

International Trade Alert

August 15, 2014

New Sanctions Guidance Increases Due Diligence Burden on Companies

On August 13, 2014, the U.S. Department of the Treasury, Office of Foreign Assets Control (OFAC) published [guidance](#) (“Revised Guidance”) that revises its 2008 guidance regarding how to treat entities that are owned or controlled by blocked persons—i.e., persons whose property and interests in property are blocked. The 2008 guidance—which is widely known as the “50 Percent Rule”—held that if a blocked person owns 50 percent or more interest of an entity, either directly or indirectly, that entity would automatically be blocked by operation of law. The Revised Guidance reaffirms this 50 Percent Rule, but now requires aggregation when determining blocked persons’ ownership interests. In other words, under the Revised Guidance, an entity is automatically considered “blocked” if one or more blocked persons together own 50 percent or more (directly or indirectly) of the entity, even if the entity itself is not formally identified as a blocked party by OFAC.

OFAC stated that this Revised Guidance equally applies to entities identified on the Sectoral Sanctions Identification (SSI) List, which is part of the Ukraine-Russia sanctions program. Thus, any entity that is owned 50 percent or more (directly or indirectly) in the aggregate by one or more persons on the SSI List is also subject to SSI restrictions.

OFAC’s Revised Guidance represents a tightening of the U.S. approach to its sanctions programs, including its Ukraine-Russia sanctions program. As a result, it is expected that a greater number of entities will be subject to U.S. blocking sanctions and sectoral sanctions. Significantly, as discussed further below, the Revised Guidance greatly increases the due diligence burden on U.S. companies and their foreign affiliates seeking to comply with OFAC sanctions programs.

The 50 Percent Rule

Under OFAC sanctions programs, the property of certain designated individuals and entities (known as Specially Designated Nationals or SDNs) is blocked pursuant to various executive orders and regulations. Blocking orders prevent U.S. persons from doing business of any kind with persons or property that are blocked pursuant to an OFAC sanctions program. Blocked property includes tangible and intangible property, as well as any present, future or contingent interest in such property, whether held directly or indirectly by the blocked person.

In the 2008 guidance, OFAC announced the 50 Percent Rule, which stated that, for the purposes of extending blocking sanctions, SDNs are considered to have an interest in all property in which the SDN owns a 50 percent or greater interest, either directly or indirectly. Therefore, any entity that is owned 50 percent or more by an SDN is automatically blocked, regardless of whether that entity is identified within an executive order or otherwise identified by OFAC as an SDN.

OFAC also applies the 50 Percent Rule to entities listed on its new SSI List, which restricts U.S. persons and persons within the United States from dealing in certain types of new debt and/or equity transactions with listed Russian financial and energy companies. Under the 50 Percent Rule, restrictions applicable to entities on the SSI List also apply to entities that they directly or indirectly own by 50 percent or more.

The New Guidance

The Revised Guidance expands the 50 Percent Rule by allowing the 50 percent ownership threshold to be achieved through aggregation of ownership interests of multiple blocked parties. Under the new rule, an entity is automatically blocked, by law, if such entity is owned, directly or indirectly, by (i) one blocked person with a 50 percent or more ownership interest or (ii) more than one blocked person that, in the aggregate, own 50 percent or more of the entity.

- For example, if three separate SDNs each own 17 percent of an entity, that entity is now automatically blocked because the aggregate ownership by blocked parties is greater than 50 percent (i.e., 51 percent).
- Conversely, where three separate SDNs each own 16 percent of an entity, that entity will not be blocked because the aggregate ownership by blocked parties is less than 50 percent (i.e., 48 percent). OFAC still advises caution when entering into transactions with entities in which a blocked person has significant minority ownership interests, as those entities may be the subject of future designations.

In addition to the Revised Guidance, OFAC also issued a set of [Frequently Asked Questions](#) (FAQs) that further elucidate the application of the new rule. The following are some key points from the FAQs:

Ownership is aggregated, but not control.

OFAC's 50 Percent Rule applies only to ownership, not to control. OFAC clarified that an entity controlled (but not owned 50 percent or more) by one or more blocked persons is not considered automatically blocked pursuant to this rule. However, companies should be cautious when dealing with entities that are controlled by blocked persons, as specific transactions involving the blocked person may still be prohibited. For example, a contract with an entity that is not blocked will be prohibited if it will be signed by a blocked person.

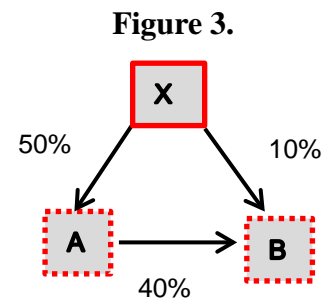
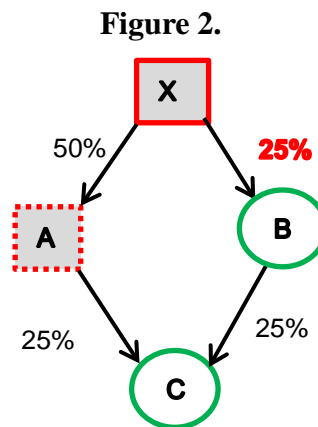
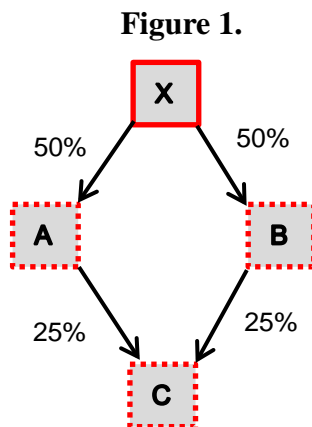
When calculating indirect ownership, only aggregate the indirect interests if the direct owner is also a blocked party.

The 50 Percent Rule applies to entities that are owned 50 percent or more, directly or indirectly, in the aggregate by one or more blocked persons. In this context, OFAC explained that "indirectly" refers to "one or more blocked persons' ownership of shares of an entity *through another entity or entities that are 50 percent or more owned in the aggregate by blocked person(s).*" (emphasis added) For the purposes of aggregation, the ownership interest of listed SDNs and/or otherwise blocked persons (by operation of law) will be aggregated. In other words, the original blocked person's (in the example below, Blocked

Person X) indirect or direct interest would be aggregated with the interest of other entities in the ownership chain that are separately considered to be blocked.

Three examples provided within [FAQ No. 401](#) provide further context:

- In Example 2 (see Figure 1 below), Blocked Person X owns 50 percent of Entity A and 50 percent of Entity B. Entities A and B each own 25 percent of Entity C. Entity C is considered to be blocked.
- In Example 4 (see Figure 2 below), Blocked Person X owns 50 percent of Entity A, but only 25 percent of Entity B. Entities A and B each still own 25 percent of Entity C. Entity C is **not** considered to be blocked. This is because Entity B is not 50 percent or more owned by Blocked Person X; therefore, Blocked Person X is not considered to indirectly own any of Entity C through its part ownership of Entity B.
- In Example 3 (see Figure 3 below), Blocked Person X owns 50 percent of Entity A and 10 percent of Entity B. Entity A also owns 40 percent of Entity B. Through OFAC's methodology, Entity B is considered to be blocked because Blocked Person X is considered to indirectly own 40 percent of Entity B through its 50 percent ownership of Entity A. When added to Blocked Person X's direct 10 percent ownership of Entity B, Blocked Person X's total direct and indirect ownership is 50 percent, meeting the 50 percent threshold. Consult [FAQ No. 401](#) for additional examples of aggregation.



- = Identified SDN
- = Persons blocked pursuant to 50 Percent Rule
- = Persons that are not blocked

The 50 Percent Rule may be avoided through divestment, but previously blocked property already in the United States or in the possession of a U.S. person will remain blocked until OFAC takes affirmative action.

If a blocked person divests ownership in an entity that was considered blocked pursuant to the 50 Percent Rule, resulting in aggregated blocked person ownership that is less than 50 percent, then the entity is no longer considered a blocked entity. Any property of that entity that comes into the United States or the possession of a U.S. person, after the divestment, would not be considered blocked pursuant to the 50 Percent Rule.

However, if property of the entity had already come into the United States or the possession of a U.S. person **prior to** the blocked person's divestment, then that property would remain blocked until (i) OFAC authorizes the unblocking of the property or (ii) OFAC removes from the SDN List one or more of the original blocked persons such that the aggregate ownership by blocked persons falls below 50 percent. This is because OFAC will not recognize the unlicensed transfer of a blocked person's interests once the property becomes blocked.

The aggregation guidance may be applied to identify entities subject to SSI List restrictions.

The SSI List, which is part of the Ukraine-Russia related sanctions program, places restrictions on certain transactions with entities identified on the list (as well as entities owned 50 percent or more in the aggregate by one or more of the persons on the SSI List). These restrictions do not require the property of listed entities to be blocked, but rather restrict U.S. persons and persons in the United States from engaging in certain transactions involving new debt and/or new equity with them. As such, OFAC clarified that the guidance and FAQs related to aggregation should be utilized to assist companies only in identifying parties subject to the SSI List restrictions, but should not be understood to require that the property of such parties be blocked.

What Are the Implications for U.S. Persons?

U.S. persons—which includes companies organized under the laws of the United States (including their owned or controlled foreign affiliates under certain sanctions programs), U.S. citizens and U.S. green card holders—generally may not engage in any transaction with an entity that is blocked pursuant to the 50 Percent Rule. Furthermore, in the context of Ukraine-Russia sectoral sanctions, U.S. persons may not deal in certain types of new debt and/or equity transactions with an entity that is owned 50 percent or more by SSI-sanctioned parties. U.S. persons that engage in either of these prohibited transactions may be subject to potential OFAC enforcement and penalties.

What Does This Mean for You?

The Revised Guidance presents an additional burden on U.S. companies and their foreign affiliates seeking to comply with the regulations. Whereas prior guidance required companies to examine the ownership structure of a company of interest to determine whether a single blocked person had a 50 percent or greater ownership interest, companies must now ensure that their screening and diligence

procedures evaluate whether the aggregated ownership percentage of all blocked persons with ownership interests in a company meets or exceeds 50 percent. Each owner—no matter how small the interest—must now be examined to determine whether it qualifies as a blocked person or SSI-sanctioned person, which, in turn, requires examining the ownership of that entity, and so on and so forth.

OFAC has not provided specific guidance on the level of diligence that is required to comply with this new rule. Companies should therefore assume they must do whatever is necessary to demonstrate that they took reasonable steps to confirm that sanctioned parties do not have a 50 percent or more ownership interest in an entity. This may include actions such as updating standard procedures to include a review of both direct and indirect ownership chains, as well as maintaining records of all diligence conducted.

Where a company discovers that a business partner is blocked or sanctioned pursuant to the 50 Percent Rule, no further business should be conducted with that entity. Furthermore, if diligence reveals partial ownership by one or more blocked persons, even if the ownership does not rise to 50 percent, companies should heed OFAC's advice and proceed with caution.

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