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United States Sanctions: General Considerations for Minority Investment

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This Stay Current provides a general overview of considerations and parameters for US minority investment in non-US entities with activities in US sanctioned countries. Permissible minority investment in foreign entities with business in US sanctioned countries is extremely fact specific, and we strongly advise individual evaluation of any such proposed investment.

In general, the regulations do not provide clear rules for permissible and impermissible investment. As a baseline, US law generally prohibits US persons from engaging in a wide range of activities in sanctioned countries or with blocked persons. This prohibition would extend to US person possession of a controlling interest in foreign entities that engage in those prohibited activities. Thus, where US persons invest in a foreign entity ("Foreign Entity") that engages in activities that would be prohibited to a US person, the law generally looks to a variety of factors to determine whether a permissible passive minority investment exists or whether the investment creates a control situation in the Foreign Entity, which is strictly prohibited. In addition to looking for indices of control, which would suggest a prohibited transaction, the law also looks to a variety of factors to determine facilitation, which would also indicate a prohibited transaction. US law prohibits "facilitation" by a US person of an act by a non-US person in sanctioned countries transactions that, if committed by a US person, would itself be a violation. Facilitation findings are complicated and very fact specific. They can be found more clearly where funds or policies are specifically set for sanctioned countries, and found in more murky situations where funds from a general investment are ultimately used for transactions in sanctioned countries.

The factors considered generally focus on the amount of control exercisable by the US person and whether the US person or its investment may facilitate prohibited transactions with the sanctioned countries. These factors include the percentage of ownership of the US entity in the Foreign Entity, the amount or significance of the activities with the sanctioned countries to the Foreign Entity (e.g., primary sales to France with minimal sales to sanctioned countries versus a business devoted to servicing Sudan), the existence and extent of participation in the Foreign Entity's governance (e.g., through grant of one or more board seats or executive positions), the kinds of transactions approved by the board, the board's structure and effect of the US entity's director's presence or abstention on voting or quorums, and the sensitivity of activities in the sanctioned countries (e.g., paper products sales versus weapons sales).

Please also note that even where minority investment is permissible, it is not without risk. Minority investment exposes the US entity to reputational risk as well as legal risk, including government

investigations and legal costs. If, for some reason, the Foreign Entity's activities and the US company's involvement were to attract the scrutiny of the U.S. government, the US company could encounter reputational, legal, public relations and other expenses likely to be associated with a government inquiry. Additionally, minority investment exposes the US entity to business and financial investment risk. For example, if a US company invests in an entity that is partially owned by a blocked person, there is risk that the US government could seize assets of the entity or take other action that would harm the US company's economic interest. For instance if a US company invests in the Bank of Serbia, and a blocked person is a significant shareholder in that bank, the US government might attempt to seize or block or otherwise impair the assets or activities of that bank, which might in turn have an effect on the US company's investment, even though the US company had done nothing itself in violation of the sanctions. For this reason, the importance of knowing the principals of the foreign entities (especially privately held companies, which have fewer "owners") in which the US company invests cannot be overstated. As noted above, minority investment transactions can be quite complicated and each individual proposed transaction should be separately analyzed.

I. General Overview of US Sanctions

Of the various countries subject to US sanctions, only Cuba, Iran, Sudan and Syria are subject to comprehensive sanctions. The other destinations are subject to more limited measures – for example, North Korea is subject to a ban on imports to the US of North Korean items and to restrictions on exports of US items to North Korea, and Burma is subject to prohibition on certain forms of investment activity and provision of financial services.

Moreover, subject to only three exceptions (the Cuba embargo, the North Korean restrictions and the Iran Sanctions Act), these prohibitions apply to US persons, typically defined to mean "any United States citizen, permanent resident alien, entity organized under the laws of the United States (including foreign branches), or any person in the United States." A corporation or similar entity organized under the laws of another country and located outside of the United States is not subject to these prohibitions. (Certain of the restrictions also apply to US-origin items or items that are manufactured abroad but incorporate US-origin technology or are manufactured in US-origin plants, but a discussion of those restrictions lies outside the scope of this memorandum.)

The Cuba and certain of the North Korean restrictions apply to foreign subsidiaries or other persons that are owned or controlled by US persons. Congress is considering legislation that would expand the scope of the Iran sanctions in ways that also might capture non-U.S. subsidiaries in certain circumstances, but at present, except for the Iran Sanctions Act, that is not the case.

The Iran Sanctions Act (or "ISA"), first enacted as the Iran-Libya Sanctions Act in 1996 and then extended with some modifications for another five years in 2001 and again in 2006, requires the President to impose sanctions on any non-US entity (even if not a subsidiary of a US entity) that, "with actual knowledge," makes "an investment of [\$20,000,000] or more [in a twelve-month period] . . . that directly and significantly contributed to the enhancement of Iran's ability to develop petroleum resources of Iran." ISA, § 5(a). "Petroleum" is defined to include natural gas. Id. at § 14(15).

In addition to country-specific sanctions, the US government maintains several lists of persons with whom various types of transactions are prohibited. Those lists include, most prominently, the Specially Designated Nationals and Blocked Persons list ("the SDN list"), maintained by the Treasury Department's Office of Foreign Assets Control ("OFAC"). As a convenience, OFAC includes on the list

persons and entities identified on several other, similar lists of terror organizations and other restricted persons. All financial transactions with anyone on the SDN list are prohibited, but, again, as is true of most US sanctions, the prohibition applies only to US persons. This prohibition extends to US persons that invest in companies where blocked persons hold significant enough ownership interest to deem the company a blocked entity.

II. General Parameters for US Company Minority Investment (with or without Minority Board Representation) in Foreign Companies that Do Business in Sanctioned Countries

The relevant prohibition in the various sanctions regulations is “facilitation” by a US person of an act by a non-US person that, if committed by a US person, would itself be a violation. Although the individual sanctions regimes vary in their particulars, all include this concept in some form.

US law would prohibit a US company from taking a controlling or majority position in any foreign entity that engages in business with the sanctioned countries that would be prohibited for a US person to undertake.

US law also might prohibit a minority investment in a Foreign Entity whose primary activities involve business dealings that would be prohibited to a US entity. For example, acquisition of a minority interest in a Foreign Entity whose activities predominantly involve trade with Iran (which would be prohibited to a US company) likely would be viewed as facilitation of those prohibited activities by the minority investor. “Predominant” in this context is commonly understood to mean 50 percent or more, but the term is deliberately undefined in the regulations. However, even a smaller percentage - if significant to the Foreign Entity’s business - may create a potential problem. Some US companies impose more stringent internal standards - we have seen ceilings that prohibit investment in foreign companies whose involvement with sanctioned countries exceeds 5 percent of total revenues in some internal corporate policies.

- First, the US investor should ensure - through contractual representations and reasonable diligence - that the funds invested are not used, directly or indirectly, to support business with sanctioned countries that would be prohibited if the Foreign Entity were a US person (“Sanctioned activities”).
- Second, to the extent the US investor gains the right to a degree of participation in the Foreign Entity’s governance, oversight or operations, it must ensure that it takes no action, directly or indirectly, that facilitates the Sanctioned activities. Thus, for example, if it acquires “veto” rights or the ability to block the Sanctioned activities, it generally must do so. Similarly, if it obtains a director nominee, it must carefully consider whether and how that nominee’s actions might be viewed as facilitating that Sanctioned activity. At times, the nominee director might be called upon to vote “no” in connection with certain activity due to sanctions concerns, while at other times the right course of action might be to recuse himself or herself entirely from board discussion. In some circumstances, simply showing up to a board meeting might present a difficulty, if his or her absence could deny the board the necessary quorum by which it could vote to approve a Sanctioned activity.

As the above examples illustrate, the concerns attendant to minority investment in a Foreign Entity with Sanctioned activities will vary, based on the specific circumstances of the investment and of the Foreign Entity’s activities. Additionally, the US company must be careful not to run afoul of the

prohibition in the Iran regulations on altering the company's policies or procedures to avoid violation. Such an alteration of company policy could also be generally regarded as evasion under the other sanctions regulations as well. Although here, technically, it might be the Foreign Entity procedures at issue - when the nominee director is recused, etc. - if at instance of the US company, it could be viewed as evasion nonetheless.

While the above pertains to the risk of direct liability imposed upon the US company, the US government could also take action adverse to the Foreign Entity that would have an economic impact on the US company. For example, if the Foreign Entity were engaged in activity that the US found to be sufficiently harmful to its interests, it might place the Foreign Entity on a prohibited list.

This would make unlawful any financial transaction by a US person with the foreign company, resulting in a freeze on or seizure of the US company's shareholding interest. Depending on the circumstances, the US company might have to withdraw its nominated director and would be unable to exercise, transfer or derive any benefit from its ownership interest in the foreign company (e.g., no dividends or profits). A listing likely also would result in seizure of any foreign company assets if within US reach, an inability of the foreign company to engage in transactions with US persons or through US financial institutions and denial of US export privileges (i.e., a prohibition on any US party exporting to the foreign company).

The government could find the Foreign Entity to be deemed a blocked party by virtue of ownership by persons identified on the SDN list. (The government would consider the Foreign Entity to be a blocked party regardless of its listing on the SDN if persons identified on the SDN held ownership in the Foreign Entity in excess of 50%.) However, the government has found Foreign Entities to be blocked where only minority ownership by blocked persons was at issue. For example, the U.S. recently added Future Bank, a joint venture between Bank Mellī and Bank Sedarat and a private bank based in Bahrain, to the SDN list based upon the minority ownership of blocked entities in Future Bank. Although Bank Mellī and Bank Sedarat (both blocked entities) each owned no more than 33.33 percent of the shares of Future Bank, the OFAC pointed to the fact that Bank Mellī and Future Bank publicly identified the same individual as the chairman of both businesses. Although their respective 33 percent holdings kept them beneath the 50 percent or greater interest threshold OFAC recently identified as the threshold it would use to designate third party entities owned by blocked persons as blocked, OFAC pointed to the common control of Bank Mellī and Future Bank as a partial justification for Future Bank's listing.

The government could place individual officers or directors of the Foreign Entity on a prohibited list. This might raise difficult issues for the US company and its nominee, depending on the nature of their interactions with the listed individuals.

Depending on the circumstances, the government could impose other sanctions against the Foreign Entity - for example, under the Iran Sanctions Act if the Foreign Entity is engaged in investment in Iran's petroleum sector that exceeds that act's thresholds. The act allows the President to directly sanction the Foreign Entity. Aside from that act, and depending on the nature of the Foreign Entity's activities, the US conceivably could impose other penalties against the Foreign Entity that might impact its value to the US company, such as fines (possible, but highly unlikely), increased scrutiny of US-regulated transactions with the Foreign Entity (such as exports or financial transactions involving US banks or correspondent accounts) and the like.

Finally, the government could apply pressure on the US company to attempt to influence the Foreign Entity's actions or to withdraw its investment in the Foreign Entity. Assuming the US company itself had not violated any regulations, this pressure would not take the form of fines or legal sanctions, but nonetheless might cause the US company to expend substantial legal expense and suffer reputational or other harms with regulators, Congress or the public.

III. Sample Checklist of General Considerations

The following is a non-exhaustive list of items that should be considered when evaluating investment opportunities in Foreign Entities that participate in Sanctioned activities:

- ✓ The extent of activities in sanctioned countries;
- ✓ The nature of those activities;
- ✓ The ownership interest in the Foreign Entity by any blocked person (including cumulative ownership by several blocked persons);
- ✓ The nature of the investment and the degree of control or participation in the governance of the Foreign Entity to be acquired;
- ✓ The ability of the US company to veto or stop Sanctioned activities (if such a veto power exists, the US company generally must exercise this veto power to stop Sanctioned activities);
- ✓ The opportunity of the US company to have board representation (board representation raises issues regarding director participation in board deliberations, recusal, etc., that need to be addressed on a case-by-case basis);
- ✓ The assessment of risk of potential economic impacts from US government action against the Foreign Entity based on its activities; and
- ✓ The reputational risks associated with investment.



If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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