CLIENT MEMORANDUM

New OFAC Guidance on 50% Rule Expands U.S. Sanctions Against Russia

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On August 13, 2014, the U.S. Treasury Department's Office of Foreign Assets Control (OFAC) issued new guidance regarding entities owned 50 percent or more by blocked persons. Effective upon publication, the new guidance on the "50 percent rule" has the potential to expand existing Ukraine-related sanctions by blocking the property of even more Russian companies. It also brings U.S. sanctions into closer alignment with EU sanctions.

Under the 50 percent rule, a person whose property and interests in property are blocked pursuant to Executive Order (EO) or OFAC regulation is considered to have an interest in the property, and interests in property of any entity, in which the blocked person owns, directly or indirectly, a 50 percent or greater interest. Thus, any company that is owned 50 percent or more by a blocked person or entity is blocked, even if the company itself is not on the OFAC list of Specially Designated Nationals and Blocked Persons (the SDN List).[1] Transactions by U.S. Persons, or within the United States, involving a blocked person, or an entity owned 50 percent or more by a blocked person, are generally prohibited.

[1] OFAC applies the 50 percent rule to entities on the Sectoral Sanctions Identification List (SSI List) as well. Although the property and interests in property of persons on the SSI List are not blocked, entities on the SSI List are subject to other restrictions. See our July 18, 2014 memo U.S. Imposes Sectoral Sanctions Against Russia; Targets Banking, Energy and Arms, But Scope Is Limited.

In a major change, OFAC will now aggregate the ownership interests of SDNs when determining whether the 50 percent rule applies. For example, if Blocked Person X owns 25 percent of Entity A and Blocked Person Y also owns 25 percent of Entity A, then Entity A is blocked, because Entity A is owned 50 percent or more in the aggregate by blocked persons. Aggregation applies even if Person X and Person Y are blocked under different sanctions programs. This change brings U.S. sanctions into closer alignment with EU sanctions, which also aggregate the interests of blocked persons.

Under OFAC's new guidance, application of the 50 percent rule to indirect ownership interests will result in a cascade-down effect.[2] For example, if Blocked Person X owns 50 percent of Entity A, and Entity A owns 50 percent of Entity B, according to the guidance, both Entity A and Entity B are automatically blocked.[3] Indeed, a 50 percent ownership will keep the automatic blocking flowing down to each subsidiary in the chain. This cascading-down effect is also a feature of EU sanctions law.

The aggregation principles also apply to indirect ownership and result in a cascading-down effect as well. For example, if Blocked Person X owns 50 percent of Entity A and Blocked Person Y owns 50 percent of Entity B, and Entity A and Entity B each own 25 percent of Entity C, then Entity C is blocked because Persons X and Y indirectly own 50 percent of Entity C. Moreover, any company in which Entity C has a 50 percent or greater interest also will be blocked.

However, there is no upward flow from an ownership interest of less than 50 percent. If Blocked Person X owns 48 percent of Entity A, and Entity A owns 50 percent of Entity B, then neither Entity A nor Entity B is blocked. Even if Entity B is also owned 48 percent by Blocked Entity C, because Entity A is not a blocked party, the aggregate direct and indirect blocked party ownership of Entity B remains below 50 percent, and Entity B is not blocked.

If one or more blocked persons divest their ownership stake in a blocked entity, and blocked-person ownership falls below 50 percent, that entity is no longer considered automatically blocked. However, the divestment must occur entirely outside of U.S. jurisdiction and must not involve U.S. Persons. Further, if a blocked entity's property has already entered U.S. jurisdiction or comes within the control of a U.S. Person, then even if the aggregate blocked-person ownership falls below 50 percent, the property remains blocked until OFAC authorizes its unblocking or removes the blocked entity from the SDN List, if applicable. In addition, OFAC urges all U.S. companies to proceed with caution in such circumstances and to exercise sufficient due diligence to confirm the validity of any purported divestments.

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2 Indirect ownership refers to one or more blocked persons owning an entity through another entity or entities.

3 OFAC FAQ 401. Entity B is also blocked because of Blocked Entity A's direct 50 percent ownership.

Importantly, to date, U.S. sanctions apply only through ownership, not control, of entities.[4] This approach differs in the EU, where the sanctions can apply to any entity that is "owned or controlled" by a designated entity or individual. The test of control, therefore, can bring into scope entities that do not meet the strict 50 percent ownership test, but are nonetheless effectively controlled by a designated individual or entity (such as through constitutional documents giving the designated entity control of the board of directors of a company).

Companies that are subject to U.S. or EU trade restrictions and do business in or with Russia or Russian entities should know whom they are dealing with and whether that entity or individual or the proposed transaction is subject to sanctions. They should have adequate screening procedures in place that utilize the most current information. The new aggregating principles adopted by OFAC underscore the importance of companies subject to U.S. or EU trade restrictions conducting sufficient due diligence on their counterparties to determine whether, and to the extent which, these companies are owned or controlled by a sanctioned entity or individual.

Related Links

OFAC Implementing Regulation, Federal Register, Vol. 79, No. 89, Thursday May 8, 2014, Ukraine-Related Sanctions Regulations (May 8, 2014)

OFAC Frequently Asked Questions, Questions Related to Entities Owned by Persons Whose Property and Interests in Property are Blocked (August 13, 2014)

OFAC, Revised Guidance on Entities Owned by Persons Whose Property and Interests in Property are Blocked (August 13, 2014)

Office of Foreign Assets Control, Specially Designated Nationals List, Ukraine-Related Designations (August 7, 2014)

Office of Foreign Assets Control, Sectoral Sanctions Identification List, (July 29, 2014)

European Union Sanctions

Client Memorandum, EU Sanctions Update – Russia/Ukraine, (August 1, 2014)

EU Council Regulation 833/2014, (July 31, 2014)

4 OFAC's Ukraine-Related Sanctions Regulations implement EO 13660, 13661, and 13662. Only EO 13662 authorizes the blocking of property "owned or *controlled* by, or to have acted or purported to act for or on behalf of, directly or indirectly, any person whose property and interests in property are blocked pursuant to this order" (emphasis added).

If you have any questions or need any assistance in determining whether your company may be affected by U.S./EU sanctions against Russia, please contact Martin J. Weinstein (202-303-1122, mweinstein@willkie.com), Robert J. Meyer (202-303-1123, rmeyer@willkie.com), Jeffrey D. Clark (202-303-1139, jdclark@willkie.com), Peter Burrell (+44 20 3580 4702, pburrell@willkie.com), Miriam A. Bishop (202-303-1126, mbishop@willkie.com) or the Willkie attorney with whom you regularly work.

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