Portfolio Media. Inc. | 860 Broadway, 6th Floor | New York, NY 10003 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Resellers Must Heighten Their Sanctions Due Diligence

Law360, New York (March 30, 2016, 4:29 PM ET) -- As global companies begin to reenter the Iranian market, a decision issued by the U.S. District Court for the District of Columbia is an important reminder that resellers and distributors can generate liability for U.S. exporters if appropriate due diligence is not exercised.


Michael V. Dobson Jr.


Robert Slack


Paul C. Rosenthal

The case involves Epsilon Electronics Inc.'s attempt to vacate a $4 million penalty determination issued by the U.S. Treasury's Office of Foreign Assets Control in 2014 for violations of the Iranian Transactions and Sanctions Regulations (ITSR). The violations involved 41 total sales of audio equipment to a customer in the United Arab Emirates with a value of about $3.4 million. OFAC contended that Epsilon knew or should have known that the customer was reselling its products in Iran and charged five transactions as "egregious" violations, assigning the maximum statutory civil penalty of $250,000 for each of those transactions.

The most interesting aspect of the case for U.S. exporters is that OFAC appears to have offered no direct evidence linking the sales to specific transactions or end users in Iran. Instead, the opinion indicates that OFAC relied primarily on circumstantial evidence gleaned from Epsilon's and the UAE customer's websites to find that Epsilon should have known that the items were destined for Iran. That evidence included statements and images on the customer's website indicating that the customer sold or marketed Epsilon products in Iran and that the customer's exclusive or predominant market was, in fact, Iran. According to OFAC, one of Epsilon's websites also included a photo gallery labeled "Iran," which was removed by Epsilon during the course of the investigation. In addition, OFAC formally warned Epsilon in 2012 that items sold by an affiliated entity in 2008 were exported to Iran in apparent violation of the ITSR. Particularly incriminating was the inclusion of an Iranian address (that matched an address on the UAE customer's website) on the airway bill for the 2008 sale. Despite OFAC's 2012 cautionary letter about the 2008 shipment, Epsilon made five additional sales to its UAE customer.

The district court agreed with OFAC that the circumstantial evidence presented by the agency was sufficient to find that Epsilon had reason to know that the items supplied to the UAE customer were specifically destined for Iran. While there appear to be some particularly bad facts in this case, the decision potentially paves the way for additional due

diligence burdens on sellers that have not been widely recognized before. Generalizing from the opinion, one could conclude that when dealing with a customer that may resell your products (particularly if that customer is in destination at high risk for diversion such as the UAE), an exporter should seek out publicly-available information on whether the customer does business with sanctioned countries. If evidence suggests that the customer does substantial business in sanctioned countries, an exporter should then conduct a risk assessment to determine whether compliance measures, such as obtaining certifications from the customer, would be sufficient to mitigate the exporter's risk under U.S. sanctions laws. Of course, more formalized distribution agreements should contain U.S. sanctions compliance provisions that protect the U.S. exporter.

OFAC and the court also easily rejected Epsilon's defense that its sales complied with the ITSR pursuant to the "inventory exception." The unwritten inventory exception (more commonly referred to as the "general inventory rule") essentially spares a company from liability under U.S. sanctions laws if an overseas customer later transfers its products to a sanctioned country, so long as: (1) the items were not intended for the sanctioned country when originally exported from the U.S. (i.e., they were ordered for the customer's overseas inventory) and (2) the customer does not predominately sell to a sanctioned country (among other standard export control requirements). In reality, the general inventory rule is very limited in scope and, as in the Epsilon case, can be too easily cited to approve activities that are actually prohibited under U.S. sanctions laws. As a result, non-U.S. companies and foreign subsidiaries of U.S. companies that are reentering the Iranian market should be wary of relying on the general inventory rule to structure compliance programs or procedures. In many cases it can lead to confusion and inadvertent violations of the ITSR by U.S. and non-U.S. parties.

As companies businesses in Iran and accompanying exposure to U.S. sanctions laws grow, implementing a solid compliance program with the right level of due diligence applied to intercompany and external sales is critical. As the Epsilon case shows, challenging an OFAC penalty determination in the courts is extremely challenging. Federal agencies are typically afforded a great deal of flexibility under administrative law, and practically have carte blanche when it comes to matters of foreign affairs and national security. It is better to make the upfront investment in a rigorous and tested compliance program than try to fight the agency after the fact.

—By Michael V. Dobson Jr., Robert Slack and Paul C. Rosenthal, Kelley Drye & Warren LLP

Michael Dobson is a senior associate and Robert Slack is an associate in Kelley Drye's Washington, D.C., office.

Paul Rosenthal is a partner in Kelley Drye's Washington office.