

Expert Analysis

Is Your Chinese Supplier Using North Korean Materials?

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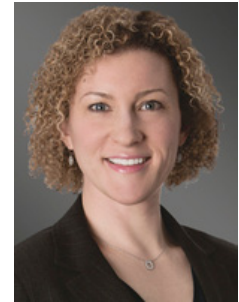
Just when you think your supply-chain program is under control, OFAC reminds you that you may have some brushing up to do. OFAC is the [U.S. Department of the Treasury's Office of Foreign Assets Control](#), responsible for implementing most of the U.S. government's country-specific and targeted economic-sanctions programs.

OFAC recently charged e.l.f. Cosmetics Inc. nearly \$1 million to settle its potential civil liability for over 100 alleged violations of U.S. sanctions against North Korea, for importing Chinese-made false eyelash kits containing materials from North Korea. Apparently, unbeknownst to e.l.f., two of its Chinese suppliers sourced materials from North Korea.

The statutory maximum civil penalty for e.l.f.'s alleged violations was \$40 million, and the base penalty amount was \$2 million, but e.l.f. garnered mitigation credit for voluntarily disclosing the matter to OFAC and improving its compliance program. In addition to the illegal imports of North Korean products into the United States, OFAC further alleged that e.l.f.'s imports may have resulted in U.S. origin funds going to the North Korean government (presumably via the Chinese manufacturer who procured the materials from North Korea).

While it may be easy for companies to discount the importance of sanctions compliance with the sincere assertions that “we don't do business with Iran or Cuba” and “our people do the right thing, we would never violate U.S. embargoes,” the operational challenge is real. Sanctions violations have no intent requirement, which means one need not intend to violate the law, nor even be aware of the law to violate it. U.S. sanctions apply to all U.S. companies and U.S. persons wherever they are located in the world, and can also reach non-U.S. companies who deal in U.S. origin goods, import into the United States or process financial transactions in U.S. dollars.

In OFAC's press release about the e.l.f. settlement, it admonished e.l.f. for a “non-existent or inadequate” compliance program at the time of the alleged violations, and noted that its supplier audits focused only on quality assurance issues, not country-of-origin verification. While North Korean materials may create sanctions risks for U.S. companies, liability could also result from dealings with any other OFAC-sanctioned banks or entities located around the world.



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Numerous financial institutions in Asia and Russia, for example, are targets of OFAC sanctions. Any payments processed directly or indirectly through an OFAC-sanctioned bank may create liability for a U.S. importer or multinational.

Companies relying on Chinese manufacturing and sourcing, as those in the fashion and beauty industries often do, may learn from e.l.f.'s mistakes and implement what OFAC refers to as "full-spectrum supply chain due diligence." Specifically, any earned mitigation credit for undertaking the following enhancements to its overall compliance program:

- Supply chain audits that verify country-of-origin of goods and services;
- Supplier certifications of compliance with all U.S. export controls and trade sanctions;
- Supplier audits that include verification of payment information related to production materials, and the review of supplier bank statements;
- Outside legal counsel engagement to train key employees in the United States and China regarding U.S. sanctions and other relevant laws and regulations; and
- Mandatory new-hire and recurring U.S. sanctions training for key-personnel employees and suppliers in China.

These enhancements are essential not only to help ensure compliance with the law, but also to increase supply-chain transparency, which has become a major issue for consumers purchasing fashion and beauty items. Today's consumers are demanding transparency and ethical corporate responsibility from brands, so it is no secret that these issues significantly influence the shopping decisions of consumers — particularly millennials. A robust enhancement to e.l.f.'s compliance program could have saved the company's public image by increasing control of and visibility into its supply chain.

Effective compliance programs also maximize protection from significant enforcement action in the event a violation occurs. Enforcement agencies such as OFAC give mitigation credit to those who have a reasonable and risk-based compliance program, with the understanding that no compliance program can prevent 100 percent of possible violations.

In fact, strong compliance programs may even position companies to mitigate civil penalties altogether, with the only agency action being issuance of a Warning or No Action letter. While e.l.f.'s program enhancements came after the alleged violations took place, they went a long way toward mitigating a potentially significant civil penalty.

Effective compliance programs encompass risk-based policies and procedures, and

communicate expectations and requirements both in writing and training to key personnel. Companies relying on China sourcing would be well-served to consider North Korea material and sanctions risks, and adopt appropriate policies and procedures to adequately address these before legal violations occur.

Separate and apart from OFAC's economic sanctions, U.S. importers also face scrutiny and enforcement action from [U.S. Customs and Border Protection](#) for any imports into the United States that involve the product of North Korean forced labor (under the Countering America's Adversaries Through Sanctions Act of August 2017. CAATSA restricts entry into the United States of goods made with North Korean labor.

Under CBP guidance, it presumes that goods made with North Korean labor involve forced labor, with the burden of proof on the importer. Like OFAC, CBP adopts a strict liability standard, so the only way to overcome this presumption is to have a best-in-class supply chain due diligence program. While e.l.f.'s imports predated enactment of CAATSA, it is hard to believe that had the imports entered the United States after August 2017, e.l.f. would not be facing allegations of North Korean forced labor in its supply chain.

This case highlights the risks companies face when sourcing their goods from China and the importance of having a robust supply chain compliance program. Not only is such a program essential to potentially avoiding a government enforcement action and a large fine, but it is responsible and ethical corporate behavior.

Ethical consumerism is a growing and important part of modern culture, and it mandates that companies that source globally be transparent about their supply chains. Those who fail to do so are at risk both from a liability perspective and from a business perspective. Reputationally, a brand is only as strong as the weakest link in its supply chain.

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