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Buyer Beware: Successor Liability for Export Violations and Due Diligence Measures to Identify and Mitigate Deal Risks

By John Barker, Ronald Lee & Michael Ginsberg

John Barker and Ronald Lee are partners in Arnold & Porter LLP's national security and public policy practices. Mr. Barker was previously the Deputy Assistant Secretary of State for Nonproliferation Controls and Deputy Assistant Secretary of State for Export Controls. Mr. Lee previously served as Associate Deputy Attorney General and Director of the Executive Office of National Security in the U.S. Department of Justice, and as General Counsel of the National Security Agency. Michael Ginsberg is an associate in Arnold & Porter LLP's national security practice. Contact: john.barker@aporter.com or Ronald.lee@aporter.com or michael.ginsberg@aporter.com.

The United States maintains a comprehensive regime of export control laws. These laws require companies to obtain licenses for certain exports, overseas transactions, and other activities abroad. The Departments of State, Commerce, and Treasury have the principal jurisdiction over the U.S. export control system, and each issues export licenses and exercises investigative and enforcement authority for the activities under its jurisdiction. The State Department enforces the export control regime for items having primarily military use; the Commerce Department has jurisdiction over the export of so-called "dual-use" items (items which have both civilian and military applications); and the Treasury Department regulates financial transactions with prohibited persons and with persons in embargoed countries.

Why Export Controls Matter for Deal Lawyers

When acquiring a company, particularly one that has significant international business or allows access by foreign nationals in the U.S. to sensitive technology, it is important to determine whether the target company is in compliance with U.S. export control law. Under the doctrine of successor liability, the successors of an acquired company may be held liable for that company's export violations that occurred before the acquisition. The 2002 *Sigma-Aldrich* administrative case made clear the government's ability to hold a successor liable for the export sins of the companies it has acquired. (See *In the Matter of Sigma Aldrich Business Holdings, Inc. et al.*, Case Nos. 01-BXA-06, 01-BXA-07, 01-BXA-11, available at http://www.bis.doc.gov/Enforcement/CaseSummaries/sigma_aldrich_alj_decision_02.pdf (last visited February 10, 2007).

The principle applies regardless of the form of the transaction; whether an asset or a stock sale, the liability attaches to the acquirer if there is substantial continuity between the predecessor and successor. Export control officials are not content to "pierce the corporate veil" only in cases of fraud—they routinely shred it and set aside the corporate transformations to have the export liabilities follow the business. Although it may be possible to negotiate indemnity provisions as part of an acquisition agreement that lessens the financial exposure of the company making the acquisition, other export penalties, including difficulties in obtaining licenses and fulfilling contractual commitments, and in more serious cases, the potential loss of exporting privileges, may result in serious damage to a company's profitability, enterprise value, and reputation. Moreover, enforcement authorities have raised questions about indemnification provisions tied specifically to export control violations in an acquisition as an indication that the cost of export violations is considered by the parties as merely the "cost of doing business."

The government has a range of enforcement mechanisms. It can suspend a company's export privileges for a specified period of time, in some cases up to twenty years, as a result of export violations. In less serious cases, the government can subject violators to a policy of license denial, meaning that any export license application by the company will be presumptively denied unless the company can convince the government to issue the license. The suspension of export privileges for any amount of time, let alone twenty years, or the presumption of export license denial, can be a fatal blow to companies that do significant international business.

In serious cases, export denial orders and presumptions of license denial can adversely affect a company's ability to continue performing government contracts requiring the export of military items or technical expertise. Moreover, the U.S. Department of Defense and other U.S. agencies may debar companies on the basis of export violations. Perhaps most frustratingly, in cases involving military exports or other defense technology, the government can exercise a "pocket veto" by holding license approvals until it is satisfied that the violator is now committed to export compliance. This can result in months, and in egregious cases, years of delay.

If a company acquires another company with export compliance problems and the compliance problems continue for more than a brief period (generally, weeks, not months) after the acquisition, there can be independent compliance problems for the acquiring company in addition to any compliance problems inherited for past activity. For example, the acquisition target may have been improperly exporting items without a license, and that line of exports represented an important part of the target's business. In order to continue making those exports and to provide maintenance services for the already-exported items, export licenses may be necessary. The company that has made the acquisition of the non-compliant company must obtain a license from the appropriate U.S. agency to continue the previously non-compliant business activities, or risk being found responsible for continuing export violations. Even in the best case, the acquiring company faces delays in obtaining the license that will temporarily prevent it from participating in the marketplace.

There are numerous examples of well-known corporations being held liable for export violations of companies they acquired under the successor liability doctrine. Boeing was held liable for violations committed by Hughes Space and Communications in the mid-1990s, well before Boeing acquired the unit in January 2000. The violations involved the widely reported incident in which Hughes provided launch failure analysis to Chinese companies following launch failures of rockets carrying Hughes satellites. Although the violations occurred before Boeing's acquisition of the Hughes unit, they subjected Boeing to a $32 million fine, jointly paid by Boeing and Hughes, and an extensive list of required compliance measures. In another case, the State Department divided liability between General Motors (GM) and General Dynamics (GD) for export violations involving GM units that were purchased by GD after the violations occurred. In that case, GD conducted an export control due diligence investigation as part of the transaction, during which it discovered the export violations, which were subsequently voluntarily disclosed to the government. Perhaps as a result of its commitment to export compliance and the actions it took in response to the discovery of the GM unit's export violations, GD was only required to pay $5 million of the $20 million fine, and allowed to spend that $5 million on developing internal compliance measures.

The Commerce Department also aggressively uses the successor liability doctrine. Recent cases include Sigma-Aldrich, where Sigma-Aldrich paid a $1.76 million fine to settle 345 export violations of a company it purchased, and ProChem, where ProChem paid a $1.54 million fine for over 150 export control violations made by a company it purchased. (Sigma Aldrich neither admitted nor denied liability for the violations under the settlement agreement.)

In order to avoid the consequences of acquiring a company with past or continuing export violations, it is essential to perform a thorough export control due diligence review and identify any possible export control issues prior to completing an acquisition. This article lists the key components of an effective export control due diligence review and provides an overview of the diligence activities that companies should undertake during the process of evaluating the purchase of another company. The article also discusses the options for handling violations discovered during the due diligence process, including having the seller conduct an internal investigation prior to the closing, and, where warranted, the filing of voluntary disclosures with the government. Filing such disclosures and completing the investigative and enforcement process these disclosures commence can often serve to reduce or eliminate the purchaser's liability and reduce the exposure and uncertainty facing the seller.

The Due Diligence Process

Export Compliance Programs — At the outset, it is essential to determine the extent and effectiveness of the compliance activities undertaken by the acquisition target. If the acquisition target has maintained the records required under U.S. law, instituted a strong export compliance program, and actively carried out that program, the process of due diligence will be fairly straightforward.

Every corporation that regularly exports commodities from the U.S. should have an export compliance program in place. Attorneys or external consultants conducting the due diligence should ask to review the acquisition target's export control compliance program. If the company is relatively small, its exports are not particularly sensitive commodities, and those exports are not to sensitive destinations, the export compliance program need not be complex or highly documented if it meets the essential objectives of such a program. However, if there is no export compliance program, and the company is a regular exporter of goods, services, or technology from the U.S., it is very possible that export violations have occurred knowingly or inadvertently. The lack of an export compliance program is a major red flag, and in going forward with the transaction, it will be doubly important to scrutinize the company's exporting activities and the legal exposure which the company's export violations create for the acquirer.

There are certain basic elements of an effective export control program that attorneys or others performing due diligence should be certain are present. An effective export control program should have a defined chain of command, with overall responsibility resting with a senior company official who has access to company executives. Employees should be regularly trained in the export controls relevant to their company's international activities, particularly those employees with export responsibilities. The program should contain procedures for retaining all documents required by U.S. law. The program should also provide for screening potential customers against the various lists published by U.S. export control agencies, to be certain that the company is not violating U.S. law by dealing with prohibited parties.

It is also important that the company have in place a means for determining whether the items it exports are controlled and, if so, to what extent and which of the various responsible U.S. agencies has export jurisdiction. This can be in the form of a classification matrix, list of commodity classifications, or other means which permits employees to determine the controls on a particular export. A classification matrix lists the U.S. government's export control classification numbers and categories for commodities and technology held by a company. Using that information, employees can determine the export controls on a particular item or technology by consulting the regulations maintained by the State and Commerce Departments.

Not all export compliance programs are alike. Some programs, while extensive on paper, are not completely implemented in practice. Export enforcement agencies such as the U.S. Department of Commerce and U.S. Department of State are taking a hard look at the actual implementation of a company's export control program when determining whether and how much to fine violators. For this reason, a review of a company's export compliance program should include a review of the implementation of the program, including past audits of the program, an assessment of the training program, and the extent to which the training is actually absorbed and acted on by company personnel who deal in international transactions or work with foreign nationals.

Documents to Review — Attorneys performing due diligence should review the documentation such as policies, export control manuals, classification guides and matrices, and checklists that the acquisition target uses as part of its export control compliance program. Attorneys should also look at the various documents that should be maintained by the acquisition target related to its past exports and exports that are still in the process of shipment. These documents will allow the purchaser to assess the items the company has exported and whether the appropriate licenses had been obtained prior to the export. Relevant documents include the export licenses that the company has obtained for its exports and shipping documents such as shipper's export declarations (SEDs).

Some companies have a history of export violations, possibly due to unawareness of the U.S. export control laws, a lack of an effective export control program, or, in the worst case, willful ignorance of the export control laws. If the company has been charged with a violation of the export control laws by a U.S. export control or law enforcement agency, then a paper trail exists and should be thoroughly researched. The acquiring company should examine not only the facts giving rise to the violation and whether the matter has been completely resolved, but also whether the target has eliminated any underlying weaknesses or gaps in the company's compliance program which could cause current or future problems. In some cases, the company will have already voluntarily disclosed the violation to the enforcing agency. Documents related to these disclosures should be identified as well.

Interviews — Export control problems can of course arise from the failure to follow license requirements, but the most serious ones typically arise because of exports made without legally required licenses. Consequently, reviewing documents alone is not sufficient. At a minimum, counsel for the acquiring company should interview export compliance managers, compliance personnel and most importantly, business representatives to ensure a full understanding of the company's exports and international business activities, the steps taken to identify and satisfy the company's legal obligations, and the company's areas of export control and trade sanctions compliance risks. While it is always a challenge to do this before the signature of a purchase agreement, prior to signature is the time when the interviews are most important. Major export control issues such as improper access to controlled items by foreign nationals and unlicensed transfers generally are discovered during interviews rather than by document reviews.

Deemed Exports — The export controls administered by Commerce, State, and Treasury apply both to tangible goods and to intangible data and services. It is possible to export not only tangible goods, but technical data, engineering know-how, and certain types of maintenance services. This point is particularly important in considering how export controls apply to the transfers of controlled items to foreign nationals within the United States.

One often-overlooked type of export is the transfer within the U.S. of controlled technology to foreign nationals, *i.e.* a person who is not a U.S. citizen or permanent resident. Such a release under the controls implemented by the U.S. Department of Commerce is called a "deemed export" because the transfer is "deemed" to be an export to the person's home country even though the foreign national is physically within the U.S. at the time of the transfer. The State Department has the same prohibitions for the technical data and defense services under its jurisdiction, although it does not use the term "deemed export."

Examples of unauthorized or deemed exports may include showing controlled blueprints or source code, or sharing engineering know-how with a foreign national. Such deemed exports can occur, for example, in the context of training foreign nationals to work in U.S. facilities that manufacture export-controlled items. This transfer need not even be intentional, as U.S. export authorities frequently refer to potential risks from foreign visitors to a company facility walking past visual displays of export-controlled information. Transfers to foreign nationals in the U.S., like all other exports, are subject to U.S. export control laws and may require licenses, as well as policies, procedures, and awareness training to prevent unlicensed transfers. It is important to determine whether the acquisition target has properly considered the possibility of deemed exports and to verify that deemed exports have not improperly occurred. This is one of the areas that is most likely to have been overlooked or misapplied both in a compliance plan and in a less-than-thorough due diligence review of a target's export control track record.

Attorneys conducting due diligence on an acquisition target must consider the possibility that deemed exports have been made by that target without appropriate authorization. They must learn whether foreign nationals are employed — whether as employees, subcontractors, or consultants--by the target company, and if so, identify their nationalities. They must determine whether any foreign nationals have visited the acquisition target. They must also research the technology to which all of these foreign nationals have been exposed. In short, attorneys conducting due diligence should fully understand the export-controlled activities of the acquisition target that involve foreign nationals.

Anti-Boycott — The Commerce Department and the Treasury Department also scrutinize potential violations of the U.S. anti-boycott laws. These laws prevent the participation of U.S. persons and entities in an unsanctioned foreign boycott. Although there are many such boycotts across the globe, in practice these laws are primarily directed against the Arab League boycott of Israel. The U.S. anti-boycott laws prohibit companies from agreeing to boycott Israel or specified "blacklisted" entities and from responding to questions about their business dealings (such as questions about whether they do business in Israel or with Israeli companies). In some cases, they also require the company to report any impermissible requests to the U.S. Commerce Department.

The Internal Revenue Service ("IRS") publishes a quarterly list of countries that require participation in or cooperation with an unsanctioned foreign boycott. During due diligence, a company should scrutinize all aspects of transactions involving the acquisition target and entities in the listed countries, and should review all documents related to those transactions.

It is important to note that although several Arab League members have officially ended the boycott of Israel, some companies in these countries and in some cases government officials still make impermissible boycott-related requests. Often, an entity's boilerplate contract, lease, letter of credit or other financing documents retain impermissible boycott-related questions even where the entity's home country has officially ended its boycott. Therefore, we suggest that as part of a due diligence exercise, counsel should review the anti-boycott compliance program and determine whether the relevant transactions have in fact been screened as recommended by the Treasury and Commerce Departments.

OFAC Considerations — There are other sanctions regimes to which companies are subject, including those of the U.S. Treasury Department's Office of Financial Assets Controls ("OFAC"), which enforces sanctions on transactions and financial dealings with specified proscribed countries, organizations, and individuals. The due diligence process should include a review of any dealings with sanctioned countries.

Not all transactions with these countries are prohibited, but all transactions with countries subject to any type of OFAC sanction should be reviewed as part of the due diligence process. As of the date this article was written, the following countries are on this list: Balkans, Belarus, Burma (Myanmar), Cote d'Ivoire (Ivory Coast), Cuba, Democratic Republic of the Congo, Iran, Iraq, Liberia, North Korea, Sudan, Syria, and Zimbabwe. (This list changes from time to time; for updates, see http://www.

treas.gov/offices/enforcement/ofac/programs/index.shtml.). The acquirer should also review whether the target screened transactions against the relevant U.S. government lists, including OFAC's Specially Designated Nationals List.

The Target's Responsibilities

Most due diligence activities are conducted by the acquiring company. Targets should not, however, underestimate the value of conducting preemptive due diligence. For one thing, the same review of export activities and potential compliance problems that an acquirer would conduct is, when engaged in by the target itself, part of the essence of a functioning, effective compliance program. In any event, most of the information noted above must generally be gathered by the target company in preparation for due diligence. As part of this information gathering, the target should conduct an appropriate review of the areas of greatest risk and, if problems are uncovered, fix them rapidly.

Handling Violations That Due Diligence Uncovers

If an acquiring company or target discovers a problem, the parties need to determine how to respond. The most important action, of course, is to prevent future violations. Beyond that, in cases involving errors on export licenses, Shipper's Export Declarations or any other documents filed with the government, these are considered "false statements" and must be corrected pursuant to the governing regulations. If there is no affirmative obligation to disclose the matter to the government, then the parties nevertheless need to determine whether or not to file a voluntary disclosure.

The decision to file a disclosure is made on a case-by-case basis, but in general, it is almost always advantageous to file a disclosure. Most purchase agreements include provisions regarding compliance with laws. Any past non-compliance likely would be disclosed by the purchaser after the completion of the sale anyway, so there is an incentive for the seller to disclose it to the government and get credit for the disclosure rather than waiting for the buyer to make the disclosure—and to discount the purchase price accordingly.

Conclusion

Due diligence in mergers and acquisitions for export control violations and compliance weaknesses is extremely important to avoid successor liability issues or other export complications well after the transaction is completed. In this day and age, because of heightened national security concerns, export control violations are receiving heightened enforcement interest from across the U.S. government. Companies can ill-afford the negative publicity and potentially steep penalties associated with export control violations. Inheriting an export control problem can also adversely the business model and revenue projections going forward, and can add an unnecessary level of complexity to any post-merger integration. Following the basic steps outlined above during a merger or acquisition will help companies avoid being held liable as successors for the expensive and embarrassing export sins of their acquisitions.

Suggested Categories for Export Control and Trade Sanctions Due Diligence

- Export control, trade sanctions and anti-boycott policies and procedures
- Copies of all filings with the government as well as copies of all correspondence and licenses received
- Export control classification (matrix) of goods, technology, services and software
- Interviews with appropriate personnel
- List of international sales
- Corporate export control records and shipping documentation
- Review of activities in the U.S. involving foreign nationals
- Information on any transfers to the Balkans, Belarus, Burma (Myanmar), Cote d'Ivoire (Ivory Coast), Cuba, Democratic Republic of the Congo, Iran, Iraq, Liberia, North Korea, Sudan, Syria, and Zimbabwe