Beware of Ofac

A little-known agency poses challenges to international finance

Tucked away in the labyrinthine US Department of the Treasury, in the old Treasury Annex across from the main Treasury Building and the White House on Lafayette Square, toil approximately 150 employees and officials of the Office of Foreign Assets Control (Ofac). If you have not heard of Ofac you are not alone. This small agency deliberately keeps a low profile – direct phone numbers are not published and seldom given out even to frequent callers, and often the person at the end of the phone will provide only a first name.

Despite its size and relative obscurity, the agency yields enormous power and influence in global financial markets and over the activities of multinational corporations. As noted on its website (http://www.treas.gov/offices/enforcement/ofac/), Ofac "administers and enforces economic and trade sanctions based on US foreign policy and national security goals against targeted foreign countries, terrorists, international narcotics traffickers, and those engaged in activities related to the proliferation of weapons of mass destruction [WMD]".

Most people reading this description of Ofac's mission statement would conclude that it would have little application to everyday corporate and financial activities. After all, few of us can be said to be involved in any way with terrorism, narcotics trafficking or the proliferation of WMD. In fact, however, not knowing about and considering the myriad of Ofac regulations can have disastrous consequences for anyone engaged in international M&A activities or global finance.

Scope of Ofac

The economic and trade sanction programmes administered by Ofac are directed against a number of countries and also against thousands of listed persons, companies, charities or entities considered to be enemies of the US or threats to national security. The countries subject to some degree of sanction include the Balkans, Belarus, Myanmar, Cote d'Ivoire, Cuba, Iran, Iraq, Liberia, North Korea, Sudan, Syria and Zimbabwe.

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The listed persons and entities are called specially designated nationals (SDNs). There are different types of SDNs, including specially designated international terrorist organizations and terrorists (SDTs), specially designated global terrorists (SDGTs), foreign terrorist organizations (FTOs), specially designated persons engaged in the proliferation of weapons of mass destruction (NPWMDs) and specially designated narcotics traffickers (SDNTs or SDNTKs). All SDNs, both individuals and entities, are published in a list by Ofac.

Understanding exactly what is required under the Ofac regulations is a formidable task. Different regulations are issued by Ofac for each programme, and each set of regulations has variations on the activities that are prohibited and to whom the prohibitions apply. Identical terms can be defined differently for different programmes, and critical prohibitions (for example, the facilitation of transactions with sanctioned countries) are missing from some programme regulations, but nonetheless understood to be applicable, or at least potentially applicable, because of their existence in other programme regulations. Moreover, Ofac does not provide clear definitions of critical terms such as facilitation, and insight into interpretations for those terms often requires a review of previous settlements, enforcement actions or published advisory opinions.

Under most of the programmes US persons (including US citizens, permanent residents and anyone physically present in the country, as well as US corporations) are prohibited from engaging in any transactions with a sanctioned country, government or SDN. US persons must also review financial and commercial dealings and transactions and block or freeze assets in which a sanctioned country, government or SDN has any interest, even if that asset or property is owned or controlled by someone else.

In addition, in the case of Cuban and North Korean regulations, these prohibitions apply not only to US companies but even to foreign subsidiaries and other foreign companies owned or controlled by US persons. Particularly with respect to Cuba, this creates a perfect breeding ground for an international conflict of laws. Multinational companies are often caught in the crossfire, and sometimes even used affirmatively by the respective governments as pawns in foreign policy disputes. In some countries, it is illegal to comply with certain US sanctions. This can create a minefield, even for those savvy concerning Ofac requirements.

Questions to ask during diligence

In conducting diligence for any activity, including mergers and acquisitions, the engagement of new business partners, and entering into contracts or agreements, certain basic questions should be asked of the entity or person under review, including the following:

- **Is the entity itself on the SDN list? Are the beneficial owners, director, and any member of the management of the entity on the SDN list?**
- **Does the entity or any of its agents or affiliates selling its products or services conduct any business, even indirectly, that involves countries subject to comprehensive US sanctions? Does it have operations in such countries? Does it buy from or sell to such countries?**
- **Does the entity transfer any technology or technical data, or license any software to such countries?**
- **Does the entity engage in any financial transactions whatsoever involving such countries?**
- **Does the entity itself have an effective Ofac screening programme to ensure that its customers, suppliers and/or distributors are not on the SDN list or operating in sanctioned countries?**
- **How is this screening conducted? Does the entity use a third-party vendor who supplies screening services, or does the entity do it in house? In either case, what search parameters are being used? A search programme that looks for exact name matches only can lead to incorrect results.**
- **Once the screening results are generated, how is the decision-making process conducted? Are there written rules and procedures for determining whether a particular name match is a true SDN hit or a false positive? Are these rules consistent with advice given by the Compliance Programmes Division at Ofac?**
- **Has the entity been the subject of any investigations by or requests for information from Ofac? Does the entity have any pending cases before Ofac, including those initiated by a voluntary disclosure?**

Ofac also extends to investments by US persons in non-US companies. Of course, US persons are prohibited from investing in a company that is an SDN or that is owned or controlled by an SDN or sanctioned country. However, Ofac has also stated that it would be unlawful for US investors to invest in third-country companies that are

predominantly dedicated to investments, projects or other economic activities in which a US person would be prohibited from engaging, or that derives the predominant portion of its revenues from such investments, projects or activities. Ofac, however, has never defined what predominantly means, leaving US investors in an uncomfortably ambiguous situation.

Violation of Ofac regulations may result in substantial civil and criminal penalties, including civil fines of up to $1 million and, for willful violations, criminal penalties of up to $10 million and 30 years in prison. The prohibitions under the Ofac regulations essentially impose a strict civil liability standard on US persons who engage in unauthorized transactions or dealings with a sanctioned country, individual or entity named on the SDN list. (The regulations set forth the prohibited activities, and do not limit the prohibitions to activities in which US persons acted knowingly.) Therefore, even though a US person may not have knowledge that he is unwittingly transacting or dealing with an SDN, Ofac may still impose civil liability. Therefore, if Ofac finds that a US person has violated the regulations, then the question focuses on what level of civil penalty will be imposed.

Protecting against liability

Diligence issues relating to Ofac can arise in any merger or acquisition, even those involving purely domestic companies. Because successor liability can be applied for Ofac violations, frequently companies will be asked to represent or warrant compliance with Ofac requirements. This, however, can create considerable difficulty, particularly in cross-border transactions, where the parties to the deal can be subject to different and conflicting laws.

In one recent case, for example, the US office of a global financial services company was interested in acting as a placement agent for a non-US fund. Under the potential deal, the financial services company was to help market the fund to potential US investors. Since it was a US person subject to Ofac requirements, the financial services company was interested in including some provisions in the agreement to avoid any inadvertent Ofac violations. The foreign fund, understandably, had less of an interest in complying with US law.

As the engagement agreement was negotiated, the financial services company wanted to include provisions to ensure that the fund would not invest in any countries or entities subject to Ofac sanctions. This was due to Ofac's position that US persons are prohibited from investing in any third-country companies that are predominantly dedicated to investments, projects or other economic activities in which a US person would be prohibited from engaging, or that derive the predominant portion of their revenues from such investments, projects or activities.

The fund was again understandably reluctant to agree to avoid certain sanctioned countries, when under the local law of the fund it was perfectly legal to transact business with these countries. The fund felt that the financial services company was trying to subject it to an extraterritorial application of US law. In fact, the financial services company was simply trying to avoid the possibility of an Ofac violation by it or its US investors.

The financial services company confronted two types of potential liability. First, should Ofac consider investments by US persons in the fund to be unlawful, the financial services company could be held liable for facilitating an unlawful transaction, which Ofac considers to be just as grave as a first-hand offence. Second, and perhaps even more significantly, if Ofac were to take that position, then it could order that the investments by the US persons in the fund be blocked or effectively confiscated. In fact, the entire investments by US persons could be blocked, even though a portion of those investments could reasonably be said to be related to non-sanctioned countries. In that case, the financial services company could be subject to lawsuits by the US investors it had solicited, who would have lost effective control over their investments.

In addition, the local law applicable to the fund prohibited it from complying with certain aspects of the US economic sanctions programmes. Many countries, including Canada and the members of the EU, have such prohibitions in place. This sets up a direct conflict of law, particularly with respect to US economic sanctions programmes that extend to foreign subsidiaries of US companies. In the end, the proposed retention arrangement was abandoned because the Ofac issues could not be overcome.

Creeping extraterritoriality

With the exception of the Cuban and North Korean sanctions, US sanctions programmes do not extend extraterritorially to companies organized under the laws of foreign countries.

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However, they do continue to be applied to all US citizens and permanent residents, even those who are working abroad for such companies. Thus, it may be technically legal under Ofac regulations for a foreign subsidiary to do business in a country subject to Ofac sanctions, but practical implementation of this can be very tricky, particularly where there are a large number of US persons at the foreign subsidiary, either in management or on the front lines. It can also be very difficult when there is tight corporate control over the foreign subsidiary by the US parent. Under Ofac regulations, the US parent cannot direct, agree or take any affirmative action with respect to the foreign subsidiary's business in a sanctioned country.

Because of the problems companies encounter in effectively administering Ofac compliance policy worldwide, where foreign subsidiaries may be subject to some economic sanctions programmes but not others, many have adopted a policy of global compliance with Ofac requirements, regardless of locale. This goes beyond that required by most of the sanctions programmes themselves. However, more and more companies are adopting this kind of policy, given the adverse publicity generated by disclosure that they do business in countries like Iran, Sudan or Syria.

Although you may not have heard much about Ofac until now, the economic and trade sanctions administered by the agency are likely to play a much larger and more visible role in cross-border transactions and global financial activity in the immediate future. In this challenging environment of conflicting, inconsistent or ambiguous laws and legal mandates, it will be important to keep these requirements and considerations in mind, and to prepare to address them, particularly when considering merging with or acquiring another business.

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