

## Five Steps to Protect Global Supply Chains from Sanctioned North Korean Input

*Contributed by Caroline J. Watson, Associate, Richard Mojica, Member, and Timothy O'Toole, Member, Miller & Chevalier*

In an effort to confront the human rights abuses of Kim Jong-un's regime, the U.S. Department of Treasury, Office of Foreign Assets Control ("OFAC") and the U.S. Department of Commerce, Bureau of Industry Security ("BIS") are increasingly focused on enforcement of the U.S. sanctions on North Korea, which include a prohibition on the importation into the United States, directly or indirectly, of (a) any goods, services, or technology from North Korea, and (b) any goods, wares, articles, and merchandise mined, produced, and manufactured wholly or in part by North Korean citizens or nationals, including outside of North Korea.

U.S. companies generally avoid sourcing directly or knowingly from North Korea. The real issue is protecting a company's supply chain from the deceptive practices employed by some foreign suppliers who surreptitiously utilize North Korean labor or content in the goods and services they provide. The incentive for suppliers to do so is appreciable in certain parts of the world and certain industries, as North Korea provides an exceptionally cheap source of labor and materials, largely due to the regime's use of forced labor. Moreover, some suppliers have few if any qualms about compliance with the trade regulations of other countries, including the United States, as they do not view themselves as subject to such foreign laws. Others may simply have minimal awareness of U.S. sanctions.

OFAC's recent enforcement action against U.S. cosmetics company e.l.f. Cosmetics, Inc. ("ELF") highlights how compliance with these restrictions on North Korean content presents a distinct challenge to businesses that source globally. On January 31, 2019, OFAC fined ELF nearly \$1 million under a settlement agreement for 156 apparent violations of the North Korea Sanctions Regulations. The apparent violations, which ELF voluntarily disclosed to OFAC, occurred over the course of several years and entailed the importation of false eyelash kits from suppliers in China that contained materials sourced from North Korea by the suppliers. Despite the significant number of apparent violations and several aggravating factors, OFAC substantially reduced the fine from a maximum penalty of \$40.8 million and base penalty of \$2.2 million due to several mitigating factors, including ELF's voluntary disclosure of the matter and the significant remediation measures that it implemented afterwards. In the settlement announcement, OFAC stated that the enforcement action "highlights the risks for companies that do not conduct full-spectrum supply chain due diligence when sourcing products from overseas, particularly in a region in which [North Korea] ... is known to export goods."

Companies that source globally should take the cue from OFAC to examine their own sourcing practices and supply chains for risk of illicit North Korean content. However, many may be at a loss of how to approach this kind of assessment in a cost-effective manner. Based on the ELF settlement agreement and other recently published guidance, companies should consider the following five steps as a starting point to protect their supply chains from risk of OFAC enforcement actions relating to North Korea sanctions:

- 1. Risk Evaluation:** OFAC urges businesses to take a risk-based approach, and provides some insight in its advisory "Risks for Businesses with Supply chain Links to North Korea" into the kinds of indicators it and other enforcement agencies consider heightened risk factors that should prompt businesses take extra precautions. For example, the two countries with the highest risk of North Korean labor or content, according to the advisory, are China and Russia, which pose more risk than all other countries combined. Certain industries also increase the risk of North Korean input, including apparel, footwear manufacturing, textiles, cosmetics, IT services, pharmaceuticals, and more. Within these areas,

there is also a greater risk for suppliers to establish partnerships with North Korean firms, such as joint ventures and subcontracting relationships, without informing customers. Below-market or artificially low pricing of goods and services in high-risk areas can also indicate that a supplier is sourcing from North Korea, which often offers cut-rate prices due to the use of forced labor. North Korean firms as well as third country suppliers may also disguise the origin of goods or materials by mislabeling them to identify only a third country where the good is processed, packaged, or sold, such as garments labeled “Made in China” when in fact the garments originated from North Korea. With these factors in mind, companies should conduct thorough risk evaluations for their supply chains and carefully document the process and their conclusions, which should result in a more effective compliance program as well as demonstrate sincerity as a mitigating factor to OFAC in the event of a compliance issue.

**2. Tailored Screening Measures:** Tailored screening measures will help insulate a company from the risk of North Korean input and can also serve as a mitigating factor to OFAC and other enforcement agencies if a compliance issue arises. Because North Korean content can often be hidden, verifying supplier names against sanctions lists may not expose the relevant red flags. As such, companies should highlight the North Korean issue by adding components to their screening measures that target the company's specific vulnerabilities. For example, a U.S. clothing company may include risk identifiers in their onboarding process for new foreign suppliers that trigger further due diligence requirements for high-risk situations such as apparel imported from China. The additional due diligence to detect North Korean issues may include making follow-up inquiries about the supplier's business practices (e.g., joint ventures, subcontracting, etc.), requesting information from the supplier on sourcing practices, conducting onsite audits, or simply remaining on high alert for other red flags. For risk mitigation in enforcement actions, companies should realize that enforcement agencies are not satisfied with a company's mere knowledge of the North Korean sanctions and risks without any follow-through application, and unapplied knowledge can potentially raise a business' culpability in an enforcement action. For example, a seriously inadequate compliance program can potentially weigh against a business in an investigation, as demonstrated in the case of ELF, which according to OFAC did not exercise “sufficient supply chain due diligence while sourcing products from a region that poses a high risk to the effectiveness of the [North Korea sanctions regime].”

**3. Supplier Code of Conduct, Compliance Certifications, and Contract Provisions:** Companies should enhance their supplier code of conduct, certifications, and contract provisions to inform and hold suppliers accountable for complying with U.S. sanctions and import/export controls, particularly with regard to North Korea. These provisions should put the suppliers on express notice of U.S. sanctions on North Korea, clearly state the company's own commitment to and expectations for suppliers' compliance and cooperation, and warn of the consequences for suppliers' failure to cooperate and be transparent. The suppliers' commitment to cooperate and comply should be required in the compliance certifications, including their contractual agreement to provide access to certain information and the facilities for audits by the company. These instruments can potentially serve to indemnify a business from some of the legal liability and costs of compliance issues as well. Businesses may occasionally face resistance to these measures from foreign suppliers that do not consider themselves subject to U.S. laws, even when the U.S. government authorities may assert jurisdiction over them. In such instances, a company might emphasize the importance of compliance to foreign suppliers as a business matter, setting contractual standards based on U.S. law, as well as informing the supplier of the impact that enforcement actions by U.S. government can have, including sanctioning foreign entities and individuals by listing them on the SDN List, the BIS Entity List, and the Foreign Sanctions Evaders List.

**4. Supplier Audits and Training:** For high-risk suppliers, companies should conduct onsite audits with a focus on the supplier's sourcing (i.e., country of origin) and labor practices. For example, ELF's regular

supplier audits failed to detect that 80% of the products from two China-based suppliers contained illicit North Korean content, because the audits concentrated primarily on quality assurance issues. Businesses should ensure that audits are conducted periodically and that they entail verification of the country of origin of the supplier's goods or services, which may include examining the supplier's origin documentation, labeling practices, payment information related to production materials, and supplier bank statements for red flags concerning origins. The audit should also cover the supplier's labor practices, such as reviewing employment documents, wages, and housing, and investigating whether the supplier uses subcontractors, joint ventures, or other third-party labor sources that might present unlawful labor issues. While searching for any red flags, the company should carefully document its process, findings, and conclusions. Depending on the size and extent of supplier relationships, businesses may consider even conducting compliance training for a foreign supplier during an audit. In ELF's settlement, OFAC specifically mentioned the value of educating and training foreign suppliers on sanctions and import/export compliance. If conducting onsite training for suppliers is not feasible, a company might at least consider providing basic U.S. sanctions and import/export training and compliance materials, including its Supplier Code of Conduct, for suppliers to implement and review.

**5. Internal Reporting Mechanisms:** Because even the strongest compliance programs are not fail-safe, companies should provide and encourage the use of internal reporting mechanisms for compliance issues and urge suppliers to do the same. Such mechanisms have proven to be an important channel for discovering compliance issues even in foreign operations, particularly when deception is used to circumvent established company policy. For example, in the recently settled action against Kollmorgen Corporation, an internal employee complaint via the company's ethics hotline alerted the U.S. parent company to sanctions violations by its Turkish subsidiary, which were committed and concealed over the course of two years by personnel in Turkey contrary to the U.S. company's policy and training. Upon internal discovery of the issue, the U.S. parent company made a voluntary disclosure to OFAC and reached a settlement for a substantially reduced penalty of just over \$13,000 from a maximum of \$1.5 million. As a cautionary tale for foreign counterparts who may feel immune to U.S. enforcement actions, OFAC designated the subsidiary's Turkish managing director on the "Foreign Sanctions Evader List", making him the first individual (as opposed to a company) to be designated on the sanctions list in connection with an enforcement action. The Turkish managing director covertly directed and blackmailed the subsidiary's personnel in Turkey to continue business operations in violation of U.S. sanctions. The Treasury Under Secretary for Terrorism and Financial Intelligence stated that this action is a "marked change to how we will counter these acts of deception" and serves as "a clear warning to anyone in supervisory or managerial position who directs staff to provide services, falsify records, commit fraud, or obstruct an investigation into sanctions violations exposes themselves to serious personal risk."

Businesses that source globally would be prudent to heed OFAC's recent warnings and take action to proactively protect their supply chains from the risk of illicit content, particularly from North Korea. For companies interested in pursuing any of the five steps above for risk mitigation, we have developed a detailed questionnaire as a tool to help assess their own supply chain risk profile, related due diligence procedures, and supply chain compliance programs for North Korean content and forced labor vulnerabilities. Anyone interested in this document should not hesitate to contact the authors of this article.