CLIENT UPDATE

OFAC EXPANDS "50% RULE" AND CLARIFIES APPLICATION OF BLOCKING SANCTIONS

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On August 13, 2014, the US Treasury Department's Office of Foreign Assets Control (OFAC) revised its published guidance on the so-called "50% Rule" under the economic sanctions laws that it administers.

Under the newly issued guidance, if one or more blocked persons – such as individuals or entities on OFAC's Specially Designated Nationals (SDN) List—*in the aggregate* own 50% or more of an entity directly or indirectly, that entity is itself automatically blocked. Where this rule applies, US law requires US persons, and in some cases foreign entities owned or controlled by US persons, to refrain from transacting business with or investing in the blocked entity and to freeze any property of the entity that they hold. These requirements apply, for example, to US companies and their subsidiaries, to US-managed private equity funds and their portfolio companies, and to individual US citizens and permanent residents, including those who are directors and officers of foreign companies. OFAC's new guidance makes it even more critical, and more difficult, for entities subject to US laws to conduct the due diligence necessary to ensure that potential contractual counterparties or acquisition targets are not blocked.

In addition, the revised guidance specifies that the 50% Rule applies to "sectoral sanctions" as well as blocking sanctions. Sectoral sanctions restrict US persons from dealing in new equity or long-

term debt of designated Russian entities and, with the recent guidance, entities that are 50% or more owned by one or more such entities.

Further, in the Frequently Asked Questions (FAQs) accompanying the new guidance, OFAC has clarified that a US person cannot engage in a transaction with a blocked person even if the blocked person is acting only in a representative capacity on behalf of a non-blocked entity. That would mean, for example, that a US person could not deal with an officer or director who is blocked as an individual but is acting on behalf of a non-blocked company.

EXPANSION OF "50% RULE"

The revised 50% Rule provides that property of an entity that is 50% or more owned, directly or indirectly, by one *or more* blocked individuals or entities is also deemed to be blocked. Thus, even if a company is not itself on OFAC's Specially Designated Nationals (SDN) list, it is considered blocked if at least 50% of its equity is owned by one or more blocked persons.

The aggregation of ownership interests of multiple blocked persons is a change from OFAC's previously expressed view, under which a company had to be directly or indirectly owned by a single blocked person for the 50% Rule to apply. The FAQs accompanying the new guidance provide the following example of how the new rule works: "if Blocked Person X owns 25 percent of Entity A, and Blocked Person Y owns another 25 percent of Entity A, Entity A is considered to be blocked."

The FAQs also provide examples of how to apply the revised 50% Rule to more complex ownership structures. Essentially, a company is blocked if it is 50% or more owned, directly or indirectly, by one or more blocked persons, even if those persons are blocked only by virtue of the 50% Rule itself. Application of this rule may sometimes produce unexpected results. For example, consider a situation in which Person X, who is on the SDN list, owns 50% each of Entity A and Entity B, and Entities A and B each own 25% of Entity C. Under both the old and new versions of OFAC's guidance, Entities A and B are blocked because Person X owns 50% of their equity. Under the old version, however, Entity C would not have been blocked because Person X has only a 25% indirect interest in the equity of Entity C (12.5% through Entity A and 12.5% through Entity B). But under the new version, Entity C is blocked because Entities A and B, which are blocked, together own 50% of its equity.

As a practical matter, the recent revision to the 50% Rule increases the burden on US companies and their foreign subsidiaries (including private equity funds and their

portfolio companies), as well as US directors or officers of a foreign company, when transacting with or investing in any company that presents a risk of being indirectly owned by sanctioned individuals or entities. The new aggregation requirement means that due diligence efforts cannot merely look for large ownership interests by one individual or entity. Rather, each ownership interest in a company must now be carefully analyzed to ensure that interests owned directly or indirectly by sanctioned persons are identified and aggregated.

The FAQs confirm that the 50% Rule continues to be an ownership test, not a control test. In other words, an entity that is controlled, but not owned 50% or more, by one or more blocked persons is not itself automatically blocked. OFAC has cautioned, however, that an entity controlled by blocked persons, even if not currently blocked, may be a potential candidate for future addition to the SDN List. In addition, independently of the 50% Rule, some OFAC sanctions programs (such as the Cuba, Iran and Sudan sanctions) impose blocking based on control as well as ownership in some circumstances.

If blocked persons reduce their aggregate ownership in an entity to below 50%, then that entity is no longer blocked under the 50% Rule. However, OFAC's FAQs explain that any property of the entity that was previously blocked in the United States or in the possession or control of a US person cannot be released until OFAC unblocks the property or removes the relevant persons from the SDN List.

APPLICATION OF 50% RULE TO SSI LIST

The revised guidance also expands the 50% Rule to apply to entities on the Sectoral Sanctions Identification (SSI) List as well as to blocked persons. Thus, entities owned 50% or more in the aggregate by entities on the SSI list, though not blocked, are subject to the same restrictions as the listed entities themselves. The sectoral sanctions, unlike blocking sanctions, do not prohibit all transactions with the listed entities or freeze their property but only prohibit dealings in the entities' newly issued equity or debt having a maturity over 90 days.

BLOCKED PERSONS ACTING IN A REPRESENTATIVE CAPACITY

In the course of explaining the revised 50% Rule, OFAC's FAQs also offer new guidance about dealing with blocked persons who are not acting for their own account. Although the 50% Rule is based on ownership and not control, the FAQs make clear that US persons may not transact business with a blocked person even if that blocked person is acting on behalf of a non-blocked entity.

This means, for example, that if an officer or director of a non-sanctioned company is a blocked person, a US person cannot enter into a contract with the company that is signed by the blocked individual on behalf of the company. In addition, US persons may need to avoid negotiating with the blocked individual, as agreements reached in the course of the negotiations could be regarded as transactions or dealings with the blocked individual.

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Please do not hesitate to contact us with any questions.

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