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DC Circuit Upholds OFAC's Broad Interpretation of Transshipment Prohibition on US-Origin Goods to Iran

On May 26, 2017, the US Court of Appeals for the District of Columbia Circuit threw out a portion of a $4,073,000 civil penalty assessed by the Office of Foreign Assets Control ("OFAC") against a California-based sound system wholesaler for violations of the Iranian Transactions and Sanctions Regulations ("ITSR"). However, the Court upheld OFAC's broad interpretation of the ITSR that a violation occurs if an exporter has reason to know its exports to a third country are intended to be re-exported to Iran.

Overview

The case, Epsilon Electronics Inc. v. US Dep't of Treasury, is a rare example of a partially successful appeal against an OFAC enforcement action under § 706(2)(A) of the Administrative Procedure Act ("APA"). The US Court of Appeals affirmed the lower court's decision in regard to thirty-four alleged ITSR violations related to shipments to a third country, thereby upholding OFAC's broad interpretation of the transhipment prohibition in ITSR § 560.204 and rejecting arguments that the "inventory exception" applied. However, the US Court of Appeals remanded the case with instructions that OFAC further consider the basis for five other alleged violations and the total monetary penalty imposed for the thirty-four alleged ITSR violations.

The decision is available at:
https://www.cadc.uscourts.gov/internet/opinions.nsf/866BFABA6593F5D68525812C0050A696/$file/16-5118-1676917.pdf

Background

In July 2014, OFAC issued a Penalty Notice assessing a $4,073,000 fine against Epsilon Electronics ("Epsilon"), a US-based car electronics company, for violating ITSR § 560.204 with respect to thirty-four shipments of audio equipment made to Asra International ("Asra"), a Dubai-based distributor, between 2008 and 2011 and five shipments made in 2012.

Section 560.204 states in relevant part:

. . . the exportation, reexportation, sale, or supply, directly or indirectly, from the United States, or by a United States person, wherever located, of any goods, technology, or services to Iran or the Government of Iran is prohibited, including the

Key issues

- The DC Court of Appeals upheld OFAC's interpretation that it does not need to prove that exported goods arrived in Iran to establish a violation of ITSR § 560.204.
- The Court nevertheless held that OFAC did not give a sufficient explanation of its decision to charge the appellant under § 560.204 for 5 out of 39 violations.
- The decision underscores the importance of conducting due diligence on customers and distributors for 'red flags' of transhipment risk, and that you may be charged with what you reasonably should have known.

exportation, reexportation, sale, or supply of any goods, technology, or services to a person in a third country undertaken with knowledge or reason to know that:

(a) Such goods, technology, or services are intended specifically for supply, transshipment, or reexportation, directly or indirectly, to Iran or the Government of Iran

OFAC alleged that Epsilon had reason to know the goods were intended to be re-exported to Iran because, among other things, information from Asra's website suggested the company was distributing exclusively in Iran.

Epsilon challenged the penalty in the US District Court for the District of Columbia in December 2014, seeking declaratory and injunctive relief against the enforcement action. Epsilon argued, among other things, that OFAC's 2002 "Guidance on Transshipments to Iran" (the "2002 Guidance") creates an exception to ITSR § 560.204 that allows US persons to export goods (that are not controlled under the US Export Administration Regulations) to distributors for their general inventory, even if the distributors later re-export the goods to Iran, provided the US exports were not specifically intended for re-export to Iran and/or the distributor's sales were not predominantly to Iran. (Often referred to as the "inventory exception.")

In March 2016, the District Court granted summary judgment in favor of OFAC, rejecting Epsilon's reading of the 2002 Guidance and holding that OFAC had sufficient evidence that Epsilon had reason to know that Asra intended to ship the goods to Iran given that Asra's dealings at the time primarily were in Iran. 168 F. Supp. 3d 131.

Reason to Know

On appeal, Epsilon again argued that the 2002 Guidance provided a safe harbor under the inventory exception. In addition, Epsilon argued that none of the thirty-nine shipments violated the ITSR because OFAC failed to produce substantial evidence showing that the shipments actually entered Iran.

The Court of Appeals reviewed the appellant's claims under the APA § 706(2)(A) "*arbitrary and capricious*" standard. With respect to the ITSR, the Court held that § 560.204(a) unambiguously does not require a showing that goods entered Iran, only evidence of "*(1) the exportation of goods to 'a person in a third country' and (2) 'knowledge or reason to know' that the third-country recipient plans to send the goods on to Iran."*

Furthermore, the Court held that the 2002 Guidance did not create an exception to § 560.204 or a safe harbor where an exporter knew or had reason to know goods were destined for Iran. Significantly, OFAC was not required to show that Epsilon in fact was aware that Asra's dealings primarily were in Iran, but only that the information was available from, for example, Asra's website.

Based on the foregoing, the Court affirmed the District Court's ruling that OFAC had substantial evidence that Epsilon had reason to know that Asra would re-export its products to Iran for each of the thirty-four shipments made between 2008 and 2011.

Arbitrary & Capricious

As to the remaining five shipments, in 2012, the Court of Appeals noted that OFAC had received copies of emails between Epsilon and Asra indicating that Asra would distribute Epsilon's products in Dubai around the time of the five shipments. The emails were sent after Epsilon had received a January 2012 cautionary letter from OFAC concerning exports to Iran. The Court remarked that Epsilon could have believed that the five shipments were intended for Dubai, not Iran, and held that the administrative record, which included an internal OFAC memo, "*failed to offer a sufficient explanation for why it did not credit the email evidence.*"

Having found OFAC's penalty with respect to the five shipments arbitrary and capricious, the Court considered the appropriateness of the penalty imposed for the thirty-four earlier shipments. After reviewing OFAC's Enforcement Guidelines, the Court concluded that OFAC had considered the five 2012 shipments (which occurred after the receipt of the cautionary letter) as an aggravating factor in its penalty assessment. The aggravating factor was applied to the penalty for all of the

shipments. Based on this, the Court held that the penalty for the five shipments could not be severed, and remanded the case for OFAC to reconsider the penalty and the basis for the five alleged 2012 violations in a manner consistent with the Court's opinion.

Takeaways

Examples of federal courts reviewing—let alone modifying— OFAC enforcement actions are few and far between. The *Epsilon* case is noteworthy in this regard, even though the appellant did not succeed in having the penalty overturned in its entirety. The case may embolden others to take a more aggressive defensive posture against future OFAC penalties where the factual or legal basis for the Penalty Notice is ambiguous.

On the other hand, the Court's affirmation of OFAC's interpretation of § 560.204 serves as a reminder of the importance of conducting adequate due diligence on customers and counterparties to look for 'red flags' that the products or services are intended for, or are likely to be re-exported to, sanctioned countries in violation of OFAC regulations. It also shows deferral to OFAC's interpretation that the *reason to know* standard can be applied if there is relevant publicly available information, such as information on a website, even if the US person does not actually review it.

The case also offers insights into OFAC's discretionary penalty calculation. OFAC found the thirty-four shipments to be violations, but found them non-egregious, perhaps because they did not find actual knowledge by Epsilon of Asra's intention to ship to Iran. Further, penalty reductions available under the OFAC Enforcement Guidelines continue to create a significant incentive for voluntary self-disclosure and cooperation with OFAC investigations and settlements.

Contacts

David DiBari
Partner
T: +1 202 912 5098
E: david.dibari
@cliffordchance.com

Wendy Wysong
Partner
T: +1 202 912 5030
(Washington D.C.)
+ 852 2826 3460
(Hong Kong)
E: wendy.wysong
@cliffordchance.com

George Kleinfeld
Partner
T: +1 202 912 5126
E: george.kleinfeld
@cliffordchance.com

Ali Burney
Counsel
T: +65 6506 1964
E: ali.burney
@cliffordchance.com

Jacqueline Landells
Counsel
T: +1 202 912 5061
E: jacqueline.landells
@cliffordchance.com

Nicholas Turner
Registered Foreign Lawyer
T: +852 2825 8854
E: nicholas.turner
@cliffordchance.com

Clifford Chance, 31 West 52nd Street, New York, NY 10019-6131, USA

www.cliffordchance.com