Hughes Hubbard & Reed

New Sanctions Advisory: Risks for Businesses with Supply Chain Links to North Korea

Client Advisories

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July 26, 2018 – On July 23, 2018, the U.S. Department of the Treasury, Office of Foreign Assets Control ("OFAC"), the U.S. Department of State, and the U.S. Department of Homeland Security ("DHS") issued a joint advisory warning businesses of North Korean efforts to avoid U.S. and UN sanctions with regard to trade with North Korea and the use of North Korean labor in third countries.

The Advisory comes in the context of a U.S. push for greater sanctions enforcement against North Korea, despite the June 12, 2018 meeting between President Trump and North Korean leader Kim Jong-un aimed at defusing tensions between the two countries. The Advisory follows a similar February 23, 2018 advisory that provided guidance on complying with sanctions targeting North Korea's shipping sector.

The July 23 Advisory focuses on two risks: (1) inadvertent sourcing of goods, services, or technology from North Korea, and (2) the presence of North Korean nationals working in third countries in companies that form part of the supply chains for U.S. businesses. Although non-binding in the sense that it does not create any new legal obligations that do not already exist under prior U.S. statutes, regulations, and executive orders and UN resolutions, the Advisory highlights a potential future U.S. enforcement focus and provides a roadmap for appropriate supply chain due diligence.

Red Flags and Best Practices: Avoiding North Korean Goods and Labor

Inadvertent Sourcing

The Advisory first focuses on the inadvertent sourcing of goods, services, and technology from North Korea, and notes several ways in which North Korean origins may be concealed:

- Sub-contractors shifting or sub-contracting out work to North Korean firms without informing the customer;

- Mislabeled products smuggled into third countries and then identified as coming from those countries;
- Joint ventures established with partners from China and other countries (the Advisory includes a list of known joint ventures, broken down by sector, in Annex 2);
- Raw materials with artificially low prices sold to intermediaries to provide a commercial incentive to purchase North Korean goods, particularly in the export of minerals; and
- IT Services sold to unwitting buyers through the anonymity of freelancing websites or by using front companies, aliases, and third-country facilitators.

North Korean Labor

The second focus of the Advisory is on North Korean labor used to create products or services in third countries. North Korea exports workers to other countries, and using such labor is prohibited by U.S. sanctions because the revenue from the labor returns to the North Korean government. (This prohibition does not extend to employing bona fide North Korean refugees or asylum seekers who have obtained non-North Korean citizenship or residence.)

Warning signs of the use of North Korean labor in third countries include:

- Sourcing products or services from countries known to use North Korean labor, especially China and Russia;
- Unusual treatment of wages, including employers withholding wages, paying wages late, making unreasonable deductions, making in-kind payments, or paying in cash;
- Long-term (2-5 year) contracts with large upfront payments, a substantial portion of which is typically paid to the North Korean government;
- Unsafe or overpriced employer-provided housing in which employees live collectively and are isolated from laborers of other nationalities;
- Employer control over laborers, including confiscating and/or destroying documents such as passports or visas, no employee access to bank accounts, little to no employee time off, and mandatory self-criticism sessions; and
- Lack of transparency in contracts, transactions, and workplaces. Employees typically cannot be interviewed without a "minder," transactions obfuscate the ultimate beneficiary, and workplace inspections are limited.

Annex 3 to the Advisory breaks down the sectors and countries that are at a higher risk of employing North Korean labor. The highest-risk sector is construction, particularly in certain African and Middle Eastern countries as well as Mongolia, Nepal, Poland, and Russia. Other notable sectors at risk include:

- Agriculture in Poland and Russia;
- Medical clinics in Africa and countries near North Korea;
- Seafood in China, Mozambique, Taiwan, and Uruguay;
- Timber in Russia; and
- Energy and textiles and apparel in China.

Practical Considerations

The July 23 Advisory did not announce new sanctions. Nevertheless, businesses transacting in the high-risk sectors identified in the Advisory should consider reviewing their compliance programs to ensure they are up-to-date and reflect the Advisory's guidance. The Advisory may also signal a future area of focus for sanctions enforcement, even for inadvertent violations far down in supply chains.

Both the February 27 and July 23 advisories reiterate that non-U.S. businesses can be subject to U.S. secondary sanctions for certain activities, even in the absence of any U.S. involvement. Under legislation enacted in 2017, non-U.S. persons may face liability for, among other things, engaging in even a single significant importation from or exportation to North Korea of any goods, services, or technology; operating in the construction, energy, financial services, fishing, information technology, manufacturing, medical, mining, textiles, or transportation industries in North Korea; or owning, controlling, or operating any port in North Korea, including any seaport, airport, or land port of entry. Engaging in such transactions could result in designation on OFAC's list of sanctioned persons, known as the Specially Designated Nationals ("SDN") list;   U.S. persons, including U.S. financial institutions, are prohibited from transacting with parties on the SDN list. And non-U.S. financial institutions that have knowingly conducted or facilitated significant trade with North Korea or an SDN risk losing access to the U.S. financial system.

The advisories strongly suggest that high-risk transactions involving industries and/or parties known to be used by North Korea to evade sanctions should be treated with caution and afforded a heightened level of due diligence. Companies engaging in such transactions should carefully review the red flags highlighted in the advisories and enhance their compliance safeguards as necessary. Heightened compliance efforts may include:

- Instituting and maintaining comprehensive compliance programs that integrate a rigorous continuous risk assessment into internal control and oversight systems.
- Conducting thorough due diligence on subcontractors from high-risk locations or industries, especially if they have operations in China or Russia. The advisories suggest that mere routine screening may not be sufficient.
- Conducting regular checks of subcontractors, including site visits and blind audits of operations in at-risk countries and industries.

The advisories further stress the potentially high penalties for violations of U.S. sanctions, which can span multiple agencies. In that regard, it is worth noting that having a robust compliance program is a mitigating factor that can often reduce or even eliminate a monetary penalty. U.S. and non-U.S. companies alike that engage in transactions at risk of violating the North Korea sanctions program should consider reviewing and revising their compliance policies and procedures to reduce the potential for North Korea products, labor, or technology in their supply chains.

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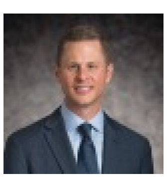

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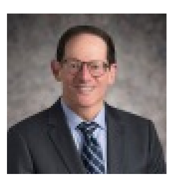

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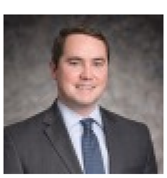

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