

PRACTICING LAW INSTITUTE  
ADVANCED CORPORATE COMPLIANCE PROGRAM  
GLOBAL CORPORATE COMPLIANCE PROGRAMS:  
LONG TERM AND SHORT TERM ISSUES

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## GLOBAL CORPORATE COMPLIANCE PROGRAMS: LONG-TERM AND SHORT-TERM ISSUES

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Consolidations, mergers, acquisitions and divestitures are on the rise again. Within the past ten years, these activities occurred either within the confines of particular countries -- *i.e.*, a U.S. company bought another U.S. company or a French company purchased the French subsidiary of a British company -- or from the U.S. -- *i.e.*, a U.S. company purchased the foreign subsidiary of another company. The recent attempt by CNOOC Ltd. to purchase Unocal and the sale of IBM's personal computer business to Lenovo of China herald a renewed trend in acquisitions -- foreign companies purchasing U.S. assets. Although foreign companies have attempted to purchase U.S. assets before, various regulatory requirements affected the acquisition process and sometimes resulted in restrictions on the assets in order for the sale to occur. Even certain joint activity -- such as the recently published deal between ExxonMobil, Aramco of Saudi Arabia and Sinopec of China to expand a refinery in Southern China -- raise serious issues under U.S. laws that need to be addressed to ensure the minimal amount of regulatory disruption of the deal. For example, if ExxonMobil intends to provide certain sophisticated oil refining equipment, sensors and high level security systems to protect against terrorist attacks, the company will need to ensure that appropriate export authorizations are obtained from the U.S. Government for the transfer of that equipment and/or systems. These authorizations may even be required if ExxonMobil is obtaining the equipment from overseas suppliers, who incorporate U.S. parts and components into that equipment. U.S. export laws extend extraterritorially and create flowdown requirements not only for the U.S. companies seeking to purchase and transfer the equipment, but for the foreign suppliers as well.

The renewed interest by foreign companies in U.S. assets creates a number of legal and practical issues that should be included in any corporate compliance program. Because business needs change in line with market shifts, corporate compliance programs of companies dealing in a globalized environment need to be flexible enough to cover issues that could arise in the context of acquisitions of, and mergers or consolidations with, any potential entity -- U.S. or foreign. That flexibility is derived generally from a program that can handle both long-term and short-term issues. Since compliance programs remain "fluid" -- they change as often as the markets do -- the approach in each program should include a process to address:

1. Long term issues:
  - a. corporate compatibility
  - b. corporate ethics culture

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- c. resource allocations
  - i. reactive approach
  - ii. proactive approach
- d. resource availability
  - i. outsourced employee base
  - ii. outsourced systems
  - iii. outsourced management

2. Short term issues:

- a. U.S. and foreign regulatory hurdles to mergers, acquisitions, consolidations and divestitures
- b. Committee on Foreign Investment in the United States requirements
- c. Restrictions on U.S. assets
  - i. export laws and their authorizations
  - ii. clearance issues, such as Special Security Agreements, dealing with the Defense Security Service, and limitations under the NISPOM

The list above is only a subset of a broader range of topics that should be included in any global corporate compliance program. This presentation focuses on these issues because the recent focus on foreign acquisition of U.S. assets appears to have highlighted sensitivities in these areas. This interest has not only been reflected through Congressional actions, such as near unanimous support for House Resolutions critical of CNOOC's attempts to purchase Unocal, but through enforcement actions by the Departments of Commerce and State concerning transfers of technology and items in the course of acquisitions and divestitures.

## **GLOBAL COMPLIANCE PROGRAMS**

### **A. LONG TERM ISSUES**

Most compliance programs address immediate needs within the context of a company's overarching approach to conducting business. Some programs are process intensive -- *i.e.*, the company provides a process for every business activity, exception or waivers, regulatory requirements, and related issues. These programs tend to be layered under a broad policy that advocates and encourages compliance with all laws and regulations. Programs of this nature are well-suited to heavily regulated industries, such as the banking and defense industries, but hamper the nimbleness needed to respond to changing market or legal environments. Other programs take an "empowerment" approach which provides all employees with the guidelines needed for the company to conduct business and with points of contact and resources within the

entity to obtain additional information on how to comply. These programs also have some processes, but tend to be more people-focused and form or template-oriented. Although slightly more nimble in responding to changes than the process intensive programs, empowerment type programs suffer from some of the same lack of responsiveness, malaise and intransigence as the process-oriented programs.

Whichever type of program a company uses, however, certain long-term issues should be included in an effort to keep the business going without having to wholesale redraft sections of the program. Some of the issues which should be included in the long-term calculation include:

1. corporate compatibility;
2. corporate ethics culture;
3. resource allocations; and
4. resource availability.

Each of these areas not only defines the approach the compliance program takes to meeting legal and regulatory obligations, but also addresses the realtime issues involved in employees facing mergers, acquisitions, divestitures and consolidations. Some of the more practical aspects of these four (4) areas are discussed below:

1. Corporate compatibility
  - a. each company has an identity
  - b. a company "identity" is generally based on:
    - i. the type of business conducted
    - ii. management's history with the company
    - iii. how the business came into existence
  - c. when mergers, acquisitions or consolidations occur, so do "identity" clashes:
    - i. do both companies have the same approach to compliance - *i.e.*, process versus empowerment?
    - ii. do both companies' management bring compliance to the Board's attention?
    - iii. have both or either company been involved extensively with the U.S. Government -- *i.e.*, government contracts? classified contracts? patent licensing from the US government? subcontractor to company doing business with the Government?
    - iv. do both companies approach employee-relations the same way?

- v. do both companies overlap in production capabilities -- geographically? through employee expertise?
  - vi. do both companies have law departments -- similarities? differences?
- d. which company "merged" or "acquired" which company?
  - e. whose "identity" or "personality" prevails -- based on (d) above? revenue? management strength? general leadership capability from one entity as opposed to another?
  - f. affects a program when companies each have different approaches to compliance programs
2. Corporate ethics culture:
- a. apart from a company's "identity," each company also has an "ethical culture" that permeates the organization
  - b. that culture generally stems from the leadership within the company -- either management or board -- which drives the business and the approach taken to obtain and retain that business:
    - i. company approach to FCPA (e.g., Titan Corporation recent FCPA and AECA settlements with Justice)
    - ii. company approach to patent licensing
    - iii. company approach to complying with U.S. Government regulations (e.g., recent draft charging letter against Boeing for alleged violations of AECA)
    - iv. company approach to challenging U.S. Government regulations (e.g., recent spate of comments by Hewlett-Packard, Boeing, the Computer Systems Policy Project, etc. regarding proposed Department of Commerce regulatory changes to "deemed export" rules)
    - v. company approach to payments and fraud (e.g., Enron, HealthSouth)
  - c. if the top is tainted, the organization can suffer (e.g., Boeing problems regarding actions by senior management that resulted in dismissal, indictment and conviction of former employees, Darlene Drunyon and Michael Sears; plus the subsequent dismissal of Harry Stonecipher)

- d. when companies merge, the ethics culture is also affected
- e. if one company has not experienced "ethical lapses," then how does that affect the company that has -- e.g., L-3 has moved to acquire Titan Corporation, after Lockheed Martin declined to do so. As of today, L-3 has not appeared in the press concerning any convictions regarding FCPA violations although the company appears to be under investigation for fraud. Which company's "ethical" compliance approach would prevail?
- f. programs should plan to include provisions which highlight which program survives a merger, acquisition or consolidation (and how)

### 3. Resource Allocation

- a. every company allocates resources on the basis of business considerations -- e.g., budgeting, market needs, geographical considerations
- b. depending upon those considerations, companies may take a "reactive" or a "proactive" approach to resource allocation
  - i. "reactive" approach:
    - A. companies address general legal and regulatory requirements, but at a baseline, almost minimalist, level
    - B. when a problem arises, the company increases resources to address that problem, and triages the rest of its compliance obligations in favor of the issue that has arisen
    - C. once the problem subsides, the baseline level for that issue area may have been raised in comparison to the remainder of the program or the baseline returns to "pre-problem" level
    - D. also known as a "brushfire" strategy, this approach yields:
      - 1. increased short term expense
      - 2. increased short term requirements until the problem is resolved; or
      - 3. long-term benefits in the form of a changed, more enhanced compliance program for the problem area

- E. creates a constant need for change as company personnel move from issue to issue
  - F. enhances the possibility of a company producing conflicting resolutions
  - G. minimizes a company's ability to take broad advantage of lessons learned, if the changes do not remain within the program
- ii. "proactive" approach:
- A. more costly, in that resources are allocated and paid for prior to the discovery of a problem
  - B. seeks to preempt issues or at a minimum, have a mechanism and personnel in place, to address issues -- for example:
    - 1. Export Laws: Personnel are assigned to handle export licensing for the company, but only one person is assigned to handle licensing for three business units, each of which produce approximately 35 licenses. The company has recognized the need for a competent person to handle a critical aspect of their ability to conduct business, but has allocated too few resources to that task, given the follow-on obligations once licenses issue.
    - 2. FCPA Laws: Personnel are assigned within the company to screen foreign agents and consultants, including review under a due diligence process that includes checking references in the foreign country, screening the individual against various U.S. Government watch lists, hiring private investigators in the foreign country to conduct background checks on the individual, and use of the Department of Commerce ICP process to determine the U.S. Government view of the individual. The company assigns two people and one in-house counsel to conduct these reviews and the company generally retains between 20 and 50 consultants a year from countries in Western Europe, Thailand, Taiwan, Indonesia and the People's Republic of China. Depending upon

the country, the resource allocation and process could be considered a sufficient "proactive" approach to prevent, as well as subsequently address, any problem that could arise.

- C. results in a fairly robust compliance program if instituted across legal requirements
- D. can minimize conflicting resolutions to problems, once they arise
- E. because resources exist to both address and prevent a problem as issues arise, the company will be able to more broadly benefit from the resolution of those problems -- *i.e.*, it is likely that the resolution would be shared across the organization

#### 4. Resource Availability

- a. as opposed to resource allocation, resource availability addresses who actually conducts the tasks required by a company, not how many
- b. given various budgetary issues, as well as a push to expand company obligations beyond U.S. borders, available resources have been drawn more and more from third parties, rather than company employees
  - i. temporary agency personnel
  - ii. computer companies that manage and oversee other companies' computer systems, databases, and related computer infrastructure concerns (*e.g.*, CSC, Oracle)
  - iii. outsourced customer support
  - iv. outsourced research and development
  - v. outsourced physical security (*i.e.*, guards, receptionists)
  - vi. outsourced training of employees on specialized areas
  - vii. outsourced legal support in the intellectual property area
- c. resource availability affects the employee base

- d. resource availability increases the need for compliance programs to address a host of regulatory issues: e.g., export laws, NISPOM, need for extra computer security, more training, language concerns

## **B. SHORT TERM ISSUES**

In addition to the long term considerations which affect all compliance programs, as companies move and expand their operations, new issues arise. As with the cases mentioned in the introduction to this chapter, the most recently publicized acquisitions have involved purchases (or attempted purchases) of U.S. assets by foreign companies. Because the United States takes a broad view of how it defines its national security considerations, several laws affect a foreign company's ability to purchase U.S. assets that participate in any of the following activities:

1. market and sell overseas
2. employee foreign nationals whether in the U.S. or abroad
3. obtain export licenses from any one of the various government agencies controlling exports (*i.e.*, Departments of State, Commerce or Treasury)
4. maintain U.S. Government contracts with, for example, the Department of Defense, the Department of Homeland Security, the Federal Aviation Administration, the Centers for Disease Control, and the national laboratories
5. maintain either facility or personnel security clearances that need to be transferred to continue work
6. perform any research and/or development projects with the U.S. Government

Any one of these activities can trigger the need to satisfy obligations under the following laws and/or regulations:

1. the Exon-Florio amendment, which is implemented by the Committee on Foreign Investment in the United States through the chairmanship of the Department of Treasury
2. the export laws -- the Arms Export Control Act and/or the Export Administration Act, as implemented through IEEPA
3. the security laws and regulations controlled by the Defense Security Service under the NISPOM

Each of these short-term issues is reviewed below. Most compliance programs may address the second and third bullets noted above -- export and security laws. Generally, however, Exon-Florio issues tend to be addressed on a case-by-case basis.

1. Exon-Florio amendment, 50 U.S.C. app. section 2170
  - a. voluntary process which can be filed by the acquirer or the acquiree
  - b. requires extensive submission pursuant to 31 C.F.R. part 800
  - c. originally thought to affect primarily defense industries
  - d. because of increased use by defense agencies of commercial off the shelf items and technology, what procurements may be affected by a cross-border purchase of U.S. assets has expanded
  - e. the implementation of homeland security requirements and the development of a new agency to handle domestic security matters creates additional mergers or acquisitions that could fall within the purview of Exon-Florio
  - f. reviewed by a committee comprised of representatives from a number of U.S. Government agencies: State, Commerce, Defense, Justice, the USTR, the National Security Council, the National Economic Council, the Office of Science and Technology Policy, and OMB
  - g. general considerations reviewed by the committee (CFIUS) when a foreign company seeks to buy a U.S. company:
    - i. US technological leadership in the products or technology involved
    - ii. existing sources for the products and technology which may be sold
    - iii. predominant customers for the products/technology
    - iv. export laws which control the transfers of the products or technology
    - v. number of U.S. companies which potential foreign acquirer already owns
    - vi. potential for foreign government access to information, products, and technology which is owned by the U.S. company

- vii. security clearances held by the U.S. company
  - viii. number and type of government contracts held by the U.S. company
  - h. these considerations are weighed against the U.S. Government's stated policy of encouraging foreign investment in the United States which does not negate national security concerns
- 2. U.S. Export Laws related to Technology or Products Controlled by the Department of State
  - a. export statute: Arms Export Control Act, 22 U.S.C. section 2778 *et seq.*
  - b. implementing regulation: International Traffic in Arms Regulation, 22 C.F.R. part 120 *et seq.*
  - c. administered by the Department of State, Directorate of Defense Trade Controls
  - d. regulations generally prohibit foreign companies from holding or obtaining export licenses
  - e. do permit foreign companies to hold reexport authorizations which permit the retransfer of previously approved goods or technology
  - f. generally do not permit foreign persons to be empowered officials without notice
  - g. generally limit foreign person access to US origin goods or technology
  - h. contain separate licensing requirements for classified transfers
  - i. generally require concurrence of U.S. Department of Defense for any transfers
  - j. do not permit foreign persons to register with State, generally a prerequisite to obtaining export authorizations
- 3. Security Clearance Issues related to Facilities and Personnel
  - a. Department of Defense, through DSS, administers the security clearance requirements for any transactions which require access to classified information
  - b. clearances may be issued for facilities or personnel

- c. the government regulation, the NISPOM, generally prohibits foreign persons from holding security clearances
- d. if foreign ownership of a U.S. site with a security clearance is permitted, DSS usually requires extensive segregation of data, product and people involved in any classified information
- e. tied to CFIUS process, in the sense that restrictions can be imposed on classified or related information of value to the U.S. Government -- *e.g.*, recent restrictions on Lenovo access to IBM North Carolina R&D facility related to the IBM personal computer business Lenovo purchased
- f. government may require:
  - i. institution of a Special Security Agreement
  - ii. voting proxies for any foreign person board members
  - iii. access restrictions on U.S. product or technology by the foreign parent/purchaser
  - iv. elimination or termination of certain government contracts to avoid passing information on to foreign governments
  - v. frequent audits to ensure compliance with restrictions
- g. can make an acquisition more expensive than anticipated
- h. generally requires extensive revisions to compliance programs to address specific issues

## **APPENDIX A**

**PAY ME NOW . . . OR PAY ME MORE LATER:**

**THE HIGH PRICE FOR INADEQUATE  
EXPORT CONTROL DUE DILIGENCE  
DURING MERGERS, ACQUISITIONS OR DIVESTITURES<sup>2</sup>**

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The face of the defense industry continues to change as waves of mergers, acquisitions and divestitures further consolidate the industry. Whether solely in the United States or as part of a cross border expansion, these consolidations result in extensive transfers of assets, including defense related technologies within the newly formed entities. This activity has been the heart of several Department of State and Department of Commerce enforcement actions and affects the type of export licensing that may be needed to close a deal.

In a number of instances, acquiring companies have been held strictly liable, as successors in interest, for violations that occurred prior to the transaction, and the U.S. Government continues to aggressively impose such liability on the basis of acquisitions and mergers. See Commerce Department Settlement with Sigma Aldrich (Nov. 4, 2002) and State Department Consent Agreements involving *General Motors Corporation and General Dynamics Company* (Nov. 1, 2004); *EDO Corporation* (Nov. 24, 2003); *MultiGen-Paradigm, Inc.* (Sept. 24, 2003); *Agilent Technologies Inc.* (Aug. 20, 2003); and *Hughes Electronics Corporation/Boeing Satellite Systems, Inc.* (March 4, 2003). Each of these settlements involved the payment of significant fines and/or the imposition of mandatory compliance measures by the Government on acquiring companies that did not themselves violate the U.S. export laws. These settlements stemmed entirely and/or primarily from violations committed by the acquired, or target, corporation prior to the acquisition.

The U.S. Government's interest in such transactions derives, in part, from a recognition of the significant impact these transactions have on the worldwide dissemination of defense technologies. The ease with which information transfers, the lack of accountability for those transfers, and the ubiquitous nature of the information itself enhance opportunities for misuse. Effective due diligence, and the accountability that

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<sup>2</sup> This article is not intended to provide legal advice. It is intended, but not guaranteed, to reflect current legal development and the current state of the law. You should not act upon information you might receive from this article without advice of counsel.

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accompanies that process, therefore, not only reduces a company's potential exposure to liability as a result of a transaction, but from a Government perspective, assists in protecting national security and fostering foreign policy. The due diligence process, and the various legal requirements that must be satisfied prior to the completion of any corporate merger or acquisition, provide governments a unique window into and opportunity to assess planned technology transfers.

In light of the Government's continuing interest in such transactions, and the ongoing "feeding frenzy" associated with prosecutions across industries for corporate governance issues, corporations need to address the ever-mounting risks associated with a failure to conduct comprehensive due diligence concerning a target's export compliance posture. As discussed below, corporations are sometimes faced with a stark choice: either invest the time and expert resources to identify and correct export violations in advance of closing the transaction or face the imposition of penalties and compliance measures by the Government after closing. Likewise, a failure by governments to monitor such activity risks loss of a significant opportunity, with each corporate transaction, to monitor the proliferation and dissemination of crucial technologies. What should or can be done?

### **A. Due Diligence**

Mergers, acquisitions and divestitures typically begin through business personnel who identify potential synergies between companies. This interest develops into discussions between an acquirer and a seller or target concerning the potential transaction. As discussions progress:

1. a letter of intent ("LOI") and confidentiality agreement setting the terms for the proposed transaction are signed;
2. due diligence (e.g., discussions with target personnel and intense document review) is conducted to assess the proposed transaction; and
3. closing documents are prepared and signed.

The structure of the transaction, and the accompanying due diligence that precedes the transaction, are influenced by a number of factors, including, but not limited to:

1. the type of transaction;
2. the type of business;
3. the size of the entities involved; and
4. whether the target company is publicly or privately owned.

Fundamentally, however, the due diligence process and final terms of a transaction are dictated by the parties involved in the deal. A buyer's decision whether to accept the ultimate terms of the deal are necessarily premised on the information provided by the seller during the due diligence process. The process, therefore, is seller driven. If a seller is unwilling to provide comprehensive information concerning the target company, the buyer is left with few options:

1. Proceed with the transaction and attempt to address potentially unknown risks in the closing documents;
2. "Walk away" from the deal; or
3. Make the closing contingent on complete, final and written resolution of any export issues.

The due diligence review, therefore, forms the foundation for the transaction and is primarily framed by the seller's willingness to share or withhold information. To the extent a seller is unwilling to reveal particular facts, a buyer is generally not in a position to obtain the information independently.

## **B. The Process**

How does the process work and where do export requirements apply? Due diligence typically begins with the exchange of an LOI between the prospective buyer and seller. The LOI describes the ground rules for the review by establishing a timeframe and outlining, in general terms, the types of records and access that will be provided by the seller. Although the companies may be required to comply with various SEC laws in conducting the acquisition or merger, the due diligence process is not governed by a particular statute or regulation and is, therefore, largely guided by industry practice and the willingness of the seller to provide complete and accurate information in advance of a deal. In international transactions, due diligence may also be influenced by international laws, such as the Investment in Canada Act, which requires notification of and potential review by the Canadian government prior to the acquisition of a Canadian company by a non-Canadian entity.<sup>5</sup>

The seller sets the stage for the transaction by disclosing information concerning the target entity. Although the buyer may submit requests for certain information, the seller ultimately determines what information is disclosed and, therefore, what information is available to the buyer. The scope or depth of a seller's response is not a legal requirement. In most instances, therefore, a buyer's simplest response to a seller's refusal to produce information is to walk away from the proposed transaction. This

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<sup>5</sup> See, e.g., R.S., 1985, c. 28 (1<sup>st</sup> Supp.).

decision is necessarily governed by many factors, including the apparent business risks compared to the advantages inherent in closing the deal.

A due diligence review generally includes assessments of written records and files, as well as on-site visits to the seller's facilities, and discussions with various target company personnel. Records are often produced in a central location, known as a "data room," that may be no more than a hotel room or may require a document warehouse. In the alternative, a seller may permit a buyer access to files located at the seller's facilities. The buyer's review of the seller's records is generally governed by confidentiality agreements designed to ensure that the buyer will only utilize the records for the purpose of consummating a transaction and will not release the documents or use them in any manner that may harm the seller. The review primarily, and sometimes exclusively, focuses on four areas:

1. Financial statements;
2. Management and operations;
3. Legal compliance; and
4. Recordkeeping.

The financial statements review generally assesses the financial condition of the seller and confirms that stated assets, liabilities and equity exist. The management and operations review provides a snapshot of the seller's activities "on the ground" and allows a potential buyer to analyze the seller's ongoing business. The legal compliance analysis may address a range of regulatory regimes, such as: SEC regulations; Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"); Occupational Safety and Health Administration ("OSHA") regulations; state or local permit requirements; and the U.S. export regulations. This review usually permits the buyer to determine the risk of potential legal liabilities associated with the seller's past activities. The recordkeeping review addresses the condition of the seller's files and other documentation at the time of the review and for various statutory periods.

Due diligence for legal requirements under CERCLA, OSHA and SEC compliance is standard practice. In comparison, due diligence to assess a target entity's compliance with the U.S. export laws has, to date, been the exception rather than the rule. Even when some assessment occurs, it is generally "templated," rushed or lacking depth. This approach, coupled with a lack of maturity, has resulted in a number of U.S. Government enforcement actions against public and private companies.

### **C. Why is This Area "Immature" and How Do Companies Generally Approach Due Diligence in This Area?**

Due diligence is often addressed through the use of "checklists" that are designed to gather information relevant to compliance with certain regulations. For export

compliance, checklists often contain no reference to specific regulations, are untailored to the transaction at issue and lack substantive requests that would permit an accurate assessment of an entity's export compliance posture. Most due diligence checklists do not separately address export compliance, but rather incorporate what few items exist into a blanket request concerning "permits, licenses and registration." Even in instances where some degree of specificity exists, the responses to the requests are: 1) reviewed by individuals whose expertise rests in other areas; 2) not reviewed at all; or 3) reviewed but minimized due to business considerations which appear to dictate consummation of the transaction.

As a result of the lack of regulatory requirements for conducting due diligence, the review process is guided by a combination of industry practice and the recommendations of merger and acquisition attorneys, despite the recent scrutiny of this area by the U.S. Government. In many instances, these recommendations emphasize financial due diligence at the expense of areas such as export compliance and confidentiality concerns stemming from insider trading regulations, although often overstated, may also minimize the number of subject-matter experts involved in the due diligence process.

In many instances, the anticipated business advantages of a merger or acquisition appear to outweigh the incumbent risks and drive the final decision to proceed with a transaction. Ultimately, the buyer and seller attempt to account for the risks and benefits of a transaction in the terms and conditions included in the closing documents. These terms include the value of the transaction, as well as certifications, representations, warranties and indemnification provisions designed to cover the risk of future liability. The due diligence process does not inherently shift responsibility for any liabilities held by the buyer and seller prior to the transaction. For example, a failure by a buyer to recognize a particular risk during due diligence does not mean that the buyer assumes liabilities that may arise from that risk after the transaction closes. Liability is primarily determined by the terms and conditions included in the transaction documents between the buyer and the seller and by corporate case law. In some instances, the buyer requires the seller to settle all matters with the Government prior to closing the deal.<sup>6</sup> These terms, however, are based only on the information made available during the due diligence process. To the extent that a potential liability is understated or omitted, the buyer is unable to account for that risk in assessing the transaction.

#### **D. Export Compliance in Due Diligence or How to Avoid Buyer's Remorse**

Based on this background, where do the greatest risks arise for export compliance in the transaction process? In general, although each transaction is unique and requires individual assessment, the greatest risks usually arise in:

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<sup>6</sup> See *Price of Merger Deal Falls* [Lockheed Martin – Titan deal], *Defense News*, April 12, 2004.

1. the preparation of the data room;
2. the “checklists” used to collect information related to export issues; and
3. the review of any export information collected.

Each of these areas alone presents sufficiently high risks that companies should tread carefully in their representations and warranties to ensure that accuracy, knowledge and notice exist through the process. Any of the three in combination, however, create such unmanageable risks that companies need to be concerned about corporate governance and fiduciary responsibilities, as well as inherited liabilities. Recent Delaware case law highlights the extent to which these fiduciary obligations extend and the impact of those duties on board members, both personally and as corporate representatives. As a crowning touch, successor liability and *respondeat superiore* concepts also impact the risks taken. Each of these risks is discussed below.

#### 1. The Data Room and Due Diligence

The “data room” is a euphemism for the location where documents related to an acquisition or divestiture may be reviewed. Sometimes the room is in a hotel facility. Other times it is located at the target or divesting company’s site. Wherever situated, however, the data room and its contents represent one of the critical resources used during the due diligence process.

What does a data room include? While no “magic” list exists, industry practice generally results in the production of the following types of documents:

1. corporate background information;
2. management structure/personnel/organizational charts;
3. tax and related financial information, including contractual documents;
4. intellectual property materials, including patents, licensing agreements, trademarks, and trade secret data;
5. environmental and safety documents, including permits;
6. human resources and employment documents;
7. documents identifying real or personal property held by the target company;
8. insurance information;

9. authorizations or permits to conduct business; and
10. documents related to ongoing litigation or existing and pending Government investigations.

Although an isolated request related to export controls occasionally appears in a catchall category for documents concerning regulatory compliance, export compliance rarely is included as a primary area of inquiry. In each of the above categories, the specific mix of documents produced is a function of the acquiror's request and persistence and the seller's willingness to produce information. These factors may obviously be influenced by the respective parties' positions *vis à vis* the proposed transaction.

From an export perspective, therefore, what additional records should the data room contain? Whatever information is included should provide a clear picture of all technologies involved in the transaction. From the initial due diligence request forward, the potential acquiror must ensure that export compliance documentation is produced in the data room. Export documentation includes, but is not limited to: copies of export licenses; classification determinations; Shipper's Export Declarations ("SEDs"); exemption or exception records; and voluntary disclosures. Appendix 1 provides a list of sample documents as a baseline for any data room.

As described below, this information should be sufficient to permit an accurate assessment of the target's compliance program implementation, license posture before the relevant Government agencies, risk areas or compliance weaknesses and any violations that may exist at the target company. In many instances, the information that must be produced in the data room will include technical documentation that is controlled under the U.S. export laws, such as: contracts; statements of work; and technical specifications. Such information is required to assess a company's export compliance, as well as understand the substance of the target company's business, and is likely subject to separate export license requirements if the transaction includes any foreign parties. Foreign parties are not limited to the buyer or purchaser, but can include outside counsel, financial consultants, individual employees or other similar personnel involved in the deal. To the extent technical information resides in the data room, the seller should ensure, and the buyer should mandate as part of the review, that all appropriate authorizations exist to permit the due diligence. These assurances should be written and accompanied by copies of all authorizations.

In coordinating this review, companies need to be aware, therefore, that the export laws regulate even the review of documents in the data room. Issues that must be considered include:

1. If a foreign company, foreign persons, or U.S. persons representing a foreign company will review controlled technical data in the data room, export authorization must be obtained from the appropriate U.S. Government agency approving such access;

2. All persons accessing the information should be required to execute detailed non-disclosure or confidentiality agreements that incorporate export and retransfer provisions;
3. As a result of the controlled nature of information included in the data room, access control procedures, such as sign-in logs, badging or even a Technology Transfer Control Plan, may be required for the room; and
4. To comply with the U.S. export laws, and in particular the recordkeeping provisions of these laws, logs should be maintained to document who accessed the room and what information they were permitted to review.

## 2. “Checklists” – Too Little or Too Much?

The data room is generally populated in response to due diligence requests by the potential acquiror, as well as materials selected by the seller. Unfortunately, these requests often take the form of template due diligence checklists that are limited to the areas identified above. While a “checklist” approach may be useful for summarizing document requests or identifying initial areas for which responses have been received, misplaced emphasis on checklists can result in a superficial and incomplete due diligence review.

A due diligence review must be exactly that: a *review*, not a mere confirmation that a stack of documents has been produced in response to a particular request. Typically, this requires an initial analysis of general export compliance documents followed by targeted follow-up inquiries in areas that merit additional analysis. An initial request for export-related documents should include, but not be limited to, samples<sup>7</sup> of all documents that could be related to technology transfer or export transactions.<sup>8</sup>

Having received samples of these documents, the utility of the checklist approach is literally exhausted. These initial samples and any summaries provided need to be substantively analyzed to determine areas of risk and to formulate detailed follow-up requests that focus on the areas of greatest risk within an export compliance program.

As discussed below, this review should be conducted by individuals with experience in all facets of export licensing and compliance, rather than generalists who are likely only to be able to confirm that documents were produced in response to the “checklist.” Factors to be considered in this assessment include:

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<sup>7</sup> Sample documents are best requested going back for a five-year period, coinciding with the criminal and civil statute of limitations applicable to the export laws.

<sup>8</sup> See Appendix 1 for a sample list of documents.

1. The nature of the company's business: Does the company manufacture or develop technologies that are controlled under U.S. export laws? Does the company conduct a significant percentage of international sales? How is the company structured? How many and what types of international operations exist? What types of collaborative efforts exist? A dearth of export compliance documents produced by a company with a significant amount of international work should raise questions.
2. The company's workforce: Does the company employ a large number of foreign persons? Does the company maintain foreign subsidiaries? Does the company have a foreign parent which provides a portion of the company's workforce? Does the company outsource any aspect of product or technology development? Does the company participate in joint ventures and share workforces? A significant amount of foreign involvement should typically be accompanied by a sizeable number of export authorizations and a detailed compliance and recordkeeping plan.
3. The company's experience with the U.S. export laws: Does the company appear knowledgeable concerning the scope of these laws? Does the company maintain a coherent and effective compliance program? Are there knowledgeable personnel with the requisite authority overseeing and implementing the company's compliance efforts? If the company is unable to respond to the above requests for documents due to a lack of familiarity with the export laws, additional inquiry is warranted.
4. Significant gaps exist in the documents produced: Did the company fail to produce a single voluntary disclosure that was submitted to the U.S. Government? This may demonstrate a "spotless" compliance record, but more often is indicative of a meaningless compliance program, a lack of understanding of the export laws or an effort to conceal export violations. Does the company self-classify all products? Does the company conduct only computerized training in the export laws? Do job descriptions exist for personnel tasked with export responsibility?

As suggested by the above factors, the initial review should lead to follow-up questions in particular areas. Follow-up requests should focus on an assessment of all export licenses, shipping documents and other records related to specific export transactions to determine whether undisclosed violations exist. Additional requests should also seek records related to internal or external export audits conducted by the company, including the audit questionnaires, methodology and audit reports or results. To the extent that the seller refuses or is unable to produce relevant documents, this lack of information must be taken into account in considering whether to proceed with the transaction. To the extent that a transaction continues despite a seller's inability (or unwillingness) to produce complete and detailed records concerning export compliance, gaps in due diligence should be addressed in the ultimate terms of the deal:

1. The gaps should be specifically noted in the transaction agreement and linked to specific, detailed representations and warranties by the seller concerning the current state of its export compliance;
2. The seller should agree to fully cooperate in any audit, investigation or review relating to export activities prior to the closing of the transaction; and
3. The seller should resolve any existing violations prior to closing of the transaction, or, at a minimum, agree to indemnify the acquiring company for any costs, including investigation costs, fines, penalties and the costs of any mandatory, imposed compliance measures, resulting from violations of the U.S. export laws that occurred prior to the closing of the transaction. Indemnification should include the establishment of an escrow account and a related clause to address any potential fines, legal fees, and associated costs.

### 3. Who's Reviewing Your Export Information?

The reviewer is as crucial to a successful due diligence effort as the documents themselves. Companies seek legal advice, or any type of advice for that matter, from experts in the field. In the same way that a company would not seek out tax experts to draft patent applications, due diligence relating to export compliance should be conducted by individuals with expertise in the field. It is, therefore, helpful, if not imperative, that the due diligence process include, from the beginning, legal experts competent to assess the export compliance risks of the transaction. The merger and acquisition team, therefore, should include an expert in the field of export compliance. This expert should be involved from the outset of the proposed transaction – from the formulation of initial due diligence requests through the final assessment of the terms of the transaction, to ensure that export compliance issues are adequately, and correctly, reflected in the terms of the deal. Absent such expertise, a blockbuster acquisition may result not only in profitable synergies between two companies but also in the unwitting acquisition of millions of dollars in export liability and Government-imposed corrective action.

### **E. Conclusion – *Caveat Emptor***

As demonstrated by recent settlements between acquiring companies and the Departments of State and Commerce, the U.S. Government has signaled its intention to aggressively impose successor liability on the basis of export violations that precede mergers and acquisitions. Based on the international regulations that govern corporate transactions, it seems likely that other governments will follow the U.S. Government's lead and increase their focus on such transactions, particularly in light of the significant impact of these transactions on technology transfer. In the context of export compliance, companies face a strict liability regime in the civil context in the U.S. that is unforgiving towards lax due diligence. Combined with the current wave of prosecutions

and litigation based on allegations of corporate misgovernance, the stakes are high anytime a company considers a merger or acquisition. The heightened level of risk in this area mandates that export compliance be included in the due diligence process as part of informal acquisition decisions, including through the terms and conditions of a deal. Similarly, the benefits of such due diligence will accrue not only to companies in the form of reduced risk and liability but also to the public at large as governments better monitor the spread of potentially dangerous technologies.

## APPENDIX 1

### SAMPLE EXPORT DOCUMENTS TO BE REQUESTED DURING DUE DILIGENCE

1. Copies of the last five years (the five-year requirement applies to all the requests) export licenses, divided by agency (e.g., Department of State, Department of Commerce, Office of Foreign Assets Control);
2. Copies of correspondence between the exporter and the U.S. Government licensing agencies, divided by license;
3. Copies of correspondence with the Department of Defense concerning any proviso interpretation, reclama or implementation information divided by license;
4. Copies of exemption logs and data transferred pursuant to those exemptions, for International Traffic in Arms Regulations (“ITAR”) § 123.26 purposes;
5. Copies of exception logs and data or technology transferred pursuant to those exceptions, for Export Administration Regulations (“EAR”) § 762.2 purposes;
6. Copies of all voluntary disclosures and their resolution, including compliance requirements, fines, audit reports and related penalties, divided by licenses to which they relate (if applicable);
7. Copies of all correspondence from the U.S. Government (including Customs) concerning directed or other enforcement actions (such as seizures, detentions, petition process releases);
8. List of all foreign national employees, including names, visa numbers, job titles, contact numbers and related licenses, exemptions or exceptions applicable to these employees’ controlled activities;
9. Copies of I-9s for all technical, scientific or engineering employees;
10. Job descriptions for all technical, scientific or engineering employees;
11. Employee numbers (or other tracking numbers used for keeping time);
12. Copies of procedures for computer access for all foreign national employees and a list of computers to which each employee has access;
13. Printout of the technical databases to which foreign nationals have or can have access;

14. Copies of initial screening performed on international shipments and foreign national employees;
15. Copies of U.S. Government contracts which involve cooperative efforts or subcontracts with foreign parties;
16. Copies of any outsourcing agreements;
17. Copies of distributor agreements and cooperative effort agreements;
18. Copies of the divesting company's last five years of export audits (preferably conducted by independent source, otherwise audits conducted by internal audit);
19. Copies of letters submitted to State under ITAR § 123.22(d) to indicate the first export of technical data; and
20. Copies of letters submitted to State returning licenses/authorizations that have been expended, expired, used, suspended, or otherwise are no longer valid.

## **APPENDIX B**

## **APPENDIX C**