel's IMO number, which accounts for the potential that a designated vessel may have been renamed. For individual voyages, ongoing and continuous screening of changing cargo interests is critical until the moment the voyage is complete and the cargo is discharged. Figure 2, below, summarizes some key diligence considerations for both vessel acquisitions and individual voyages.

C. Sanctions Clauses Should be Targeted to Address Risk: Consider Whether Prohibitions are Overly Broad

In the shipping sector today, nearly every agreement includes sanctions compliance clauses, from charter party and pooling contracts, to loan agreements and insurance policies. Counterparties often propose overbroad sanctions compliance clauses, while shipping compa-

Due Diligence Considerations

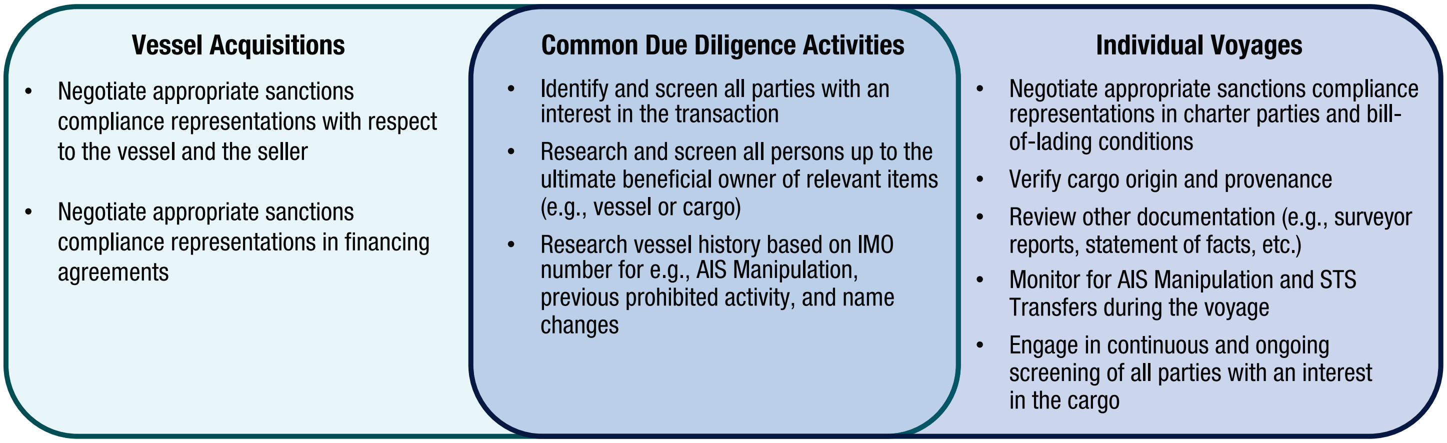

FIGURE 2

nies may seek provisions limited to "compliance with laws applicable to the shipper's business." In practice, sanction clauses, when drafted properly, can allocate — and sometimes mitigate — sanctions risk. However, poorly drafted clauses can have significant negative unintended consequences, including placing a shipper at a competitive disadvantage to others in the industry.

Often, sanctions clauses are "templates" which categorically restrict any activity that could be in breach of any sanctions, regardless of whether or not these sanctions laws apply to the relevant business. Such broad-brush clauses may prohibit activity that is not prohibited by sanctions applicable to the parties to the transaction. For example, a blanket exclusion on all dealings with an entity designated on OFAC's SDN list would prohibit a non-U.S. vessel from carrying mining product from an SDN-owned mine in Africa to a destination outside the United States, which may be legally permissible if there is no U.S. nexus.

Shipping companies, therefore, should be ready to identify and negotiate sanctions compliance language in these documents. For example, shipping companies should pay particular attention to how "sanctions laws" and "sanctions targets" are defined, whether past activities could trigger potential default, and whether or not activities that may trigger contractual default have a "materiality standard" or are "knowledge qualified." Because a violation of broadly defined sanctions obligations in one financing agreement can trigger cross default and mandatory prepayment of loans, borrowers should ensure that they have thoroughly reviewed their obligations and, to the extent possible, align and tailor their obligations to address the specific risks presented consistent with the business operations in which they engage.

Further, where shipping companies have greater control over contractual terms, e.g., in their Bill of Lading conditions, it is important to include robust conditions to ensure that the shipper is not obliged to deliver cargo in violation of applicable sanctions. For example, if a shipping company, through ongoing screening, determines that the Bill of Lading was assigned to a sanctioned party, it could invoke the protective Bill of Lading condition and refuse delivery to the sanctioned party, and the shipping company should not be found to have violated any contract in doing so. In view of the specificity of many requirements imposed by sanctions, general 'compliance with law'-clauses often do not provide a solution.

III. CONCLUSION

Sanctions violations carry heavy civil and/or criminal penalties. However, collateral effects from a violation can be even more devastating to a company. The potential peril depends on how broadly or narrowly sanctions obligations are defined in material agreements, and whether they are aligned across commercial and financing documents. Thus, a robust compliance program and carefully crafted commercial and financing agreements are necessary to ensure compliance both with sanctions laws and regulations, and the contractual obligations relating to sanctions. A properly structured and considered top-down risk-based approach to sanctions compliance will materially improve compliance with all sanctions applicable to a company's business activities, and increase efficiency by clearly distinguishing acceptable and unacceptable business. It thereby enhances a company's market position and access to capital by preventing the significant financial, reputational and other collateral costs that result from sanctions violations.

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