BUSINESS UPDATE | MAY 2, 2019

OFAC Clarifies: Russia-Ukraine Sectoral Sanctions Prohibitions on "Debt" Apply to Credit Sale and Licensing Transactions

On April 25, 2019, the Office of Foreign Assets Control (**OFAC**) published information indicating that New Jersey corporation Haverly Systems, Inc. ("**Haverly**") paid $75,375 "to settle two apparent violations" of the Ukraine-Related Sanctions Regulations (**URSR**) and OFAC Directive 2, a sectoral sanctions implementing measure that, pursuant to Executive Order 13662 of March 20, 2014, restricts certain transactions with sanctioned parties involved in Russia's energy sector.

Haverly apparently violated sectoral sanctions by transacting or otherwise dealing "in new debt of greater than 90 days maturity of JSC Rosneft ("**Rosneft**")," an entity that was added to the Sectoral Sanctions Identification List (the "**SSIL**") on July 16, 2014.

The Haverly case is instructive as it clarifies OFAC's position, with respect to Haverly and likely more broadly, as to the meaning of "debt" under Directive 2, which prohibits, by U.S. persons and within the United States, dealings in "new debt" issued by parties that are listed on the OFAC-maintained Sectoral Sanctions Identifications List (**SSIL**) or not so listed but are owned 50% or more by one or more sanctioned parties.

Specifically, OFAC Directive 2 prohibits "all transactions in, provision of financing for, and other dealings in new debt" of sanctioned parties where such debt is either:

(1) "**new**" because it was issued on or after July 16, 2014 and before November 28, 2017 **and prohibited** because it is "of longer than 90 days maturity," or,

(2) "**new**" because it was issued on or after November 28, 2017 **and prohibited** because it is "of longer than 60 days maturity."

In finding that Haverly apparently violated Directive 2, OFAC made clear that that Directive 2's debt prohibitions apply not only to transactions that, at their inception, are "debt" in substance or form, but also to licensing and sale of goods and services transactions that create indebtedness on the part of sanctioned parties.

The operative Haverly facts are as follows (the explanatory notes are MassPoint's):

- Haverly licensed software and sold software support services support to Rosneft on deferred payment terms and issued two separate invoices for the same on August 19, 2015.
- Payments were "originally" due between 30 and 70 days. However, after roughly 70 days had passed, Rosneft had not paid the invoices and requested "corrected tax documentation." Haverly obtained the corrected documentation after several months.
- Haverly received payment on the first invoice on May 31, 2016.
- Rosneft attempted four times to pay the second invoice between May 31, 2016 and October 27, 2016. Each payment "was rejected by financial institutions after determining that the

transaction was prohibited by OFAC's regulations as debt of greater than 90 days maturity of an [SSIL] entity subject to Directive 2."

- Haverly received from Rosneft information about the rejected payment attempts, including copies of SWIFT messages, "some of which contained information and instructions stating that the underlying activity may have a nexus to sectoral sanctions."
- "[A]t the time of the payment attempts Haverly did not have a sanctions compliance program ***and did not recognize that the delayed collection of payment was prohibited***. Haverly did not approach OFAC for guidance or authorization, however, and instead explored various options to collect the payment associated with the second invoice from Rosneft" (emphasis added).
- "At the suggestion of Rosneft, Haverly re-issued and re-dated the second invoice. Haverly then successfully received payment on the second invoice from Rosneft on January 11, 2017."

EXPLANATORY NOTES

- Rosneft's debt was "issued" on August 19, 2015, the date the invoices were issued.
- Because Rosneft's debt to Haverly was "issued" or after July 16, 2014 and before November 28, 2017, its maturity period should not have exceeded 90 days; the original payment periods of between 30 and 70 days, had they been observed, would not have violated Directive 2.
- OFAC appears to have regarded the original invoices issuance dates as operative for the purpose of calculating maturity periods under Directive 2.
- Haverly's receipt of SWIFT messages demonstrably put Haverly on notice of potential sanctions violations.

Key Legal and Compliance Takeaways

- The key legal takeaway from the Haverly case is that "debt" within the scope of Directive 2 includes—as to Haverly and likely generally—debt created by licensing transactions and sales of goods and services on credit, and presumably to other transactions that create indebtedness on the part of sanctioned parties.
- It would be prudent to assume (unless and until clarified by OFAC) that OFAC's interpretation of "debt" in the Haverly case applies with respect to two additional OFAC directives that restrict "new debt": OFAC Directive 1 (targeting Russia's financial services sector) and OFAC Directive 3 (targeting Russia's defense and related materiel sector).
- Businesses should not assume that their relevant personnel understand that debt created by trade or other business transactions is within the scope of OFAC sectoral sanctions directives. As OFAC indicated, Haverly "did not recognize that the delayed collection of payment was prohibited" debt. It is highly likely that Haverly's prior lack of awareness is shared by other businesses (and, perhaps, some financial institutions).
- Entities that are owned 50% or more by SSIL entities are subject to sectoral sanctions even if not listed in the SSIL. Due diligence is required to determine if an issuer of "new debt" is sanctioned pursuant to OFAC's "50% rule."
- Where a party obligated to comply with sectoral sanctions issues payment terms, invoices, or other documentation creating or evidencing the debt of a sanctioned party stemming from a credit sale or other transaction, such terms or documentation should conform to the debt restrictions of OFAC Directive 2 (or Directives 1 or 3, if applicable).

- To determine if a transaction is or may become a "debt" transaction for sectoral sanctions compliance purposes, assess the nature of the transaction at inception, as well as its consequences. For example, a sale on open account that becomes a payable for the purchaser and a receivable for the seller should be viewed also as a debt transaction, rather than only a "sale."
- Extending the time for payment, such as by re-issuing invoices, will not, where OFAC's reasoning in Haverly applies, reset the debt "issuance" date and restart the debt maturity calculation period for sectoral sanctions compliance purposes. Moreover, repapering a transaction could be construed by OFAC as a willful or egregious sanctions violation meriting harsher penalties.
- Accounting, sales, and other relevant personnel should be educated on the relevance of their functions to sectoral sanctions compliance.
- Businesses involved in debt or debt-creating transactions that are permissible at the outset but become problematic over time should consider timely seeking OFAC's guidance and/or applying for a specific license from OFAC to transact in debt that has or will foreseeably become prohibited.
- Where a business becomes aware that a transaction has been rejected by one or more financial institutions, prompt action should be taken to ascertain the reason(s) for the rejection(s) and chart compliance steps, such as: creating or amending compliance programs, ensuring that relevant personnel have the information and training needed to act lawfully (and not aggravate matters), voluntary self-disclosure to OFAC, and/or submitting one or more OFAC license applications, as appropriate. (Note that financial institutions are obligated to reject and report to OFAC prohibited transactions (31 C.F.R. § 501.604)).

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