CLYDE&CO

Trading update

Iranian sanctions and OFAC sanctions-compliance clauses in trading and shipping contracts

June 2010

Recent developments

On 9 June 2010 the UN Security Council extended the scope of its existing arms embargo and restrictions on financial and shipping companies related to proliferation sensitive activities by extending the assets freeze to 40 additional Iranian companies and organisations. Fifteen are linked to the Iranian Revolutionary Guard and 22 are involved in nuclear or ballistic missile activities.

The EU is also considering imposing additional sanctions against Iran. These sanctions will go beyond those adopted by the UN Security Council resolution. They are aimed at key sectors of the oil and gas industry with a prohibition on new investment, technical assistance, technology transfer, equipment and services. The new rules will also impose further trade restrictions on insurance, additional Iranian banks and the Iranian transport sector including shipping and air cargo. The technical details of the new EU measures will not be settled until July.

The UN Security Council resolution calls for the need to exercise vigilance over transactions involving Iran or Iranian banks and companies can expect to see an increased use of sanctions-compliance clauses. Typically a compliance clause will be aimed at the range of existing sanctions. As the US has a number of sanctions programmes in place including those for Cuba, Iraq, Syria, Sudan and most recently Somalia, there are a number of targeted countries where trading and shipping companies may encounter difficulty.

Use of sanctions-compliance clauses

The use of "OFAC" clauses in trading agreements and charterparties has been spreading. Typically such clauses set out representations about compliance with financial sanctions regulations administered by the US Office of Foreign Assets Control (OFAC), and in some cases with financial sanctions imposed by other countries. The compliance clauses may include a right for either or both parties to withhold performance if a vessel chartered in connection with a transaction is blacklisted, its owner or charterer is a "specially designated national" ("SDN") or if performing the contract could otherwise lead to one of the parties breaching sanctions. This can be coupled with an indemnity to make the clause more effective. This update focuses on the US sanctions regime and clauses used in response to the compliance risk it poses. The OFAC sanctions programmes operate under a strict liability regime and can directly impact on companies that do not have any direct connection to the US. There are a number of reasons for this.

First of all, US companies involved in international trade use OFAC clauses to comply with US law and will also impose them on their counterparties, even if the regulations do not directly apply to the counterparty. This is because the OFAC regulations prohibit "US persons" from "facilitating" any transactions that would violate US sanctions if carried out by a US person. Secondly, OFAC has targeted foreign banks and financial service providers including insurers that are involved in processing transactions in dollars through the US financial system and claimed jurisdiction over them. In 2009 Lloyds TSB Bank plc was fined for action it had taken outside the US to delete references to US sanctioned parties in wire transfer instructions routed through US based banks. The US Department of Justice intervened on the grounds that the relevant US dollar transactions would have been prohibited if they had been conducted in the US and there was a US nexus as the dollars had to pass through Lloyds TSB's US correspondent banks. As a result many European and non-US banks have refused to issue letters of credit for Iranian related trades for fear that the funds may be blocked. Sellers of Iranian commodities risk having payment by their buyers blocked, a refusal by the vessel's master to release bills of lading, cargo delays and a refusal of insurers to pay out on claims.

Application and enforcement of OFAC sanctions programmes

As the US authorities tend to take a very expansionist approach to jurisdiction over alleged sanctions breaches, clauses on US sanctions can be very wide-ranging. US sanctions apply to US citizens wherever they are based, any company located in the US, the worldwide operations of entities organized under US law and in some cases companies owned or controlled by US shareholders. Companies with relatively weak links to the US may find themselves subject to US sanctions regulations.

The current US sanctions rules are very complex and in the case of Iranian sanctions include broad restrictions on trade and financial and other dealings with entities within Iran. Transhipment is also prohibited. Where US origin goods such as aeroplanes are exported to a country that is not affected by US sanctions and are then re-exported to Iran, even if the re-exporter is not a US entity this also violates OFAC regulations. The EU sanctions programme is currently more limited and restricts dealings with governmental entities within Iran and named Iranian companies and individuals. For example, the EU has prohibited dealings with some Iranian banks, the state owned Islamic Republic of Iran Shipping Lines and its vessels.

A breach of US sanctions may lead to considerable financial penalties and in a criminal case to imprisonment. For example, Lloyds TSB agreed a $217 million settlement with OFAC. As part of the enforcement process OFAC may also freeze any payments made in US dollars that relate to a cargo or vessel associated with a sanctioned party and US financial institutions are required to reject fund transfers referencing blocked vessels or cargoes. We also understand that the port authorities in certain countries are adopting a practice of checking the sanctioned persons list and will not accept blacklisted vessels or vessels owned by listed persons. As a result there is pressure on companies where trades are in US dollars to ensure that they are not dealing with SDNs or otherwise breaching US sanctions at any point in their supply or shipping chain.

Tackling the OFAC risk by introducing OFAC clauses

Many companies – both those subject to US sanctions and some that are not - are including OFAC compliance clauses in their contracts in the hope of reducing their compliance risk.

This may allow a US company to run a defence to any allegation that it did not know its counterparty was breaching US sanctions. As US sanctions against Iran prohibit direct and indirect imports and exports and any other dealings with entities within Iran, US companies that are subject to these rules have to check their supply chains in both directions to ensure compliance. They will want to pass the compliance risk up and down the chain and so require their counterparties and service providers to warrant that they are complying with US sanctions rules.

Provisions to avoid

The broad scope of a typical US sanctions clause presents difficulties for many non-US companies who will not have the necessary compliance systems in place to ensure they can comply. These companies should try and avoid the following provisions:

- Representations, warranties and undertakings that they comply and will continue to comply with OFAC sanctions. If a company accepts a clause like this, it will have to ensure that it understands the complex US sanction rules which would otherwise not apply to it. It could also be liable for additional costs. For example, if a blacklisted vessel is provided for a FOB trade and is rejected by the seller, the buyer will need to provide a substitute vessel and could also incur additional storage costs.

- Indemnities for breaching an OFAC compliance clause.

- Obligations to inform the counterparty of any potential breach of sanctions. Accepting a clause of this kind could lead to a significant compliance burden.

What to agree to

In practice it can be difficult where a US entity needs to ensure that it has a wide-ranging OFAC sanctions compliance clause and is dealing with a non-US regulated company.

Here the approach taken by Global Coal's© Standard Coal Trading Agreement (SCoTA) for coal supply contracts can be used as a benchmark for the compromise position. This allows parties to reject nomination of a vessel if the vessel is owned, chartered, operated or controlled by anyone on the SDN List, is itself blacklisted or flagged by a country subject to US sanctions laws or would otherwise put the party in breach of US sanctions. Importantly the SCoTA provisions are defensive in nature and do not include any representations or warranties about general compliance with US sanctions or give any indemnities for breach of sanctions. The requirement to monitor is placed on the party wishing to reject the vessel although it will, of course, always be in the interest of anyone nominating the vessel to conduct compliance checks on its vessels to avoid the risk of a last minute rejection.

Non-US companies should consider ensuring that OFAC sanctions compliance clauses are not one way and, where they accept them, they pass on the risk to those in their own supply chain.

Finally, it is in the nature of sanctions regulations to change rapidly in response to political developments and so it is important to have a watching brief to monitor the position.

Further information

If you would like further information please contact:

Clare Hatcher
Tel: +44 (0) 20 7648 1881
clare.hatcher@clydeco.com

Ben Knowles
Tel: +44 (0) 20 7648 1974
ben.knowles@clydeco.com

John Woods
Tel: +1 212 710 3915
john.woods@clydeco.us

Mary Mulhearn
Tel: +1 212 710 3906
mary.mulhearn@clydeco.us