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Iran Sanctions: What's Old Is New Again

By [Danforth Newcomb] and [Christina Lee]

The lifting of sanctions on Iran in January has wound the clock back in time. The international Iran sanctions program has returned to an era where U.S. and EU sanctions are no longer aligned with one another. Now, companies looking to do business in Iran will have to face similar issues of the past era of sanctions that changes in 2012 sought to address.

Companies had a hard time navigating sanctions before 2012. For a long time, the United States alone had broad sanctions prohibiting U.S. companies and individuals from doing business in Iran (called "primary sanctions"). These sanctions were not particularly effective, because Iran simply looked to other countries for business opportunities. From 1996 through 2010, the United States developed "secondary sanctions," which were designed to dissuade non-U.S. companies from doing business with Iran. The secondary sanctions subjected non-U.S. companies to penalties or restrictions in the United States for doing business with Iran. The secondary sanctions had minimal impact. Businesses in Iran continued to find loopholes to pursue other options, because EU sanctions did not place similar restrictions on European companies. However, multinational companies found it hard to operate in multiple countries because of these conflicting sanctions rules.

The United States then worked with the European Union to reduce these problems by coordinating sanctions against Iran for its proliferation activity. In 2012, the United States and the European Union coordinated new sanctions that prevented European companies from doing most business in Iran, particularly in petroleum and financial sectors. Shortly thereafter, Iran's crude oil output dropped precipitously after the implementation of these coordinated sanctions, significantly impacting the oil-reliant nation.

The negative impact of the EU and U.S. coordinated sanctions on Iran's economy eventually led Iran to negotiate and agree to non-proliferation commitments in exchange for lifting of many sanctions. Under the agreement, the European Union promised to lift most of its sanctions prohibiting European companies from doing business with Iran. In a related move, the United States agreed to lift secondary sanctions that prohibited non-U.S. companies from doing business with Iran.

These two moves have returned us to the old world of Iran sanctions where the U.S. and EU sanctions are not aligned with one another. Multinational companies in particular once again are struggling to comply with conflicting sanctions programs. Until these issues are resolved, multinational companies that look to do business with Iran will continue to find themselves mired in the intricacies of international sanctions on Iran. In an era of aggressive enforcement, these challenges translate into high compliance costs or risking potential fines for companies looking to do business in Iran.

Foreign Subsidiaries of U.S. Companies Face Practical Difficulties in Doing Business in Iran

An example of the problems that companies face is the challenge of a foreign subsidiary of a U.S. company doing business in Iran. OFAC, the U.S. agency that enforces sanctions, has attempted to address the lack of alignment through a new general license, called [General License H], for foreign subsidiaries of U.S. companies. The general license permits non-U.S. subsidiaries (but not branches) of a U.S. parent company to engage in transactions with Iran. General License H, in theory, allows non-U.S. subsidiaries to engage in the same activity as non-U.S. companies in line with EU sanctions. In doing so, General License H tries to provide a middle ground through a limited exception so that U.S. parent companies can modify its corporate policies and practices to allow the foreign subsidiary to do business with Iran. The general license narrowly allows the U.S. parent to provide automated, globally integrated services such as email to the foreign subsidiary that does business with Iran.

However, this license is largely a mirage. Multinational companies will have difficulty complying with the narrow exceptions provided by the general license without the U.S. parent company facilitating a business deal with Iran. U.S. primary sanctions continue to prohibit U.S. companies from facilitating any dealing with Iran. The language of General License H is clear that U.S. parent companies may not "facilitate," or assist, the foreign subsidiary's dealings with Iran other than the exceptions provided in the license. Companies can engage in facilitation by providing any service or approval short of purely clerical support. In 2015, U.S. regulators fined the multinational oil services company Schlumberger over $230 million for facilitating business with Iran and Sudan. Even though Schlumberger is not a U.S. company, employees based in the United States had approved capital expenditures and provided technical services to overseas divisions that did business in Iran and Sudan. In light of this broadly interpreted prohibition, a U.S. parent company and any U.S. employee, including U.S. directors and officers, cannot be involved in the day to day activities of the foreign subsidiary's business with Iran. American globally integrated companies in practice will have difficulty in walking this very thin line provided for foreign subsidiaries.

Lack of Alignment in Financial Sector Sanctions Limits Business Opportunities in Iran

The lack of alignment in the U.S. and EU financial sector sanctions also creates problems for non-U.S. companies that do business in Iran. While European financial institutions are no longer prohibited from providing services to Iran, U.S. financial institutions continue to be prohibited from doing so. As a result, European companies looking to do business deals with Iranian counterparties or in Iran are unable to access to the U.S. financial system. They continue to be unable to obtain loans from or receive financial services from the U.S. financial institutions. In particular, the ongoing prohibition on U.S. dollar clearing of transactions continues to be a major obstacle. OFAC has clearly stated in guidance that "the clearing of transactions involving Iran through the U.S. financial system, including foreign branches of U.S. financial institutions continue to be prohibited." In other words, companies with U.S. bank accounts cannot send or receive funds that are connected to Iranian business. Any business involving the U.S. financial system—and by extension any U.S. company barring a few exceptions—and Iran will continue to be off limits.

This continued prohibition on U.S. dollar clearing significantly limits options to do business with Iran, even for foreign companies not otherwise connected to the United States. For example, the United States and European Union lifted sanctions that had previously restricted foreign trade of Iranian petroleum. Despite the removal of these sanctions, the petroleum industry continues to be largely traded in dollars. Any petroleum-related transaction in U.S. dollars will clear in U.S. financial institutions—something that a U.S. financial institution will be prohibited from doing because the transaction involves Iran. Without the option of conducting a transaction in U.S. dollars, European companies will have to weigh the convenience of doing business with the dollar and the U.S. markets or the costs of switching to another currency to do business with Iran.

Companies Will Struggle to Avoid Prohibited Counterparties under U.S. Sanctions Rules

Companies face another challenge of identifying prohibited individuals and entities as a result of the conflicting sanctions rules. The European Union and the United States both maintain a "black list" of prohibited individuals and entities under Iran sanctions. When the U.S. and EU sanctions were aligned, U.S. and European companies generally could not do business with the set of individuals and entities. On Implementation Day, the European Union and U.S. removed a number of individuals and entities from these lists. European companies can now deal do business with these removed individuals and entities under the EU sanctions. The U.S. list, on the other hand, has become fragmented and difficult to decipher. When the U.S. and EU sanctions were aligned, U.S. and non-U.S. companies could not deal with the same individuals and entities under the U.S. black list, known as the Specially Designated Nationals (SDN) List.

Things are no longer that simple. On Implementation Day, OFAC removed a number of Iranian entities and individuals from the SDN List. Now, non-U.S. companies can do business with those entities and individuals removed from the SDN List. However, U.S. companies and individuals are prohibited from dealing with entities owned or controlled by the Iranian government or certain Iranian financial institutions as a part of the ongoing U.S. primary sanctions on Iran. Other nuances of the SDN List further complicate the identification of these prohibited individuals and entities. Not all SDNs under the Iran program were removed on Implementation Day. Bank Saderat, a major Iranian bank, continues to be listed as a SDN. Under continuing U.S. sanctions, U.S. and non-U.S. companies continue to be prohibited from dealing with Bank Saderat. Additionally, companies still face restrictions on doing business with Iranian individuals and entities—even if they are removed from the SDN List—because of continuing U.S. sanctions on Iran's weapons program and human rights violations.

In addition to these changes, companies have to make sure that they do not do business with any entities majority owned by one or more prohibited entity. In February 2016, Barclays was fined $2.5 million for processing payments for customers not on the SDN List but were 50 percent or more owned by someone on the SDN List. As a result, U.S. and non-U.S. companies alike will have to conduct even more careful due diligence to ensure that they are not dealing with prohibited counterparties.

Companies Face Challenges and Uncertainties from Disconnect between EU Sanctions and U.S. State Sanctions

The differences in EU and U.S. sanctions create problems for foreign companies looking to do business in Iran and in the United States. Half of U.S. states have restrictions on companies that do business in Iran. These sanctions are not affected by the Iran nuclear deal, which only removed federal sanctions. Several U.S. states, such as New York and Pennsylvania, continue to require state pension funds to divest funds from companies doing business in Iran. Other states, such as California, also have ongoing procurement practices that bar companies that do business in Iran from entering into contracts with state or local governments. Because of these restrictions, foreign companies will have to weigh opportunities in Iran with restrictions that U.S. states still impose. For some companies, these prohibitions alone may be enough to reconsider entering the Iran market. In 2011, the state of California pressured the Swiss engineering firm, ABB, to cut off business in the oil and gas sector business in Iran before the EU had imposed broad sanctions on Iran. Now, numerous other non-U.S. companies with connections to state pensions and same governments face the same dilemma.

It is also unclear whether states will respond to the lifting of sanctions by amending or passing new state sanctions on Iran. After the Iran deal was announced, state officials of Oklahoma and Michigan wrote a letter attached with draft legislation to their counterparts encouraging new state sanctions on Iran. However, new legislation will have to be reconciled with the United States federal government's commitment under the Iran deal to "actively encourage officials at the state or local level to take into account the changes in the U.S. policy reflected in the lifting of sanctions under th[e] JCPOA and to refrain from actions inconsistent with this change in policy." It remains unclear what specific steps the U.S. government would take if state legislation is in conflict with an international sanctions regime that allows non-U.S. companies to do business in Iran.

Renewed Questions on Sanctions Relating to International Trade with Iran

The lack of alignment between U.S. and EU sanctions programs also brings focus back to sanctions provisions that were not in play when sanctions programs were in coordination with one another. In particular, the U.S. restriction on the importation of Iranian products from European countries will play a key role in how strictly the U.S. comprehensive embargo will be enforced. Under U.S. sanctions regulations, a product originating in Iran must be "substantially transformed" in a third country, such as a European country, in order to be imported into the United States. In the past, companies involved in international trade struggled with the extent to which an Iranian product must be changed in a European country before entering the United States to be considered a "substantially transformed" product under the sanctions. The same requirement that Iranian origin products be substantially transformed before being imported into the United States will likely play a key role again as European companies begin to import Iranian crude oil and other Iranian products once again. The interpretation of these restrictions will indicate whether or not the continuing U.S. prohibitions on dealing with Iran will enjoy any degree of flexibility in light of renewed business between Europe and Iran.

Compliance Burden for Companies Navigating U.S. and EU Sanctions

Multinational companies face an extremely high compliance burden to do business with Iran, while ensuring that they do not run afoul continuing U.S. sanctions in light of the most aggressive sanctions enforcement environment in history. In recent years, multinational companies and financial institutions have faced record-setting penalties for doing business with Iran. In 2014, U.S. sanctions regulators imposed penalties totaling $8.9 billion on the French bank BNP Paribas for removing or altering information identifying prohibited transactions from U.S. financial institutions. The BNP Paribas fine remains the largest fine to date, but Commerzbank, Lloyds Bank, HSBC, and ING Bank have been fined for similar conduct. In 2015, as mentioned above, Schlumberger was fined over $230 million for facilitating business in Iran and Sudan. And the rigorous enforcement shows no signs of stopping. In 2015, U.S. authorities reopened an investigation into Standard Chartered for continued sanctions violations after multiple rounds of fines totaling almost $1 billion to date. Banks have responded by overhauling or implementing new compliance measures. In February 2016, Standard Chartered disclosed in its 2015 annual report that it has spent over $1 billion improving compliance infrastructure after facing multiple fines for sanctions violations.

While not every business will have the same risks or resources as Standard Chartered, compliance programs now require more resources and sophistication to navigate the differences between the EU and U.S. sanctions programs. Multinational companies looking to do business with Iran will have to establish more robust due diligence practices that capture the subtleties of the SDN List changes. Compliance programs will also have to delineate the ongoing U.S. sanctions imposed on Iran for its human rights violations, ballistics program, and destabilization activity from the EU and U.S. sanctions that have been lifted. Compliance programs must also take into account the possibility that sanctions could be reimposed or "snapped back" in the event that Iran has not fulfilled its obligations. OFAC has indicated that any contracts that are entered into after Implementation Day will not be "grandfathered" in the event sanctions against Iran are reinstated. Because of this risk, OFAC has suggested that parties doing business with Iran include a termination clause in contracts in anticipation of potential "snap back."

Conclusion

As the dust continues to settle, the lack of alignment between U.S. and EU sanctions will only raise more and more questions. Moreover, because companies will spend considerable time and resources attempting to navigate the gray areas and conflicts between these two sets of rules, the cost and confusion will inevitably raise the question of whether the current sanctions regime is sustainable. While future changes to sanctions may be on the horizon in light of upcoming U.S. presidential elections, companies for now will have to accept that Iran sanctions have returned to the old world order.

Danforth Newcomb is of counsel at Shearman & Sterling LLP and advises financial institutions and multinational companies on U.S. sanctions. Christina Lee is a former associate of Shearman & Sterling LLP and currently is an associate at Morvillo Abramowitz Iason Grand & Anello P.C.