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To Russia Without Love: New Sanctions and Their Implications for U.S. Manufacturers and Their Customers

Client Alert

4.11.2022

We all have been watching the events in the Ukraine these past weeks and the response of the United States and NATO allies in the form of various controls and sanctions on businesses located in the U.S. or other certain NATO countries doing business with Russia and their allies in Belarus and newly declared “independent states” in the Donbas region. Just recently, on April 6, 2022, President Biden issued the strongest sanctions yet when, by executive order, he banned all new investment by U.S. persons in Russia. But even these sanctions at the moment continue to permit U.S. persons to engage in some export and import transactions with Russia.

While these actions by the U.S. and our NATO allies are designed to put economic pressure on Russia to withdraw from Ukraine, they have also had an impact on many U.S. companies. For example, many materials that are important to the U.S. automotive industry and are in short supply have historically been imported from Russia. Palladium, nickel, and neon gas, which are all used in automobiles or electronic components used in their manufacture, are among the affected materials.

It is not possible to cover every aspect of these recent events in this client alert and there are new developments almost every day. Our goal is simply to familiarize our clients with the various governmental agencies and programs involved and how to best navigate through them. Some companies that could possibly find some exceptions to do business with Russia are declining to do so for various humanitarian and public relations concerns.

There are several U.S. government agencies that regulate different aspects of Russian sanctions. The Commerce Department, Bureau of Industry and Security (“BIS”), the State Department, Directorate of Defense Trade Controls (“DDTC”) and the Treasury Department, Office of Foreign Assets Control

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CLIENT ALERTS

(OFAC) are the principal U.S. government agencies involved. Products that have military applications are regulated by the State Department (“DDTC”) or dual use items the Commerce Department (“BIS”). All other products and transactions are also typically regulated by the Treasury Department (“OFAC”).

Sanctions issued on April 6, 2022. In response to reports of Russian human rights abuses in Ukraine, President Biden issued a newer, tougher executive order on April 6, 2022. This new executive order prohibits any U.S. persons, wherever located, from entering any new investments in Russia. It also gives OFAC the authority to ban U.S. persons from exporting “any category of services as may be determined by [OFAC], to any person located in the Russian Federation....” While OFAC has not yet banned U.S. persons from selling any services to any person located in Russia, this new authority bears watching.

But it is equally important to point out what the executive order does not do – at least for now. The order does not require any U.S. companies or persons to disgorge any existing investments they currently have in Russia. Future activity relating to those investments will need to be carefully handled to ensure that the investor does not create new investments that would run afoul of the executive order.

The executive order also does not prohibit all imports or purchases from Russia, and OFAC’s authority to ban exports extends only to services, not to goods. Other considerations may counsel in favor of disengaging from these types of transactions, but they are not currently subject to U.S. sanctions. And as explained further below, even the range of transactions that are permissible under this new executive order are still subject to a web of other export and import regulations that individuals and businesses need to consider.

Military or dual use products and services. Defense items designated on the U.S. Munitions List (“USML”) or involving a transfer of technology related to defense articles to a foreign person are covered by the State Department, Directorate of Defense Trade Controls (“DDTC”). If the items are on the USML, the item is under the jurisdiction of the DDTC, and the International Trafficking in Arms Regulations (“ITAR”) would apply. If the item is not described in any of the USML’s 21 categories, you move next to the Commerce Control List (“CCL”) to see if it meets any of the descriptions for “dual use” items there. If it is unclear which agency jurisdiction applies, you can apply for a commodity jurisdiction (“CJ”) determination.

Basically, commercial items, including software and technology, can be “dual use items” if they have both commercial and military uses. When dual use items are exported from the United States, they fall within the jurisdiction of the Commerce Department, Bureau of Industry and Security (“BIS”). This would include so called “deemed exports” when technology is transferred in the U.S. to a foreign national who is also in the U.S.

Once you determine that your product is under BIS jurisdiction, you need to check the CCL. You would need to identify the Export Control Classification Number (“ECCN”) to determine whether the product requires a license. You should also check the “country list” to see what licenses are required for certain countries. There is a “country list” that indicates which products are subject to specific controls in

CLIENT ALERTS

various countries. See Bureau of Industry and Security, Commerce Country Chart

What is new is that the Commerce Department has essentially stated that when a license application is required, applications for such items will be subject to a policy of denial. This is also referred to as a “presumption of denial”. A limited exception applies to export, re-export, or transfer (in-country) of items that ensure safety of flight, maritime safety, meet humanitarian needs, enable government space cooperation.

Many items, including many inexpensive consumer electronics, are listed as EAR99 (Export Administration Regulations). These items can generally be exported to most countries without a license but, with the new sanctions, on Russia they must be scrutinized. First, under the new sanctions, exporters are prohibited from exporting certain EAR99 products on a special list if those products will be used for deep-sea oil or gas exploration or production. Second, the new sanctions place an almost absolute ban on export of any EAR99 items to three regions of Ukraine occupied by Russian troops – Crimea and two breakaway republics in eastern Ukraine (Donetsk People’s Republic and Luhansk People’s Republic). Only certain food, medicine, and computer software used for social media or similar programs are exempt.

In addition, the U.S. government has become much more aggressive in banning any exports to or imports from certain Russian companies. Exporters will need to check two lists maintained by BIS – the Entity List and the Military End User List – to determine whether the end-user of the export is an individual, company, research institute, government organization, or other person which is banned on one of these lists.

These determinations of the end user can be very complicated since an exporter does not usually know the end user. You might sell to someone that then sells to another party that itself may resell. While you are not required to know everyone who buys your products from someone else, you are required to exercise due diligence and to recognize, and act on, “red flags” suggesting that a banned company may be the end-user. In addition to knowing the end user you must determine that the sale is not in support of a prohibited end use (e.g. nuclear). These are set out in 15 CFR part 744 so you must try to determine the end use from the end users and if it is prohibited.

Finally, there are some products made outside the United States that are also subject to BIS’s export controls. These include products manufactured abroad using U.S. technology or software that requires an export license. It also applies to goods manufactured in a plant built using U.S. technology or software that requires an export license.

Other restrictions on commercial exports. OFAC is also involved in various types of sanctions in addition to restrictions imposed by either the Commerce or State Departments. These sanctions go back to the first Russian incursion into the Ukraine in 2014.

The Ukraine/Russia-related sanctions were initially implemented by OFAC beginning on March 6, 2014, when the President issued Executive Order (E.O.) 13660 in response to Russia’s annexation of Crimea. The U.S. has issued three subsequent Executive orders that expanded the scope of U.S. trade sanctions.

CLIENT ALERTS

Together, these orders authorize, among other things, the imposition of sanctions against persons responsible for or complicit in certain activities with respect to Ukraine; against officials of the Government of the Russian Federation; against persons operating in the arms or related material sector of the Russian Federation; and against individuals and entities operating in the Crimea region of Ukraine. E.O. 13662 also authorizes the imposition of sanctions on certain entities operating in specified sectors of the Russian Federation economy. Finally, E.O. 13685 also prohibits the importation or exportation of goods, services, or technology to or from the Crimea region of Ukraine, as well as new investment in the Crimea region of Ukraine by a United States person, wherever located.

On February 24, 2022, and again in March and on April 6, the United States responded to Russia's most recent incursion into Ukraine announcing new OFAC sanctions, including, *e.g.*:

- Strong sanctions on the Russian Central Bank (“RCB”), combined with several layers of overlapping sanctions on major Russian financial institutions. The U.S. first announced these sanctions at the end of February 2022, but substantially strengthened them in the executive order issued April 6.
- Broad new sanctions on Russian government officials, and many Russian oligarchs and the many companies and entities they control. Like the sanctions on the Russian financial institutions, these sanctions were strengthened by actions OFAC took on April 6 in coordination with the new executive order.
- Additional sanctions on Belarusian officials, banks and businesses directly or indirectly supporting the Russia invasion of Ukraine.
- Russian Central Bank Impacts the value of the Ruble and the Russian Government reserves. These sanctions could have a long-term impact on the Russian economy. New economic sanctions have been imposed on Russian government officials and oligarchs.
- Similar to the SDN sanctions on banks, these designations prohibit commercial and financial transactions with a large number of leading Russian government and business leaders.
- Ukraine itself is not sanctioned, but certain Russian-occupied regions are. These include Crimea, the occupied Donetsk and Luhansk regions are now subject to what is known as territorially based sanctions programs. All commercial, financial, and investment activities in Crimea, Donetsk and Luhansk is now banned with certain limited exceptions. These are similar to the country-based sanctions that OFAC imposes on Cuba and Exceptions for humanitarian, medical, and telecommunications activities are limited and narrow.

Under the OFAC 50 Percent Rule, U.S. citizens, permanent residents, and companies may not transact business with any corporation, entity, or other property 50% or more of which is owned by one or more individuals or entities on the SDN List. This is true even if the entities do not appear on OFAC sanctions lists. This has a broad impact across the Russian economy given that government and oligarchs have financial interests in a wide range of companies. A significant percentage of the Russian automotive and manufacturing sector could be “indirectly sanctioned” because of more than 50% government or Oligarch ownership.

CLIENT ALERTS

These rules require companies conducting business in Russia to perform “upstream” due diligence on the owners of their business partners in order to avoid accidental sanctions violations.

For example, if you sell an auto part that eventually is resold in Russia, you need to try to determine if the end user is the Russian military or the Russian government for non- military uses (e.g. government agency fleets). One example is the large state-owned Russian company Rostec that has an interest in hundreds of separate entities, some in the automotive field.

Other Economic Sanctions. Additional U.S., British, and EU sanctions are likely, given Belarus’ continued active participation in the conflict.

Other Considerations. Separately, the U.S. and 7 European states have denied Russia Most Favored Nation Treatment (“MFN”). This means all imported products from Russia will pay new much higher rates similar to Iran or Cuba. For example, in the United States Harmonized Tariff Schedules, there is a listing for “Gear boxes and parts thereof: Gear boxes: for the vehicles of subheading 8701.20 or heading 8702, 8703 or 8704..... 8708.40” the MFN rate is 2.5% but the non-MFN rate is 25%. Russia can also increase its duty rate for imports from the United States and NATO countries ,making it considerably more costly to export. Also, many shipping companies have stopped serving Russia (e.g. Maersk) which is a factor to be considered.

Force Majeure: Many companies are interested in whether the Russian actions in Ukraine would be considered as *force majeure* that would excuse non-performance of an existing contract. This is a complex question that has no single right answer. In general, it will turn on a variety of factors, including: (i) the specific wording of the contractual *force majeure* provision; (ii) the nature of your substantive obligations in the underlying contract; and (iii) the causal relationship between the events in Ukraine and the burdens or impossibility of continued performance. Not only is the question complex, but suspending performance based on *force majeure* can have severe adverse consequences if it is ultimately determined that performance was not excused. Accordingly, it is prudent to consult with experienced counsel before claiming *force majeure* or before responding to your supplier’s or customer’s claim of *force majeure*.

Most importantly, more restrictions are likely to come. BIS and OFAC are informally advising companies to be careful in making decisions since there could be new stricter controls coming out and waiting is advisable. There already have been frequent upgrades to sanctions. In addition to moral considerations that have determined many decisions to stop shipping to Russia, the risk of bad publicity or an investigation can hurt a company and be expensive. For example, the large automotive supplier, Magna has announced it is discontinuing all activities in Russia (Auto News).

Attorneys at Butzel Long have been advising clients on these issues and are available to answer questions on these issues. This client alert is only a summary of a rapidly changing area and is not intended as legal advice.

CLIENT ALERTS

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