OFAC Modifies the 50% Rule and Expands the Reach of U.S. Export Controls

Michael E. Burke

The U.S. Department of Treasury's Office of Foreign Assets Control ("OFAC") has made compliance with U.S. economic sanctions more difficult and complex by modifying, on August 13, 2014 the '50% Rule' used to determine whether an entity owned by a blocked person should itself be blocked. The bottom line for businesses required to comply with U.S. economic sanctions: the universe of blocked companies is now significantly larger and, consequently, the compliance burden on accurately identifying blocked companies has increased.

First, Some Definitions

OFAC administers the U.S. economic sanctions programs issued pursuant to the International Emergency Economic Powers Act and the Trading with the Enemy Act. These programs prohibit U.S. Persons (defined below) from transacting with or investing in (i) entire jurisdictions, including persons and businesses from such jurisdiction (Iran, North Korea, Syria, Sudan, and Cuba); (ii) targeted people, companies and groups within certain jurisdictions (Belarus and D.R. Congo, for example); and (iii) specific persons or entities under sanctions programs that are not country-specific (counter-narcotics, for example). OFAC's list of Specially Designated Nationals and Blocked Persons ("SDN List") identifies the individuals and companies owned or controlled by, or acting for or on behalf of, sanctioned countries, and individuals, groups, and entities designated under targeted and non-country specific sanctions programs.

If a person, entity or company is on the SDN List, such person, entity or company is 'blocked' and U.S. Persons: (i) are prohibited from transacting business with or investing in such entity without first obtaining a license to OFAC; (ii) must freeze any property of such person, entity or company that they hold; and (iii) are prohibited in dealing in such assets until such time as the assets are 'unfrozen' by OFAC. The term 'property' in this context means any property or any direct or indirect interest in property, tangible or intangible, including present, future or contingent interests.

The term 'U.S. Person' under U.S. sanctions regulation includes U.S. companies and their subsidiaries, U.S. citizens and permanent residents anywhere in the world (including those who are officers and directors of a foreign company), and certain portfolio companies of U.S. investors.

Next, Comparing the Old and New 50% Rule

U.S. economic sanctions programs also block the property of entities *owned or controlled* by a blocked person, even if such controlled entity is not itself on the SDN List. The August 13 guidance changes the ownership test but does not change the control test for blocking the property of a person or entity controlled by a blocked person. The guidance states that an entity that is controlled, but not owned 50% or more by one or more blocked persons is not considered automatically blocked. However, OFAC cautioned that such entities may be designated in the future and that there are significant risks with regard to transacting with such entities.

The former 50% Rule provided that the property of an entity that was not itself on the SDN List was blocked if at least 50% of its equity was owned by a blocked person or entity. For example, if I were a blocked person and owned more than 51% of a company, that company's property would be blocked. However, and again assuming that I were a blocked person, if I owned 40% of a company, that company's property would not be blocked. In other words, the former 50% Rule required U.S. Persons to determine whether any *single* blocked person or entity owned 50% of another person or entity not otherwise included on the SDN List.

The revised 50% Rule blocks the property of a person or entity, not itself on the SDN List, if that person or entity is 50% or more owned, directly or indirectly, by *one or more* blocked individuals or entities. Rather than looking at the ownership interests held by a single blocked person, the revised rule requires aggregation of the ownership interests of all blocked people in an entity to determine whether that entity's property is blocked.

Using the example in the last sentence of the above paragraph, and again assuming I am a blocked person, the property of the company in which I owned a 40% interest would be blocked if the company had other blocked owners and the aggregate ownership interest owned by me and the other blocked persons exceeded 50%. Taken one step further, the guidance addresses 'indirect ownership' in an interesting manner. We can (perhaps for the last time) assume that I am a blocked person and I own 50% of Newco. Based on the revised 50% Rule, Newco's property is blocked. Assume further that I own 40% and Newco owns 10% of an entity named ReallyNewco. In that case, since ReallyNewco is owned 50% by blocked persons, its property is also blocked.

Wrinkles and Headaches

As with many OFAC pronouncements, the revised 50% Rule has some 'interesting' wrinkles and details. For complex corporate structures, the revised rule provides that a company's property is blocked if it is 50% or more owned, directly or indirectly, by one or more blocked persons, even where those persons are blocked only by virtue of the 50% Rule itself. So, taking the above example, if the blocked company in which I and my blocked friends own more than 50% of the equity in turn owns more than 50% of the equity in any other company, the property of any downstream companies is blocked.

In addition, the August 13 guidance clarifies that a U.S. Person is prohibited from transacting with a blocked person, even where the blocked person is acting only in a representative capacity on behalf of a non- blocked entity. This would prohibit, for example, a U.S. business from negotiating with a blocked person or having such blocked person execute a document, on behalf of a non-blocked company.

In the past, a blocked person could have reduced their ownership in an entity to below 50% in order to facilitate a transaction with a U.S. Person. Such divestitures must take place outside of the U.S., but such a strategy may not be sufficient under the revised 50% Rule. The OFAC guidance accompanying the revised 50% Rule clarifies that the property of a blocked entity or in the possession or control of a U.S. person must be released by OFAC before any U.S. Person may transact with such property. Therefore, a divestiture will not, by itself, be sufficient to enable a transaction where (i) the property already has been blocked; or (ii) the aggregate interest owned by blocked persons in an entity remains above 50% even after a divestiture.

Interplay with Other U.S. Sanctions Programs

Certain U.S. sanctions programs, such as the Cuba sanctions impose blocking based on control, on ownership levels below 50% or other criteria (the Cuba sanctions do not specify a threshold ownership percentage to determine ownership, and takes ownership/control on a case by case basis). The revised 50% Rule does not change such blocking requirements; in fact, the lower-threshold blocking requirements could be read into the revised 50% Rule insofar as such thresholds define ownership or control for blocking purposes.

The revised 50% Rule will have a significant impact on the sectoral sanctions imposed as a result of the situation in Ukraine by extending relevant U.S. sanctions to entities that are 50% or more owned by one or more of the entities included on the Sectoral Sanctions Identification List ("SSI List"). While property of these entities is not required to be blocked, the revised 50% Rule helps to identify those subsidiaries and affiliates of SSI List entities subject to the prohibition on dealings with such entities' newly issued equity or debt having a maturity over 90 days.

What Companies Need to Do Now

As before the revision to the 50% Rule, U.S. Persons should screen all parties to a contemplated transaction in high sanctions risk countries. Screening against the SDN List remains a good starting point, but is not sufficient to fully mitigate sanctions risk.

While the former 50% Rule required U.S. Persons to determine if a single blocked person owned more than 50% of the equity in a given entity, the revised 50% Rule now requires U.S. Persons to screen each ownership interest in a company, and then aggregate the ownership interests of each blocked party. Due diligence must now provide significantly more detail on a company's ownership structure, including indirect ownership interests.

OFAC guidance also suggests that U.S. Persons may need to conduct a retrospective analysis of an entity and its property to ensure that the entity was not previously owned 50% or more by blocked parties. This suggestion, of course, presents a huge challenge to U.S. Persons.

Authors and Contributors

Michael E. Burke
Partner, DC Office
202.677.4046
michael.burke@agg.com

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Atlanta Office	**Washington, DC Office**
171 17th Street NW	1775 Pennsylvania Ave., NW,
Suite 2100	Suite 1000
Atlanta, GA 30363	Washington, DC 20006

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