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FOREIGN TRADE CONTROLS

Successor Liability

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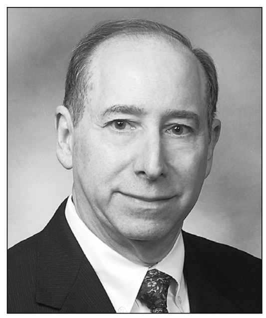

CORPORATE COUNSEL have become increasingly aware of the significant liability that can arise from acquisitions of businesses that have violated U.S. foreign trade controls—export controls, economic sanctions, anti-boycott measures or the Foreign Corrupt Practices Act (FCPA). In acquisitions of stock or assets, the performance of a due-diligence review should help to identify potential undisclosed liabilities so that the buyer can consider their possible effect on the acquisition or, at least, the purchase price. However, U.S. law applicable to foreign trade controls introduces some unique issues that require planning before the acquisition closes or immediately afterward. For counsel in both U.S. and non-U.S. companies, the key question is: What steps should we take to identify, minimize and manage the risk both before and after the acquisition?

Sigma-Aldrich settlement is an important precedent

To respond to that question, it is necessary to review the background of this enhanced concern with successor-liability issues. The recent emphasis traces its origins to the settlement by the U.S. Department of Commerce's Office of Export Enforcement with Sigma-Aldrich Corp. in November 2002. Sigma-Aldrich and two of its subsidiaries agreed to pay a $1.76 million civil fine to settle charges arising from the unauthorized export of biological toxins, none of which led to biological weapons-related uses. Sigma-Aldrich challenged the authority of Commerce to impose penalties because the acquisition arguably was an assets acquisition. In a ruling that was not appealed, an administrative law judge (ALJ) refused to dismiss the charges based on his reading of the broad definitions in the International Emergency Economic Powers Act and the federal rules of statutory construction.

The ALJ also concluded that state law supported imposing successor liability even for an assets acquisition if there was "substantial continuity" of the business of the assets purchased. The ALJ found grounds to infer the requisite knowledge of potential wrongdoing on the part of the acquirer based, in part, on the post-closing violations by the managers who continued to operate the business after the assets transfer. Further, the ALJ seemed to believe that the terms of the acquisition involved more than an assets transfer and possibly an effort to avoid the assumption by the acquirer of preclosing liabilities.

In settling *Sigma-Aldrich*, the undersecretary of commerce for industry and security stated that "corporations will be held accountable for violations of U.S. export control laws committed by companies that they acquire." Since the *Sigma-Aldrich* case, the Commerce Department's Bureau of Industry and Security and the State Department's Directorate of Defense Trade Controls have settled a number of successor-liability cases. For example, in early 2005, the departments of State and Homeland Security reached a settlement of their claims for export violations against General Motors Corp. as well as against General Dynamics Corp. as the "legally liable successor" to certain defense businesses that it acquired from GM. GM paid a $10 million fine to resolve charges that included unauthorized disclosure of U.S. Munitions List technical data to foreign-national employees and agreed to devote $5 million to enhanced compliance. General Dynamics agreed to spend $5 million over five years for export compliance enhancement directed at the acquired GM units.

The Treasury Department's Office of Foreign Assets Control administers a number of economic sanctions programs under which it also could rely upon successor liability to impose penalties for preclosing violations of acquired entities. The Justice Department and the Securities and Exchange Commission have also applied successor liability in enforcing the FCPA.

While there are several unresolved issues raised by these successor-liability enforcement cases, particularly as they involve asset purchases, U.S. and non-U.S. companies engaged in acquisitions need to consider taking steps to ensure that they do not acquire a compliance case. In general, the required action can be organized into three phases:

■ *Due diligence*. There is generally limited time and other constraints during an acquisition due diligence that impair the ability of the prospective buyer to

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learn of potential compliance problems. Lawyers for the acquiring company need to prepare well in advance a careful master list of questions designed to identify potential foreign trade controls issues. Also needed is a plan for assessing the information obtained since the issues under applicable U.S. regulations may exceed the acquirer's expertise. Non-U.S. prospective acquirers may need a license to access some relevant information.

Issues requiring examination include whether the company has a product matrix showing the export control classifications of its products for specific destinations under Commerce, State and other agency programs. If not, the chances of finding unauthorized exports or re-exports are much greater. Other questions include whether some employees are not U.S. nationals or permanent residents and whether they have access to U.S.-origin proprietary data. Such data are "deemed exports," and disclosure of them to foreign employees may require prior authorization.

Understanding how the target company does business is essential to framing questions that will identify where problems may arise. If a non-U.S. target entity or a non-U.S. subsidiary of a U.S. target sells products to Iran, the acquirer needs to determine whether the products are sourced in the United States, and whether the non-U.S. entity maintains a bona fide inventory of such products, the markets served by the inventory, etc. Also requiring review is what role, if any, the U.S. parent or its U.S. affiliates plays in any non-U.S. subsidiary sanctioned-country business. Middle East sales often raise anti- boycott compliance issues just as sales to foreign governments, especially with highly paid commission agents, raise FCPA issues.

The status of any existing licenses of the acquired entity and compliance with their conditions, including reporting requirements, must be studied, too. Finally, are there outstanding commitments that will be impossible to perform immediately following the closing because of FCPA, sanctions or other concerns? How will the liability exposure be managed?

■ *Contracting and pricing.* In acquisitions of an entity engaged in international trade or any assets so utilized, standard contracts need to incorporate appropriate requirements for disclosure of any known violations or allegations of violations whether from government sources or third parties. Further, the agreement should include representations and warranties pertaining to compliance with U.S. foreign trade controls and indemnities against losses arising from any noncompliance. Resolving potential compliance issues may require much more than the short period for post-closing survival of some representations and warranties and indemnities. Thus, the contract may need to allow a longer period for discovery and assessment of the losses associated with any problems. Finally, even if no violations are known to have occurred, the acquirer needs to assess the costs of implementing a compliance program and what impact these costs have on the price.

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■ *Post-closing actions, immediate and long-term.* Previously issued licenses may require amendment or novation to take account of new parties or names. Each of the concerned administering agencies has detailed rules on transfer or amendment of such authorizations. State Department procedures for novation of approved manufacturing license and technical assistance agreements have proved particularly challenging for acquirers because of timing problems.

If the acquiring company has an existing policy and procedures for foreign trade controls, these need to be communicated promptly to senior management and operating personnel of the acquired business. Even if the *Sigma-Aldrich* precedent does not apply to some asset acquisitions, these actions should occur for stock and asset acquisitions particularly when personnel from the acquired company become employees of the acquirer. If the acquired entity has existing compliance procedures, these require immediate attention to ensure that they either continue, when necessary, or become part of the operating procedures of the new owner. If a violation were to occur after the acquisition, a good-faith effort to address foreign trade controls issues would likely be a factor in support of mitigation of any penalties for violations during the ownership transition.

Complete compliance may take some time

The concerned U.S. government enforcement agencies recognize that it takes some time for even an experienced U.S. company to integrate a new business entity. If the acquirer has moved promptly following the closing with some of the previously noted measures, further steps may reasonably require a number of months, even a year or more, to implement. However, government officials are likely to show less understanding when the acquirer takes little or no action for several years or when potential problems identified during due diligence remain unattended.

Special issues may arise if, for example, an acquirer finds violations in an acquired entity. The purchaser needs to address promptly whether to disclose voluntarily to concerned U.S. government agencies any violations that are detected after an acquisition when the infractions occurred prior to the closing. Under the regulations or practices of each of these agencies, a prompt voluntary disclosure, internal investigation, report of findings and enhanced compliance program will often contribute to significant mitigation of penalties for the preclosing conduct. In such situations, prompt notice of the violations to the former owner is usually required under the acquisition agreement, particularly to cover indemnities for losses or legal fees. NLJ