

ADVANCED CORPORATE COMPLIANCE

UNITED STATES EXPORT LAWS:  
UNIQUE APPLICATIONS AND PRACTICAL IMPLICATIONS REVISITED

Giovanna M. Cinelli, Esquire  
Partner  
Patton Boggs, LLP

## **United States Export Laws: Unique Applications and Practical Implications Revisited**

Ask most individuals and industry representatives and they will know that moving goods or commodities out of the United States likely needs an authorization from the U.S. Government prior to shipment. A fair number of those individuals will also know that the primary U.S. Government agencies involved in the process include the Departments of State, Commerce and Defense. A smaller group will be able to identify the types of authorizations that apply in the context of physically moving these goods and commodities from one destination to another. But query the same groups about the need for authorizations to hire an employee who is not a U.S. citizen or to conduct due diligence for an acquisition or to litigate against a foreign company, and fewer than a handful will be aware of the export authorizations required for each of these activities.

At the July 2003 Advanced Corporate Compliance conference, these issues were raised and reviewed. Within the last year, a number of legislative and regulatory changes have occurred, each impacting the materials presented in 2003. This chapter now revisits those unique circumstances where U.S. export laws apply outside the scope of the physical shipment of goods and commodities to foreign destinations and identifies shifts in priorities and other changes.

The statutes which govern most export activity remain the same. The primary laws that apply include:

1. the Arms Export Control Act, 22 U.S.C. §§ 2778 *et seq.* ("AECA"), and its implementing regulations, the International Traffic in Arms Regulations ("ITAR"), 22 C.F.R. §§ 130 *et seq.*; and
2. the Export Administration Act of 1979, as implemented through Executive Order and the International Emergency Economic Powers Act, 50 U.S.C. App. §§ 1701 *et seq.*, and its implementing regulations, the Export Administration Regulations ("EAR"), 15 C.F.R. §§ 730 *et seq.*

Additional laws include the Trading with the Enemy Act, the Customs Modernization Act, the Bureau of Alcohol, Tobacco and Firearms Regulations, and the Atomic Energy Act. This chapter will focus primarily on the unique issues raised under the AECA, the ITAR, and the EAR, since those authorizations affect over 90% of trade conducted today. For ease, this chapter is organized in outline form.

### **PRACTICAL ISSUES**

- I. Export Requirements Apply Broadly
  - A. Apply to the physical shipment of goods outside the United States
  - B. Apply to the transfer of "intangibles" in whatever context - *e.g.*, technical discussions with foreign nationals in the United States under visa

authorizations or the transmission of technical specifications by electronic mail, facsimile, or voice mail message;

- C. Apply to "assistance" provided to foreign nationals or individuals representing foreign nationals - e.g., training a foreign national overseas or in the United States in the use of a particular good, piece of equipment or software program;
  - D. Apply to the transshipment of goods or technology through other countries - e.g., a commodity destined for final export to the United Kingdom is shipped first to Canada, then Gibraltar and finally the United Kingdom; and
  - E. Apply to the contracts obtained between companies and various parties, including the United States Government, foreign governments, universities, laboratories, private companies, public companies, foundations, trusts, or individuals.
- II. Conflicts in policy create implementation difficulties in the more esoteric areas where U.S. export laws apply: e.g., the transfer of intangibles among parties whether in the United States or abroad.
- A. Conflicts center primarily around jurisdictional issues
    - 1. Does the Commerce Department control the item, technology or transfer?
    - 2. Does the State Department control the item, technology or transfer?
    - 3. Do both agencies control the transfer?
    - 4. Does no one control the transfer? If not, is it due to:
      - a. An oversight; or
      - b. Duplicative controls with no clarity? See GAO-02-120, *Export Controls: Clarification of Jurisdiction for Missile Technology Items Needed* (October 9, 2001).
  - B. Resolution of jurisdictional conflicts:
    - 1. State jurisdictional determinations pursuant to the ITAR are considered binding on both State and Commerce;
    - 2. Commerce jurisdictional determinations pursuant to the EAR are not considered binding on more than the Commerce Department;
    - 3. Jurisdictional conflicts are sometimes resolved through the National Security Council, as was ostensibly accomplished in the matter of controls over "satellite related items," such as traveling wave tubes, solar arrays, and solar cells. The Department of State, however, inconsistently determines jurisdictional controls. See, e.g., 69 Fed. Reg. 873 (Jan. 7, 2004) (jurisdictional shift of military item – QRS11

inertial navigation system chip – to Commerce Department control based on end-use).

### III. Enforcement

- A. State: Enforcement is pursued vigorously by the Department, although the "judge" and "jury" exist within the same directorate. An administrative process exists, under 22 C.F.R. § 128, through which companies may be charged and civilly "prosecuted," but to date, only two cases have resulted in the issuance of charging letters and none has proceeded through the Part 128 process beyond the issuance of a signed charging letter. As with most enforcement actions, one of the key determinations in proceeding is the impact of the alleged violations on U.S. "national security" or "U.S. interests." Of interest to industry is the expansion of enforcement actions beyond the traditional "shipment of goods" scenarios into the acquisition context. Of concern is the State Department's broad approach to successor liability in the export area. See Appendix A.
- B. Commerce: Also enforces the regulations vigorously and maintains an administrative process through 15 C.F.R. § 766. Unlike the State Department process, Commerce has conducted a number of proceedings through Administrative Law Judges and civilly "prosecuted" several companies and individuals. As with State, one of the pillars of enforcement actions revolves around the impact of the alleged violations on U.S. "national security" or "U.S. national interests." As with State, Commerce has also expanded its enforcement reach into the "nontraditional" area of acquisitions. *Id.*
- C. Defense: Although the Defense Department is not a "licensing" or "enforcement" agency under the export laws, it plays a critical role in both processes for determining what constitutes "national security" and the impact on that security. As with most processes that are policy oriented and subjective, the definition of "national security" is not static nor readily definable. The definition all depends on the circumstances of the actions being reviewed.

- IV. Globalization within and among industries has expanded the scope, reach and impact of liability deriving from export laws and decisions made under those laws.

### **UNIQUE CIRCUMSTANCES**

With the background provided above, this section of the chapter highlights those areas where individuals may not readily apply the export laws. Although constantly changing, this chapter identifies what may be considered today's "Top Ten Legal Issues Under U.S. Export Laws." The issues are divided between the two primary governing agencies: State and Commerce. The chart below presents the issues, followed by an outline of information on each section:

**“TOP TEN” LEGAL ISSUES  
UNDER THE EXPORT LAWS**

<b>STATE/ITAR</b>	<b>COMMERCE/EAR</b>
1. Foreign national licensing	1. “Deemed” exports: employees, interns, students
2. Due diligence in acquisitions	2. Overlapping jurisdiction (State, Commerce, OFAC)
3. Technical Data and Product Classification	3. “Fundamental” research
4. Use of DFOISR releases as license exemption	4. Mandatory flowdown clauses for foreign national licensing
5. When is a “U.S. Person” not a “U.S. Person”	5. Commerce classification process <i>versus</i> State commodity jurisdiction review
6. Registration due diligence	6. Acquisition due diligence
7. Technical data pitfalls	7. LEAP initiative
8. Canadian exemption	8. Antiboycott requirements
9. The meaning of a defense service	9. Reporting
10. Litigation/Arbitration licensing	10. FOIA and EAA legislation

In addition to these issues, three common legal issues exist, regardless of which U.S. Government agency or export law applies:

1. Recordkeeping requirements;
2. Audits; and
3. Industry-University collaborations.

These issues are reviewed first, followed by select legal issues.

I. Common Legal Issues

A. Recordkeeping

1. Biggest weakness with greatest impact
  - a. Few or inconsistent records
  - b. Conflict within company policies – e.g., 90 day retention policy for e-mails *versus* five year recordkeeping requirements
  - c. Too many records
  - d. Records not readily available (e.g., unable to retrieve within 48 hours)

- e. No definitions of what is to be maintained
- f. Records destroyed willfully

## B. Industry-University Collaboration

1. Frequently used for concept studies, testing, prototype development, part of U.S. Government contracts or other similar activities
2. University participation is a profit-making venture for the academic institution
3. Industry, at a university's urging, treats the academic institution differently than other for-profit partners
4. Licensing, foreign nationals, scope of the activity, and a university's claims of academic freedom represent major challenges
5. Universities should be contractually subject to the same export requirements as any other collaborator or entity:
  - a. Mandatory export compliance clause
  - b. Mandatory, annual certifications regarding foreign nationals
  - c. Indemnification for violations
  - d. Clear definition of "public domain," "publicly available," and other "open source" activities
  - e. Clearly defined nondisclosure provisions
  - f. Clearly defined classification for the products, data or technology under the collaborative effort
6. Recent studies confirm:
  - a. The application of U.S. export laws to the university setting
  - b. That violations occur within the university context
  - c. That export clauses identifying the classification of technology need to be included in contract documents

*See Export Controls: Export-Controlled Technology at Contractors, University and Federally-Funded Research and Development Center Facilities, D-2004-061, Department of Defense, Office of the Inspector General, March 25, 2004*

## C. Audits

1. Scope of Audits
  - a. Type
  - b. Purpose
  - c. Results
  - d. Protection

2. Key Concerns Addressed by Audits
  - a. Due diligence analyses for acquisitions and divestitures
  - b. To continue to conduct business in a legally compliant manner
  - c. To satisfy the SEC on due diligence exercised in matters materially or substantially affecting the company
  - d. To persuade U.S. Government agencies to refrain from or cease investigations into international activities
  - e. To establish a course of conduct sufficient to respond to allegations of “breaches of fiduciary responsibility”
  - f. To provide legally sufficient information for Board of Directors’ meetings, reports, or presentations so that courses of conduct can be adequately justified
  - g. To implement corrective action for violative activities or procedures
3. Types of audit
  - a. Due diligence audits
  - b. Compliance audits
4. Possible auditors
  - a. Internal auditors
  - b. In-house counsel
  - c. Outside counsel
5. “Choice of auditor” issues
  - a. Self-evaluative privilege issues
  - b. Work product issues
  - c. Methodology of review
  - d. Factual role
  - e. Consultative role
  - f. Future witnesses
  - g. Type of corrective action needed
  - h. Voluntary self-disclosures
6. Due diligence audits during acquisitions or divestitures
  - a. Counsel consultation
  - b. Legal and financial liability is key: successor liability theories apply
  - c. Purpose: to determine the scope of export authorizations in place, while assessing the compliance and licensing posture of the potential target:

- i. To analyze a company's international business transaction base against regulatory requirements
  - ii. To assess potential export violations and liabilities for valuation purposes
  - iii. To negotiate price for acquisitions and/or divestitures
  - iv. To assess limits of liability, if any
  - v. To establish escrow accounts for fines, penalties, and associated legal fees
  - vi. To determine the *true* scope of international business by calculating the dollar value for which international transfers are authorized
- d. Limitation: the review is primarily driven by the seller and could result in gaps in information which adversely affect analysis
- e. Utility: provides justification for seeking certifications, indemnification, correction of problems before closure of any deal, and price adjustments. Helpful in:
- i. Liability allocation
  - ii. Proper valuation
  - iii. Correcting deficiencies pre-acquisition
  - iv. Negotiating settlements for liability
  - v. Meeting SEC due diligence standards
  - vi. Predicating or delaying deal closure until any violations or deficiencies are completely settled with the U.S. Government
- f. Elements:
- i. Identify entity to be acquired/divested
  - ii. Identify entity's assets and corporate structure
  - iii. Coordinate strategy with counsel, underwriters, financial analysts
    - (a) Determine scope of review
    - (b) Assess work product, privilege and disclosure issues
  - iv. Establish threshold regulatory standards
    - (a) Identify applicable regulations – *i.e.*, ITAR
    - (b) Identify “mandatory” and “precatory” requirements
    - (c) Identify potential penalties

- v. Develop specific lists of questions needed to determine issues which may exist under the relevant laws
- vi. Identify documents to be requested and reviewed
- vii. Identify, with specificity, all relevant international activities
- viii. Obtain proper export authorizations to conduct appropriate technical due diligence
- ix. Analyze each transaction against applicable standards
- x. Draft analysis of findings and conclusions
- ix. Assess valuation/price/structures issues for liability or purchase purposes

7. Compliance audit

- a. Comprehensive analysis of export/import activities
- b. Legally-oriented
- c. Purposes:
  - i. To determine whether a company's export compliance program meets the threshold requirements of the ITAR
  - ii. To uncover noncompliant transactions
  - iii. To investigate noncompliant transactions
  - iv. To institute corrective action based on noncompliant activities
  - v. To provide a basis for an initial voluntary disclosure to State (precedes an investigation)
- d. Offers degree of mitigation:
  - i. Mitigation: actions taken by individuals or corporate entities which limit the "damage" inflicted by violative or criminal conduct
  - ii. Discretionary: the U.S. Government retains discretion to accept or reject mitigation for purposes of reducing fines or penalties
- e. Establishes reasonableness of approach towards compliance as mandated by U.S. Sentencing Guidelines for effective compliance programs:
  - i. § 2M5.1
  - ii. § 2M5.2
  - iii. § 8A1.2(3)(k)

f. Establishes justification for “good corporate conduct,” as defined by new standards under Sarbanes-Oxley

g. Elements:

i. Coordinate strategy with counsel

ii. Determine facility product/technology mix:

(a) Comprehensive

(b) Focus on technical data, know-how, technology, collaborative exchanges

iii. Identify services, collaborative arrangements, exchange programs, ongoing training and other similar activities (See Appendix B)

iv. Establish applicable threshold regulatory standards:

(a) Identify appropriate regulations – *i.e.*, ITAR

(b) Identify “mandatory” and “precatory” requirements

(c) Identify potential penalties

v. Identify company policies involving export controls – *e.g.*:

(a) Export/import

(b) Use of consultants and/or foreign agents

(c) Trade shows

(d) Symposia

(e) Exchange programs for technical staff

(f) Limits on teaching advanced technical subjects

(g) Hand-carrying technical information or software

vi. Develop procedures regulations matrix – *e.g.*:

	§ 122.5	§ 126.13
Procedure 1	Y/N	Y/N
Procedure 2	Y/N	Y/N
Procedure 3	Y/N	Y/N

vii. Compare procedures to the regulations to determine whether the regulatory requirements are met:

(a) Legal analysis

(b) Procedural and/or other voluntary disclosure material

- viii. Review specific transactions, records, and documents to determine how the procedures are implemented:

Example: ITAR § 122.5 requires companies to maintain export-related records for five years. Identify ten (10) transactions out of 50 and examine all documentation related to those transactions. Repeat the process going back five years to determine whether the § 122.5 recordkeeping requirements were reasonably met.

- ix. Initially notify State of activities which will be investigated (mitigation)
- x. Implement *initial* corrective action to address deficiencies prior to completing an investigation
- ix. Follow-on investigations

## II. Select Legal Issues

### A. Department of State, Directorate of Defense Trade Controls (AECA/ITAR)

#### 1. Foreign nationals – licensing and limitations

- a. Define who fits within this category
- b. Assess the immigration status of the individual
- c. Obtain current, appropriate immigration information for each foreign national
- d. Determine the scope of employment and duties expected of the individual
- e. Determine the scope of any exemptions that apply
- f. Determine appropriate export licensing
- g. Obtain a signed nondisclosure agreement
- h. Confidentiality
- i. Economic Espionage Act of 1996
- j. State license *versus* Defense implementation
- k. Multi-party licensing
- l. Multiple citizenships

#### 2. Classification

- a. Commodity jurisdiction process
- b. Classifies products and intangibles
- c. Due diligence for technical parameters
- d. Binding on U.S. Government, but sometimes limited
- e. Foundation for licensing determinations and subsequent liability
- f. Direction of jurisdictional transfers – focus on end-use of product, as opposed to inherent product capabilities

3. Use of Directorate for Freedom of Information and Security Review (“DFOISR”) releases as license exemption
  - a. Use of the DFOISR process to release technical data without an export license
  - b. Limits of the release process
  - c. Applicable ITAR exemptions
  - d. “Confidential and proprietary” legend
  - e. Scope of the release
  - f. Interrelationship between DFOISR, export laws and other Department of Defense directives
  - g. Legal implications under the export laws
4. Litigation/Arbitration licensing
  - a. Export laws apply in a litigation/arbitration/mediation context whenever technical information, products or technology are at issue. Export authorizations are required for:
    - i. Lawyers
    - ii. Arbitrators
    - iii. Staff
    - iv. Foreign parties
    - v. Courtroom personnel
    - vi. Technical experts
  - b. Licenses are required to:
    - i. Retain foreign counsel
    - ii. Handle intellectual property or other litigations involving controlled goods, technology or technical data
    - iii. Take depositions, exchange documents and/or respond to interrogatories, pleadings or motions
    - iv. Exchange data or hold discussions with U.S. parties acting in a representative capacity (*i.e.*, brokers)
  - c. Contexts where issues arise:
    - i. Presentation of technical data in intellectual property licensing or litigation context
    - ii. Breach of contract suits based on technically defective product
    - iii. Noncompete situations where employees are accused of taking proprietary information

- iv. Government contract suits involving the Departments of Defense or Energy, Nuclear Regulatory Commission or the military services
  - v. Insurance claims in the satellite and launch industries
  - vi. Preparation of technical experts who are not U.S. citizens or U.S. permanent residents
- d. Practical aspects:
- i. Protective orders
  - ii. Control plans
  - iii. Monitoring by the U.S. Government
5. Technical data pitfalls:
- a. Issues arise primarily under the ITAR whenever parties transfer “intangibles,” such as technical data
  - b. Broad definition of technical data – includes “information, . . . which is required for the design, development, production, manufacture, assembly, operation, repair, testing, maintenance or modification of defense articles.” It also includes “information covered by an invention secrecy order” and software directly related to a defense article.
  - c. The most common technical data pitfalls occur under the following ITAR sections:
    - i. § 120.9
    - ii. § 123.22(d)
    - iii. § 123.26
    - iv. § 124.2
    - v. § 125.4(b)(1)
    - vi. § 125.4(b)(3)
    - vii. § 125.4(b)(13)
    - viii. § 125.5(c)
    - ix. § 125.6
    - x. § 126.6(c)
    - xi. § 126.8
    - xii. § 129
6. The meaning of “defense service” – ITAR § 120.9
- a. To “furnish assistance:”
    - i. Manufacturing context – requires manufacturing license agreement
    - ii. Subcontracting context – requires licenses or technical assistance agreements (“TAAs”)

- iii. Customer/purchaser context – requires licenses or TAAs
  - iv. Litigation context – requires licenses or TAAs
- b. Scope of “assistance” – what does it mean and how is it practically defined?
  - c. Defense services with technical data
  - d. Defense services with “public domain” information – ITAR § 124.1(a). *See also Loral Settlement Agreement (2002); Boeing/Hughes Settlement Agreement (2003); and MultiGen-Paradigm/Computer Associates Settlement Agreement (2003)*
7. When is a “U.S. Person” not a “U.S. Person”?
- a. Definition: ITAR § 120.15 – definition of U.S. person  
ITAR § 129.2 – definition of broker
  - b. Consultants, technical reviewers, facilitators
  - c. Representations, warranties and certifications
    - i. Registration
    - ii. Maintains a compliance program
    - iii. Is in compliance with U.S. export laws and regulations
    - iv. Is eligible to receive licenses
    - v. Not currently under investigation
    - vi. Annual certification
    - vii. Description of representative status

B. Department of Commerce Bureau of Industry and Security

1. “Deemed” exports – an export, whether tangible or intangible, to a foreign national, whether in the United States or abroad, is “deemed” to be an export to that national’s home country. EAR §§ 734.2(a)(1), (a)(2)
- a. Applies whether under licenses or exceptions
  - b. If licensed, requires control plan for technology release
  - c. Comprehensive deemed export licenses:
    - i. Judgment on Commerce Control List (“CCL”) controlled items, nondisclosures, technology and implementation within company purview
    - ii. Training of foreign nationals
  - d. Annual certifications from foreign nationals involved in “deemed” exports
  - e. Due diligence concerning immigration status of foreign nationals

- f. Special concerns in hiring foreign national interns or students:
    - i. Immigration requirements imposed on students and universities/institutions of higher learning
    - ii. Accountability for work performed
    - iii. Reexport concerns
  - g. *U.S. v. Silicon Telecom Industries*, indictment (2000), trial (2001)
2. Commerce classification process *versus* State commodity jurisdiction (“CJ”) review
    - a. Process used depends upon degree of risk in classifying products and/or technology
    - b. Depends upon Congressional mandate: Congress periodically classifies products and legislatively determines jurisdiction – *e.g.*, satellites
    - c. State CJ provides greater degree of certainty
    - d. “Parsing” product capabilities is not recommended
    - e. “Head-in-the-sand” approach is inappropriate, especially for sophisticated exporter
  3. Overlapping jurisdiction
    - a. Where is the line drawn between “dual-use” military and “defense article” military?
    - b. What is the impact of parts, components, payload and other comparable items being added to a dual-use item?
      - i. Multiple licenses from multiple agencies
      - ii. Flowdown requirements for classification, notice and licensing to subcontractors and/or other third parties
  4. “Fundamental” research
    - a. Definition – EAR § 734.8(a)
    - b. Arises frequently in the industry-university context
    - c. Requires precise understanding of the concept of “fundamental” or “university-based” research when compared to “applied” research
    - d. Requires coordination with intellectual property (“IP”) personnel to ensure consistency in approach between export requirements and IP protections
    - e. Requires recordkeeping to support conclusion of “fundamental” nature of research
    - f. Subject to license reviews

5. Antiboycott requirements

- a. Regardless of stated policy changes from Middle East governments, boycott requests still exist
- b. High risk areas:
  - i. Letters of credit
  - ii. Appointments of forwarders
  - iii. Contracts and/or side agreements
  - iv. Representations clauses
  - v. General negotiating correspondence

## **APPENDIX A**

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

**THE HIGH PRICE FOR INADEQUATE  
EXPORT CONTROL DUE DILIGENCE  
DURING MERGERS, ACQUISITIONS OR DIVESTITURES**

Giovanna M. Cinelli<sup>1</sup>

Jeremy K. Huffman<sup>2</sup>

In recent years, the face of the defense industry has changed radically as a result of a wave of mergers, acquisitions and divestitures. During this same period, the U.S. government, and in particular the Department of State (“Department” or “State”), has exhibited an increasing willingness to examine such transactions to identify past export violations committed by the target company and continuing violations that may carry over after the acquisition or merger. In a number of instances, acquiring companies have been held strictly liable, in a successor capacity, for violations that occurred prior to the transaction, and State has indicated that it intends to continue to aggressively impose such liability on the basis of acquisitions and mergers.<sup>3</sup> Each of these settlements involved the payment of significant fines and the imposition of mandatory compliance measures by the government on acquiring companies that did not themselves violate the U.S. export laws. These significant settlements stemmed entirely from violations committed by the acquired, or target, corporation prior to the acquisition.

In light of the Department’s increasingly aggressive focus on such transactions, and the current government feeding frenzy associated with prosecutions for corporate governance issues, corporations must recognize 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 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.

**A. Due Diligence**

Mergers, acquisitions and divestitures typically begin as a glimmer in the eye of business personnel who identify potential synergies between companies. This glimmer

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<sup>1</sup> Partner, Patton Boggs, LLP. Ms. Cinelli chairs the Firm’s Export Compliance Group and the Technology Transfer, National Security and Homeland Security Practice Group.

<sup>2</sup> Associate, Patton Boggs, LLP. Mr. Huffman is also a member of the Firm’s Export Compliance Group and Technology Transfer, National Security and Homeland Security Practice Group.

<sup>3</sup> See Commerce Department Settlement with Sigma Aldrich (Nov. 4, 2002) and State Department Consent Agreements involving EDO Corporation (Nov. 24, 2003); MultiGen-Paradigm, Inc. (Sept. 24, 2003); Agilent Technologies Inc. (Aug. 20, 2003); and Hughes Electronics Corp./Boeing Satellite Systems, Inc. (March 4, 2003).

develops into discussions between an acquirer and a seller or target concerning the potential transaction. As discussions progress:

1. the execution of a letter of intent (“LOI”) and confidentiality agreement setting the terms for the proposed transaction occurs;
2. due diligence (e.g., discussions with target personnel and intense document review) is conducted to assess the proposed transaction; and
3. the negotiation of closing documents establishing the terms and conditions of the transaction takes place.

The structure of a merger, acquisition or divestiture, 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 (e.g., acquisition, merger, asset sale, stock swap);
2. the type of business (e.g., product manufacturer, financial institution, service provider);
3. the size of the companies involved; and
4. whether the target company is publicly or privately owned.

For example, stock sales generally result in greater assumed liability for the buyer while, in asset sales, the buyer is typically not liable for the debt and legal liabilities of the seller.<sup>4</sup> Likewise, product manufacturers often have greater legal exposure than service providers as a result of potential product liability. Mergers and acquisitions involving large, public companies generally result in more sophisticated letters of intent and acquisition agreements than those transactions involving small, private companies. Conversely, however, public companies are required to regularly disclose certain financial information as a result of their public status, e.g., Securities and Exchange Commission (“SEC”) SEC 10K, 10Q, while private companies face no similar SEC disclosure requirements.

Fundamentally, however, the due diligence process and final terms of a transaction are dictated by the two parties involved. A buyer’s decision whether to proceed with a transaction, and the ultimate terms of the deal, are necessarily premised on the

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<sup>4</sup> See *Golden State Bottling Co., Inc. v. N.L.R.B.*, 414 U.S. 168, 182 n.5 (U.S. 1973) (“ . . . the general rule of corporate liability is that, when a corporation sells all of its assets to another, the latter is not responsible for the seller’s debts or liabilities, except where: (1) the purchaser expressly or impliedly agrees to assume the obligations; (2) the purchaser is merely a continuation of the selling corporation; or (3) the transaction is entered into to escape liability”).

information provided by the seller during the due diligence process. Due diligence consists of the buyer's review of the seller's business sufficient to permit the buyer to assess, at a minimum: the benefits to be gained from a proposed transaction; the existing liabilities across a broad legal spectrum; and the appropriate valuation of the target entity. If a seller is unwilling to provide comprehensive information concerning the target company, the buyer must make a decision whether:

1. to proceed with the transaction and attempt to address potentially unknown risks in the closing documents; or
2. "walk away" from the deal.

The due diligence review, therefore, forms the foundation for the entire 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**

Due diligence typically begins with the exchange of a 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 statutes and regulations 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 transaction.<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 only response to a seller's refusal to produce information is to walk away from the proposed transaction. This decision is necessarily governed by many factors, including the apparent business risks and advantages inherent in the transaction.

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

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<sup>5</sup> In international transactions, due diligence may also be influenced by international laws, such as the Investment 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. See, e.g., R.S., 1985, c. 28 (1<sup>st</sup> Supp.).

“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 seller’s records is governed by extensive confidentiality agreements designed to ensure that the buyer will only utilize the records for the purpose of due diligence and will not release the documents or use the documents in any way that may cause harm to 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 review of financial statements is designed to assess the financial condition of the seller and confirm 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 review of legal compliance may address a range of regulatory regimes, including: 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. The legal compliance review is generally intended to permit 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.

In the context of due diligence, the review of areas such as 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. This lack of maturity has resulted in a number of U.S. Government enforcement actions against public and private companies (see footnote 3). Due diligence is often addressed through the use of “checklists” that are designed to gather information relevant to compliance with certain regulations. With respect to 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 may exist, 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. In many instances, these recommendations emphasize financial due diligence at the expense of areas such as export compliance. Confidentiality concerns stemming from insider trading regulations, although often overstated, also may minimize the number of individuals involved in the due diligence process and the participation of certain subject-matter experts.

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.<sup>6</sup> In some instances, the buyer requires the seller to settle all matters with the Government prior to closing the deal.<sup>7</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 the liability in assessing the transaction.

### **C. 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:

1. the preparation of the due diligence 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 need to 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, so unduly

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<sup>6</sup> 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.

<sup>7</sup> See *Price of Merger Deal Falls* [Lockheed Martin – Titan deal], Defense News, April 12, 2004.

create unmanageable risks that companies need to be concerned about corporate governance and fiduciary responsibilities. 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” centralized and published 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; and
9. documents related to ongoing litigation or existing and pending Government investigation.

Although an isolated request related to export controls occasionally appears in a catch-all 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 document 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 a vis* the proposed transaction.

The information produced in the data room will form the foundation for the entire due diligence effort, the decision whether to consummate a transaction and the fundamental terms of any deal. From the initial due diligence request forward, the potential acquiror must ensure that export compliance documentation is produced in the 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 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.

In coordinating this review, companies need to be aware 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. Unfortunately, these requests often take the form of a 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 review. An initial request for export-related documents should include, but not be limited to, samples<sup>8</sup> of the following:

1. Copies of the last 5 years<sup>9</sup> 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 USG 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 exceptions, 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 USG (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 foreign national employees;
10. Job descriptions for all foreign national employees;

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<sup>8</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>9</sup> The 5-year requirement applies to all the requests.

11. Employee numbers (or other tracking numbers used for keeping time) for all foreign national employees;
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 US Government contracts which involve cooperative efforts or subcontract with foreign parties or restrict access or work by foreign nationals;
16. Copies of any outsourcing agreements (such as computer maintenance, computer management, temporary personnel);
17. Copies of distributor agreements and cooperative effort agreements;
18. Copies of the divesting company's last 5 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.

Having received samples of these documents, the utility of the checklist approach is exhausted. These initial samples and any summaries provided need to be substantively reviewed to determine areas of risk and to formulate detailed follow-up requests that focus on the areas of greatest risk in 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:

1. The nature of the company's business – does the company manufacture or develop technologies that are rigorously controlled under U.S. export laws and does the company conduct a significant percentage of

international sales? 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 or 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? 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 the laws and appear to maintain a coherent and effective compliance program? 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. Do significant gaps exist in the documents produced? For example, 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.

As suggested by the above factors, the initial review should lead to follow-up questions in particular areas. Follow-up requests should focus on a review of export licenses, shipping documents and other records related to specific export transactions to assess 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 to or is unable to produce relevant documents, this lack of information must be taken into account in considering whether to proceed with the transaction.

Other areas that often require detailed review include:

1. Unshipped balances on export licenses that will transfer to the acquiring company;
2. Outdated registration statements with the Department of State under the ITAR;
3. Export recordkeeping that is not in compliance with the provisions of the ITAR and the EAR;

4. OFAC and antiboycott licensing and compliance;
5. Erroneous or unsupported classification of company products; and
6. Failure to document and license foreign person employees.

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 or escrow account and related clause to find 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.

### **C. 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. In the context of export compliance, companies face a strict liability regime in the civil context that is entirely 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 and inform acquisition decisions, including the terms and conditions of a deal. In other words, the merger and acquisition area is today, more than ever before, a situation where the buyer must beware.