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U.S. TRADE CONTROLS CONSIDERATIONS DURING M&A AND TRANSACTIONAL DUE DILIGENCE

U.S. trade controls are a complex web of statutes, regulations, executive orders, and guidance issued by various government agencies. The authors describe this web as it may apply to transactions with an international dimension. They discuss risks in the trade controls area, highlight cases in which penalties have been imposed, and explain how risks can be identified and effectively managed by conducting due diligence. They then provide a checklist of key risk areas to consider when conducting due diligence of trade controls and discuss key trade controls considerations that may arise at various stages of a transaction, from evaluating prospective partners to post-acquisition issues.

By Kim Strosnider and Stephen Bartenstein *

A merger, acquisition, joint venture, or other significant transaction can present a panoply of legal and compliance risks. When such a transaction has an international dimension — such as because the target company or business partner is a non-U.S. company or a U.S. company with non-U.S. offices or operations — one potential risk area that should be considered is compliance with U.S. trade controls, including export controls, economic sanctions, and antiboycott laws and regulations.[1]

This article is intended to serve as a resource to be used in assessing U.S. trade control risks in such transactions, and structuring, carrying out, and responding to due diligence specific to U.S. trade controls. It first explains what U.S. trade controls laws and regulations are, and why it is important to conduct due diligence specific to this area when pursuing transactions that have an international dimension. The article then provides a high-level checklist of the major trade controls risk areas to consider. Finally, the article discusses key trade controls considerations that may arise at various stages of a transaction, including the

[1] The European Union and other jurisdictions also maintain separate trade controls that can overlap in certain ways with U.S. trade controls, but also differ in some material respects. While these separate trade controls regimes are not the focus of

footnote continued from previous column…

this article, their impact, if any, also should be considered when conducting due diligence of an M&A deal or other transaction.

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evaluation of business partners, conducting and responding to due diligence, negotiating the deal, and handling post-acquisition transition issues.

WHAT ARE U.S. TRADE CONTROLS?

U.S. trade controls are set out in myriad statutes, regulations, executive orders, and guidance issued by several different government agencies. They impose export and import controls; economic sanctions targeting certain countries, entities, individuals, and vessels; and antiboycott measures that prohibit or penalize cooperation with international boycotts that the U.S. government does not endorse.

Export Controls: The U.S. government controls through various laws and regulations the export of goods, software, and technology from the United States, transfers of controlled technology and software source code within the United States to foreign persons (so-called "deemed exports"), various other defense trade activities (including the provision of defense services and brokering), and reexports or retransfers of items subject to U.S. jurisdiction from one foreign country, foreign end user, or end use to another. These laws and regulations also control exports of certain foreign-made items containing controlled U.S.-origin content or that are the products of controlled U.S.-origin technology.

There are two principal export-control schemes in the United States: the Export Administration Regulations ("EAR")[2] and the International Traffic in Arms Regulations ("ITAR").[3] The EAR, which are administered by the U.S. Commerce Department's Bureau of Industry and Security ("BIS"), control exports and reexports principally of commercial, dual-use,[4] and some military items. The ITAR, which are administered by the U.S. State Department's Directorate of Defense Trade Controls ("DDTC"), control the export, temporary import, brokering, manufacture, and retransfer of defense articles, related technical data, and defense services.

The government agencies that administer these controls may specifically authorize — through licenses, agreements, permits, etc. — certain transactions that would otherwise be prohibited under the controls. In addition, the EAR contain "license exceptions" and the ITAR contain "license exemptions" that permit eligible parties to carry out certain activities without the need to obtain specific licensing.

Economic Sanctions: In addition, the U.S. government maintains sanctions laws and regulations that impose comprehensive trade embargoes on certain countries (currently, Cuba, Iran, Sudan, Syria, and the Crimea region of Ukraine), extensive restrictions on dealings with others (*e.g.*, North Korea), and restrictions on dealings with various entities, individuals, and vessels on U.S. government restricted-party lists. These sanctions are primarily, although not exclusively, administered by the U.S. Treasury Department's Office of Foreign Assets Controls ("OFAC").

Antiboycott Laws and Regulations: The U.S. government also administers two distinct but overlapping sets of antiboycott laws and regulations that prohibit or penalize cooperation with international boycotts that the U.S. government does not endorse. One such program is administered by BIS and consists of a set of prohibitions and reporting requirements in Part 760 of the EAR; the other is administered by the U.S. Treasury Department and imposes reporting obligations and tax consequences on U.S. taxpayers for certain boycott participation agreements undertaken by the taxpayers or members of their controlled groups. The primary but not the only target of these antiboycott programs is the Arab League boycott of Israel.

WHY CONDUCT TRADE CONTROLS DUE DILIGENCE?

Risk of Significant Penalties for Violations

M&A deals and other business transactions can be fast-moving and the number of issues to be considered can be significant. It therefore may be tempting to focus

[2] 15 C.F.R. Parts 730-774.

[3] 22 C.F.R. Parts 120-130.

[4] Items are referred to as "dual-use" when they have or could have both commercial and military applications. "Dual-use" items under U.S. export controls are generally those set out on the EAR's Commerce Control List.

limited resources on other areas or to defer consideration of trade control issues, especially since they can be complex and technical. However, paying short shrift to U.S. trade controls risks can have serious adverse consequences. The U.S. government can impose significant civil or criminal penalties on companies and individuals that violate U.S. trade control laws, such as fines, criminal liability, or even debarment from government contracting, or the loss of export privileges. Further, being charged with trade controls violations also can cause reputational damage. Although a U.S. regulator that charges a company with a civil violation of the trade controls laws typically will be willing to negotiate a settlement of the charges outside of the courtroom, the agency often will then make its proposed charging letter, consent agreement, and/or other documentation related to the charges and their settlement publicly available on the internet. The agency also may issue a press release regarding the settlement, and the news media could pick up on the story and disseminate its details to the wider public.

If a company or one or more of its employees is charged with a criminal violation of the trade controls laws, it can carry particularly severe legal and reputational consequences. Federal prosecutors will publicly file the charges in court, and culpable employees could be arrested, prosecuted, and even imprisoned. A notable enforcement trend in recent years has been for federal prosecutors to increasingly target individual employees and executives for criminal violations of trade controls laws.[5]

Importantly, ignorance of U.S. trade controls laws does *not* excuse civil violations. To the contrary, U.S. trade controls are generally strict liability regimes for civil violations — that is, civil violations can be committed even by parties who have no knowledge that they are running afoul of the law and no intent to do so.

The table in Appendix A identifies maximum civil and criminal penalties for violations of the EAR, ITAR, and economic sanctions programs.

In the M&A context, BIS, DDTC, and OFAC have each relied upon the doctrine of successor liability in recent years to impose penalties on acquiring companies for violations of U.S. trade controls laws and regulations committed by acquired companies prior to acquisition. In some cases, those penalties have been severe.

In the first case by BIS to impose successor liability, U.S. life science and high-technology company Sigma-Aldrich Corporation was charged by BIS in 2001 with numerous violations of the EAR that were committed both by Research Biochemicals Limited Partnership, whose assets Sigma-Aldrich acquired in 1997, and directly by Sigma-Aldrich.[6] BIS alleged that Research Biochemicals had made numerous unauthorized exports of EAR-controlled biological toxins to countries in Europe and Asia beginning in 1995 and that Sigma-Aldrich continued these exports for more than a year after it acquired Research Biochemicals. Sigma-Aldrich agreed to a $1.76 million civil penalty to settle its EAR violations.[7]

Not only is the *Sigma-Aldrich* case notable for pioneering the use of the successor liability doctrine to allocate liability for trade controls violations, it also makes clear that successor liability may be imposed on an acquirer even when the acquisition is structured as an asset purchase. In other words, successor liability is not reserved just for companies that acquire others through stock purchases.

Subsequent years saw further employment of the successor liability principle in the trade controls context. In 2008, DDTC and BIS charged U.S.-based aerospace and defense company Northrop Grumman Corporation with numerous ITAR and EAR violations committed by Litton Industries, Inc., a defense contractor that Northrop acquired in 2001.[8] Following the acquisition, Northrop discovered and disclosed to the U.S. government that Litton had misclassified inertial navigation systems that it manufactured and sold as EAR-controlled when they were in fact controlled under the ITAR. As a result of the misclassification, from 1994 to 2001, Litton had exported the navigation systems and related technical

[5] *See* U.S. Department of Justice, *Summary of Major U.S. Export Enforcement, Economic Espionage, Trade Secret and Embargo-Related Criminal Cases, Jan. 2009 to the Present* (Aug. 12, 2015) (identifying recent criminal prosecutions of employees and executives for violations of trade controls laws), *available at* https://www.pmddtc.state.gov/compliance/documents/OngoingExportCaseFactSheet.pdf.

[6] *In the matter of Sigma-Aldrich Business Holdings, Inc.*, Case Nos. 01-BXA-06, 01-BXA-07, and 01-BXA-11, Order Denying Respondents' Motion for Summary Judgment (Aug. 29, 2002).

[7] BIS, *Annual Report: Fiscal Year 2003* at 63, *available at* http://www.bis.doc.gov/index.php/forms-documents/doc_view/923-bis-annual-report-fy-2003.

[8] DDTC, Proposed Charging Letter to Northrop Grumman Corp. (March 14, 2008), *available at* https://www.pmddtc.state.gov/compliance/consent_agreements/pdf/NorthropGrummanCorp_ProposedChargingLetter.pdf.

data to various countries without the required licensing from DDTC. Northrop Grumman failed to discover this misclassification during due diligence and so continued the sales under Commerce authorizations until 2003, when it discovered, discontinued, and disclosed them. To settle its ITAR violations with DDTC (both predecessor liability and its own sales), Northrop agreed to a $15 million civil penalty, of which $10 million went to DDTC and $5 million was used to implement ITAR compliance measures.[9] Northrop also agreed to a $400,000 civil penalty to settle its EAR violations with BIS.[10]

Apart from these civil penalties, DDTC also made its proposed charging letter to Northrop publicly available online, and the letter stated that Litton's violations "resulted in harm to U.S. national security" because Litton had exported to Russia source code unique to Air Force One, which identified "certain capabilities, limitations, and vulnerabilities of Air Force One to Russia."[11]

Penalties in the M&A context are not reserved just for U.S. companies, since various U.S. trade control laws and regulations also apply extra-territorially. In 2008, the Luxembourg-based company Qioptic S.a.r.l., a designer and manufacturer of photonics products, was charged by DDTC with 163 violations of the ITAR committed by high-technology optic companies that Qioptic had acquired several years earlier.[12] More specifically, prior to the acquisition, the acquired companies had exported or retransferred ITAR-controlled night vision equipment and/or related technical data to various countries without authorization, among them Israel, Russia, Iran, China, and Cyprus. The exports/retransfers to Iran, China, and Cyprus were particularly egregious, since Iran is subject to a comprehensive U.S. trade embargo, China is subject to an arms embargo prohibiting all defense trade between the United States and China, and Cyprus is subject to a partial arms embargo.[13] To settle its ITAR violations with DDTC, Qioptic agreed to a $25 million civil penalty.[14]

More recently, in 2013, DDTC charged Meggitt-USA, Inc., a U.S. subsidiary of the UK-based aerospace, defense, and energy company Meggitt PLC, with ITAR violations committed by — among other subsidiaries and business units — Meggitt Training Systems, Inc. and Engineered Fabrics Corporation, which Meggitt-USA had acquired in 2006 and 2007, respectively.[15] Following its acquisition of these companies, Meggitt-USA discovered and voluntarily disclosed to DDTC that they had committed ITAR violations. Most of these violations occurred prior to the companies' acquisition by Meggitt-USA.[16] As part of a settlement with DDTC, Meggitt-USA agreed to pay a $25 million civil penalty.[17]

OFAC also has employed the successor liability doctrine in the sanctions context. In 2008, for example, Fidelity National Information Services paid a $12,260.86 civil penalty to OFAC to settle allegations involving a company Fidelity acquired in 2006, Certegy Card Services.[18] OFAC alleged that on or about June and July 2004, Certegy had processed, without an OFAC license, transactions on behalf of an individual whose property was blocked under the Foreign Narcotics Kingpin Designation Act.[19]

In addition, in 2013, the U.S.-based medical device manufacturer Ellman International, Inc. paid a $191,700 civil penalty to OFAC to settle allegations that, between

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[9] DDTC, Consent Agreement: Northrop Grumman Corporation (March 14, 2008), *available at* https://www.pmddtc.state.gov/compliance/consent_agreements/pdf/NorthropGrummanCorp_ConsentAgreement.pdf.

[10] BIS, *Don't Let this Happen to You* at 55 (July 2008), *available at* https://www.bis.doc.gov/index.php/forms-documents/doc_view/152-don-t-let-this-happen-to-you.

[11] DDTC, *supra* note 8, at 3.

[12] DDTC, Proposed Charging Letter to Qioptic S.a.r.l. (Dec. 4, 2008), *available at* http://www.pmddtc.state.gov/compliance/consent_agreements/pdf/Qioptiq_ProposedChargingLetter.pdf.

[13] *See* 22 C.F.R. § 126.1 (identifying countries subject to arms embargoes maintained by the United States).

[14] DDTC, Consent Agreement: Qioptic S.a.r.l. at 3-4 (Dec. 5, 2008), *available at* https://www.pmddtc.state.gov/compliance/consent_agreements/pdf/Qioptiq_ConsentAgreement.pdf.

[15] DDTC, Proposed Charging Letter to Meggitt-USA, Inc. (Aug. 19, 2013), *available at* https://www.pmddtc.state.gov/compliance/consent_agreements/pdf/Meggitt_PCL.pdf.

[16] *Id.* at 2.

[17] DDTC, *Consent Agreement: Meggitt-USA, Inc.* at 17-18 (Aug. 19, 2013), *available at* https://www.pmddtc.state.gov/compliance/consent_agreements/pdf/Meggitt_CA.pdf.

[18] OFAC, Enforcement Information for Dec. 5, 2008, *available at* http://www.treasury.gov/resource-center/sanctions/OFAC-Enforcement/Documents/12312008.pdf.

[19] 21 U.S.C. §§ 1901-1908. OFAC alleged that these transactions violated the OFAC-administered Foreign Narcotics Kingpin Sanctions Regulations, 31 C.F.R. Part 598.

2005 and early 2008, Ellman had violated U.S. sanctions against Iran by selling and exporting medical equipment to Iran and engaging the services of an Iranian physician without an OFAC license.[20] While this case is somewhat different from the others described above in that it did not involve the direct imposition of successor liability on an acquiring company, it still is notable because the activities at issue all occurred before Ellman was acquired by a private equity investment group in 2008, and new ownership and management was put in place. Upon discovering the problematic activities after the acquisition, Ellman's new owners and management disclosed the matter to OFAC.

Managing Risk Through Due Diligence

Virtually any M&A deal or other business transaction that has both a U.S. nexus and an international dimension will present at least some level of U.S. trade controls compliance risk. To identify and effectively manage this risk, it is important to conduct trade controls due diligence *before* the transaction is carried out. Even if diligence reveals that the risk is significant, various options may be available to mitigate risk that is identified in advance.

First, it may be possible to eliminate or greatly reduce the risk by requiring a merger or acquisition target or a joint venture partner to resolve a pending trade-controls-related enforcement matter before closing on a deal. Thus, the target company or prospective business partner would be responsible for any penalties that result, as well as the associated legal fees. However, the timing of transactions often makes it difficult to resolve matters prior to closing, since investigation and resolution of trade control compliance matters may take months or even years.

Second, as described in more detail below, a party may be able to include representations and warranties or other clauses regarding trade controls compliance, as well as indemnification/remedy provisions for their breach, in the contract governing the transaction. If properly structured, these provisions can shift the financial consequences of trade controls violations, such as fines and potentially legal fees, onto the company that committed the violations, so the acquirer does not have to bear those costs. For example, if an acquisition target represents in a purchase agreement that it has complied with U.S. trade controls laws over the past five years, but after the deal closes is found to have recently exported items to a sanctioned country in violation of U.S. law, the target could be in breach of contract and obligated to indemnify the acquiring company for any monetary penalty imposed for the violation. However, such provisions cannot effectively shift the financial consequences of trade controls violations when the selling company will not survive the transaction. They also cannot shift the risk of reputational damage that comes with acquiring a company that has violated U.S. trade controls. In addition, recovery for breach may be difficult, and could be subject to caps or deductibles, depending on how the contract clauses are structured.

Third, the acquiring company in an M&A deal can develop a post-closing plan of action to promptly stop, and potentially voluntarily disclose to the U.S. government, an acquired company's trade controls violations, including implementing corrective actions to prevent recurrence. This could prevent a situation such as that which occurred in *Sigma-Aldrich*, where Sigma-Aldrich increased its exposure by failing to identify and halt the acquired company's ongoing trade controls violations for more than a year after the acquisition. While committing to such a clean-up effort would not protect the acquirer from liability for the target's violations, the regulator to which the violations are disclosed likely would consider the acquirer's compliance efforts as a significant mitigating factor when considering whether and to what extent to penalize the violations, as was true in the *Qioptic* case. After all, it also benefits the U.S. government when a company is acquired and its trade controls compliance practices are strengthened.

Fourth, in a situation where trade controls risks are particularly high and cannot be effectively mitigated through any of the strategies described above, it may be necessary to adjust valuation or, in extreme cases, to call off the transaction. Such drastic action is most likely to be required if the transaction involves a criminal violation, a pattern or practice of violations, or significant sales that, while perhaps lawful for the target, could not be sustained post-closing (such as sales activity by a European or Latin American company with Cuba that could not be continued post-closing by a U.S. company that is subject to the U.S. sanctions against Cuba).

TRADE CONTROLS CHECKLIST

The following is a checklist of key risk areas to consider when conducting trade controls due diligence of an M&A deal or other business transaction. The questions posed in the checklist are framed at a high level to help identify major risk areas and should be supplemented as a transaction progresses with more

[20] OFAC, Enforcement Information for Jan. 2, 2013, *available at* http://www.treasury.gov/resource-center/sanctions/CivPen/Documents/20130102_ellman.pdf.

focused questions tailored to the nature of the transaction and the specific risks it presents. In addition, particular transactions may present other types of trade control issues that also should be the subject of due diligence.

✓ ***Does the transaction have a nexus to any U.S. economic sanctions?***

When conducting trade controls due diligence, it is critical to consider at the outset whether the proposed transaction will implicate any of the four types of U.S. economic sanctions described below.

1. Country-Based Sanctions: The U.S. government maintains sweeping sanctions programs targeting Cuba, Iran, Sudan, Syria, and the Crimea region of Ukraine that broadly prohibit most unlicensed business and financial dealings by U.S. persons with these countries, as well as their governments, residents, and entities organized under their laws or operating in them; the sanctions also require the blocking of certain property.[21] U.S. persons to whom these measures apply include U.S. citizens and lawful permanent residents (i.e., "green card" holders"), even if located outside the United States and/or employed by a non-U.S. company; entities organized under the laws of the United States, including their foreign branches and offices; and persons located in the United States.[22] The U.S. sanctions programs against Iran and Cuba also prohibit many dealings with these countries, their governments, and their nationals by non-U.S. entities that are owned or controlled by U.S. persons.[23] In addition, the U.S. government maintains extensive trade controls measures that greatly restrict U.S. export-import trade with North Korea.[24]

It also is important to consider more limited sanctions against Burma/Myanmar that prohibit certain dealings with the Burmese Ministry of Defense and armed groups, and require reporting for new U.S.-person investment in Burma that reaches certain monetary thresholds.[25]

2. List-Based Sanctions: The U.S. government's list-based sanctions programs target dealings by U.S. persons in the property or interests in property of particular entities, individuals, and vessels. The key such list is the List of Specially Designated Nationals and Blocked Persons ("SDN List"), maintained by OFAC. Some, but not all, list-based sanctions programs target entities and nationals of particular countries, such as Belarus or Yemen. List-based sanctions programs prohibit most unlicensed dealings by U.S. persons in the property or interests in property of listed SDNs, as well as any entities in which one or more SDNs own, directly or indirectly, a 50% or greater interest (even if the company in which the SDN owns an interest is not itself listed on the SDN List).[26] They also require that the property and property interests of all such parties be blocked (*i.e.*, frozen) when they come into the United States or the possession or control of a U.S. person.

3. Sectoral Sanctions against Russia: The U.S. government also has imposed more targeted "sectoral" sanctions on certain entities in Russia's financial, energy, and defense sectors.[27] These sanctions do not forbid all transactions by U.S. persons with the sanctioned parties. Rather, they prohibit U.S. persons from being involved in certain types of financial and other dealings with entities specifically targeted by the sanctions, as well as entities owned 50% or more by one or more of the specifically targeted parties. Relatedly, the U.S. government also has implemented export controls in the EAR that restrict the export and reexport of even non-sensitive, commercial items that are of U.S. origin or contain U.S. content to certain end users and for certain end uses in Russia's energy sector.

While a U.S. person could not without OFAC authorization pursue a business opportunity that involved a country, entity, individual, and/or vessel subject to the first two types of U.S. sanctions described above, it remains permissible for U.S. persons to engage

[21] The primary U.S. sanctions against Iran, for example, are set out in the Iranian Transactions and Sanctions Regulations ("ITSR"), 31 C.F.R. Part 560.

[22] *See, e.g.*, 31 C.F.R. § 560.314 (definition of "U.S. person" in the ITSR).

[23] 31 C.F.R. § 560.215 (ITSR); 31 C.F.R. § 515.329(d) (Cuban Assets Control Regulations).

[24] These controls are set out primarily in the EAR and in Executive Order 13570 (Apr. 18, 2011), *available at* http://www.treasury.gov/resource-center/sanctions/Programs/Documents/04182011_nk_eo.pdf.

[25] These sanctions are set out in the Burmese Sanctions Regulations, 31 C.F.R. Part 537.

[26] OFAC, Revised Guidance on Entities Owned by Persons whose Property and Interests in Property are Blocked (Aug. 13, 2014), *available at* http://www.treasury.gov/resource-center/sanctions/Documents/licensing_guidance.pdf.

[27] OFAC provides additional information about the sectoral sanctions that it administers on its "Ukraine-/Russia-related Sanctions" webpage, which is *available at* www.treasury.gov/resource-center/sanctions/Programs/Pages/ukraine.aspx.

in many types of transactions with entities subject only to the sectoral sanctions. Thus, when conducting due diligence for a transaction that may involve a party subject to the sectoral sanctions, it is important to consider whether the specific types of activities being contemplated would trigger the sanctions.

4. "Secondary" Sanctions: The U.S. government has targeted non-U.S. persons that engage in certain identified activities involving Iran, and to a lesser extent Syria, with "secondary" (or "retaliatory") sanctions that restrict their access to U.S. markets. The U.S. government has imposed different types of secondary sanctions on different parties, some of which more broadly restrict such parties' dealings with the United States or U.S. persons than do others.

The U.S. government temporarily suspended certain secondary sanctions during the nuclear negotiations between the P5+1 powers (the United States, China, France, Germany, Russia, and the United Kingdom) and Iran, and the U.S. government's nuclear-related secondary sanctions against Iran are proposed to be lifted if and when the July 2015 comprehensive nuclear agreement struck with Iran is implemented.[28]

Non-U.S. persons or companies subject to secondary sanctions may also be blocked parties, although that is not always the case. Even if they are not blocked, however, any sanctions levied against them could have a serious impact on their ability to access U.S. markets and/or controlled U.S. items, and thus should be carefully considered in the context of any transaction with such parties.

✓ *Are items subject to U.S. export controls restrictions involved?*

Another key consideration during trade controls due diligence is whether the transaction will involve items controlled by the EAR or ITAR, or, in the M&A context, whether the acquisition target engages in trade involving such items. As described above, the EAR control commercial, dual-use, and some military commodities, software, source code, and technology. Items subject to export restrictions under the EAR are identified on the EAR's Commerce Control List ("CCL").[29] Other items that are "subject to the EAR" but which are not listed on the CCL are considered "EAR99," and generally do not require a license unless destined to an embargoed country, designated/restricted person, or restricted end use. The ITAR, by contrast, control defense articles, related technical data (which includes software), and defense services, which are identified on the ITAR's U.S. Munitions List ("USML").[30] In recent years, the U.S. Government's "export control reform" initiative has resulted in significant changes in these two control lists. Certain military items that were previously defense articles subject to ITAR control have been determined not to warrant such control and instead have been shifted to the jurisdiction of the EAR.

It is important to keep in mind that the general jurisdictional reach of U.S. export controls and sanctions are different. Whereas U.S. sanctions programs primarily restrict activities by U.S. persons (and in the case of the Iran and Cuba sanctions, the owned or controlled non-U.S. affiliates of U.S. companies), U.S. export controls apply equally to both U.S. and non-U.S. persons that handle items that are subject to the controls because they are of U.S. origin, contain U.S. content, or are products of controlled U.S.-origin technology.

It also should be noted that the ITAR cover a broader set of activities than simply exporting or reexporting defense articles, technical data, or defense services. Among other things, the ITAR also control temporary imports of defense articles into the United States (such as for maintenance or modification/upgrade in the United States), and the brokering of defense articles, and they additionally contain a requirement that manufacturers of defense articles and exporters and brokers of defense articles and defense services register with DDTC.

Thus, when controlled items or other defense trade activities are at issue in a transaction, a number of issues will need to be considered, including export licensing and ITAR registration issues.

✓ *Are restricted end users or end uses involved?*

Even non-sensitive commercial items not otherwise controlled for export or reexport to a non-sanctioned destination require authorization if exported or reexported for certain end uses — *e.g.*, certain nuclear,

[28] *See United States, EU, Other Global Powers Reach Comprehensive, Long-Term Nuclear Deal with Iran*, Covington Alert (July 15, 2015), *available at* https://www.cov.com/~/media/files/corporate/publications/2015/07/united_states_eu_other_global_powers_reach_comprehensive_long_term_nuclear_deal_with_iran.pdf. Under the terms of the agreement, the U.S. government also has committed to license non-U.S. entities owned or controlled by U.S. persons to engage in certain activities with Iran that would otherwise by prohibited by the primary U.S. sanctions against Iran.

[29] 15 C.F.R. Part 774.

[30] 22 C.F.R. Part 121.

chemical/biological weapons, weapons of mass destruction, or missile-related end uses.[31]

In addition, BIS and DDTC maintain separate lists of parties that are restricted from making and/or receiving exports or reexports of items subject to U.S. export controls. In particular, BIS maintains the followings lists: the Denied Persons List, which consists of individuals and entities that have been denied export privileges; the Entity List, which identifies non-U.S. parties that are prohibited from receiving some or all items subject to the EAR without a license from BIS; and the Unverified List, which identifies parties whose bona fides BIS has been unable to verify, and who are ineligible to receive controlled items under license exceptions. State additionally maintains the Debarred List, which identifies parties prohibited from participating in defense trade, and a list of parties sanctioned under various statutes for proliferation-related activities.[32]

When conducting due diligence on a transaction that involves the export or reexport of U.S.-origin or U.S.-content items, these restrictions make it imperative both to consider the end use of the items to be exported/reexported, and also to screen all counterparties against the BIS and DDTC lists described above (in addition to applicable sanctions lists). In the M&A context, dealing with a company whose export privileges have been revoked or are otherwise limited by U.S. government export control restrictions could have significant business ramifications, even during due diligence, when such party may seek access to technical data through documents or a site visit. Further, if a proposed counterparty is engaged in restricted end use activities, the business and compliance ramifications can be significant.

✓ ***Does the transaction implicate other trade control areas?***

Apart from the U.S. trade controls areas described above, a thorough trade controls diligence effort also should consider:

- the antiboycott programs administered by BIS and the U.S. Treasury Department, especially where the transaction counterparty or M&A target does business in a country that the Treasury Department has identified as boycotting Israel;[33]
- the controls on permanent imports of certain defense items administered by the U.S. Department of Justice's Bureau of Alcohol Tobacco, Firearms, and Explosives;
- nuclear controls administered by the Nuclear Regulatory Commission and the U.S. Department of Energy;
- import controls administered by U.S. Customs and Border Protection;
- the Foreign Trade Regulations[34] maintained by the U.S. Census Bureau, which require the electronic filing of certain export information;
- controls on information classified for national security purposes; and
- the impact on the transaction, if any, of non-U.S. trade controls.

✓ ***Does the acquisition target have an effective trade controls compliance program?***

Finally, when conducting due diligence of an acquisition target or partner in a significant business venture, such as a joint venture, the target's existing trade controls compliance program should be carefully reviewed for adequacy and effectiveness in light of the specific nature and extent of the target's activities that implicate trade controls. An important point to keep in mind when conducting such a review is that there is no one-size-fits-all compliance program. Rather, an effective compliance program is one that is appropriately tailored to such factors as the company's industry, size, position in the supply chain, and international footprint, including the countries where it does business. Thus, for example, while larger companies — and particularly those that engage in defense trade activities or

[31] The EAR's end use controls can be found at 15 C.F.R. Part 744.

[32] "Export.gov," which is a website maintained by the U.S. Commerce Department, provides a consolidated screening list comprised of all restricted parties on the BIS and DDTC lists described in this section, as well as the SDN List and other OFAC sanctions lists. This consolidated list can be found *at* http://export.gov/ecr/eg_main_023148.asp.

[33] The nine countries currently so listed are Iraq, Kuwait, Lebanon, Libya, Qatar, Saudi Arabia, Syria, the United Arab Emirates, and Yemen. List of Countries Requiring Cooperation with an International Boycott, 80 Fed. Reg. 39,197, 39,197 (July 8, 2015).

[34] 15 C.F.R. Part 30.

manufacture and/or export other sensitive and tightly controlled items — could require separate, tailored control programs for each trade controls area (*e.g.*, export, import, sanctions, technology security, etc.) and multiple employees dedicated full-time to trade controls compliance, smaller companies may find it adequate to rely on a single set of compliance protocols or procedures, and a single full-time or part-time trade controls compliance manager.

An effective trade controls compliance program generally should contain at least certain core elements. *First*, the program should demonstrate a tone of compliance from the top, such as through a corporate policy statement issued by a senior executive regarding the importance of trade controls compliance. *Second*, the program should have a process for screening business partners and other counterparties against the various government lists of restricted parties described in this article. *Third*, the program should have a process for country-based screening of transactions to ensure that they do not involve any countries subject to comprehensive sanctions, and in the case of exports/reexports of controlled items, to evaluate whether the destination is one for which government authorization is required. *Fourth*, the program should have a process for determining the export controls jurisdiction and classification of items that the company manufactures and/or exports (*e.g.*, whether the item is controlled under the ITAR or the EAR, and the classification of the item under the applicable regime). *Fifth*, if the company engages in controlled exports/reexports for which government authorizations are required, the program should have a process to apply for such authorizations and to ensure compliance with the terms of authorizations received. *Sixth*, the company should have a process for maintaining detailed, export-related records for a period of at least five years from the date of export.[35] *Seventh*, an individual and/or department within the company should be formally appointed to administer the program and oversee compliance with it.

ISSUES BY TRANSACTION PHASE

Assessing the above issues will help determine the trade controls risk profile of a transaction. Ideally, this risk would be assessed up front and then periodically revisited at each stage of the transaction or as further relevant information becomes available.

In this section, we discuss key due diligence issues to consider at each stage of an M&A deal or other significant transaction.

Evaluating Prospective Business Partners

Before engaging in any substantive business dealings with an acquisition target or other potential business partner, such as a meeting to negotiate the purchase of a target, it is critical to screen the business partner to ensure that it is not subject to any of the types of sanctions described above in the checklist. The potential business partner also should be screened at this early stage against the BIS and DDTC lists of restricted parties, in order to ensure that it is not restricted from making or receiving exports or reexports of items subject to U.S. export controls.

When screening the potential business partner, a best practice is to use a software or web-based tool for screening that aggregates up-to-date information about the entities and individuals identified on the various government lists of restricted parties. Ideally, such a screening tool also should employ a "fuzzy logic" algorithm to identify close as well as identical matches with restricted parties. A number of third-party vendors offer such screening tools.[36]

This screening effort also should account for the fact that a potential business partner could be a restricted party if it is owned or controlled by one or more parties on a restricted-party list, even if it is not itself included on such list. In this regard, another best practice is to perform targeted searches for information about screened parties using an internet search engine (such as Google), a subscription news archive (such as LexisNexis), and/or a corporate intelligence service (such as Dun & Bradstreet) to avoid dealings with parties that are restricted because they are owned or controlled by restricted parties, as well as parties that could become sanctioned in the future due to their ties to restricted parties. Such sources also may be used to search for the names of a party's significant

[35] Five years is the amount of time that companies are required to retain records under the EAR's and ITAR's recordkeeping provisions. *See* 15 C.F.R. Part 762 (EAR recordkeeping requirement); 22 C.F.R. § 122.5 (ITAR recordkeeping requirement).

[36] Such vendors may offer software or web-based tools for manual screening; batch or bulk screening of large numbers of business partners at once; solutions that integrate screening capabilities into a company's enterprise resource management, supply chain management, or customer relationship management platforms; and/or "hit" resolution services to help resolve potential matches to restricted parties.

shareholders, directors, and senior executives/managers so that they may be screened, and to rule out "false hits" identified by the tool used for screening.

In some circumstances, such as when considering the acquisition of a non-U.S. company that press reports suggest could have ties to restricted parties or about which little public information concerning ownership structure is available, it may be desirable to commission a third-party investigation of the target company and prepare a detailed report on its ownership structure and/or relationship to restricted parties. It also may be desirable in certain cases to obtain a certification from the potential business partner that it is not a restricted party (although this generally should not be relied upon without further diligence).

In addition to screening the potential business partner against the various lists of restricted parties, the transaction also should be screened for the involvement of sanctioned countries. More specifically, it is important to check whether the potential business partner is organized under the laws of a sanctioned country, and/or has operations in or business dealings with a sanctioned country or its entities or residents.[37]

It is appropriate to scale this screening effort to the nature, size, and level of trade controls risk of the potential transaction. In this regard, while OFAC has not provided specific guidance about what it considers to be effective screening procedures, it has specifically recognized that a tailored, risk-based approach is merited in designing screening protocols and procedures.[38]

It also is important to consider foreign ownership in the defense trade context, when a merger, acquisition, or divestiture is involved. Sales and acquisitions of companies registered with DDTC under the ITAR, or their subsidiaries engaged in defense trade, require notification to DDTC. If the buyer is a foreign person, the notice must be provided to DDTC 60 days in advance of the transaction closing.[39] Such acquisitions also may trigger a separate review by the Committee on Foreign Investment in the United States ("CFIUS").

Conducting Due Diligence

Once the business decision is made to pursue an M&A deal or other significant business transaction, it is time to conduct more robust trade controls due diligence of the prospective transaction. To appropriately tailor the diligence effort to the trade controls compliance risks, an up-front assessment should be performed of those risks, focusing on each risk area described in this article's checklist. This assessment will help to inform what risk areas to focus on while conducting diligence and the extent of resources to allocate to the diligence effort.

The main diligence effort will consist of requesting and reviewing trade-controls-related documents and information. While initial due diligence requests to the acquisition target or other business partner can follow a template, it is important to make tailored, follow-up requests as more information becomes available. Due diligence calls also can be valuable depending on the knowledge and role of the person responding to the questions — *i.e.*, it can be significantly more informative to speak with an employee who directly supervises the company's trade controls compliance efforts, such as a trade controls compliance manager (assuming he or she is authorized to speak on behalf of the company), than with a senior executive who has little or no first-hand knowledge of the company's trade controls compliance program.

In the M&A context, when an acquirer is conducting due diligence of a target company, it often can be useful for the acquirer to focus its preliminary diligence requests on the following general areas:

- the nature and extent of the target's international activities and operations;

- the target's voluntary and directed disclosures of trade controls violations over the past five years to the agencies that enforce the trade controls laws, how those disclosures were resolved by the agencies (*e.g.*, was a penalty imposed, or was the target required by the agency to take a corrective action to correct a deficiency?), and subsequent efforts to

[37] If a business partner has dealings with a sanctioned country, this would require further review as to the nature of those dealings, and whether and how they are connected to the transaction at issue.

[38] In 2007, for example, OFAC published a "Risk Matrix" to help charities assess the risk that funds they were disbursing to grantees may be used for illicit purposes. The Risk Matrix recognizes that entities differ, *inter alia*, in size, products, services, the geographic locations that they serve, "and numerous other variables," and states that OFAC will take such variables into account in evaluating compliance efforts. The Risk Matrix is *available at* http://www.treasury.gov/resource-center/terrorist-illicit-finance/Documents/charity_risk_matrix.pdf.

[39] 22 C.F.R. § 122.4(b).

implement corrective actions to resolve issues that led to the violations;[40]

- export licenses issued to the target and licensing agreements entered into by the target;
- the export controls jurisdiction and classification of the items the target manufactures and/or exports, and the impact of export control reform, if any, on the items' jurisdiction/classification; and
- the target's compliance infrastructure, including its policies, procedures, guidance/training materials, etc.

Finally, it often can be beneficial to document the scope, key findings, and limitations of the due diligence effort in a report or memorandum. Among other things, such a report can help ensure that all key stakeholders are aligned as to the nature and extent of the trade controls risks raised by a transaction, and serve as a useful resource when integrating an acquired company into the acquirer's trade controls compliance infrastructure. In some cases, such a report may be specifically required by a third-party lender or insurer/underwriter.

Responding to Due Diligence

For companies on the other end of the bargaining table that expect to receive due diligence requests from an acquirer or other business partner, recordkeeping and preparation are key. In this regard, a best practice is for the company's legal or compliance department to prepare an internal due diligence request list in advance for the purpose of identifying and locating documents and information that the acquirer is anticipated to need. It also can be beneficial for an acquisition target to work with regulatory agencies to try to resolve any pending compliance issues before the deal is carried out, since that will reduce the likelihood that the acquirer will demand stringent representations and warranties specific to trade controls, and could even increase the target's valuation.

It also is important to anticipate any export controls issues raised by making technical information available to a potential acquirer and its advisors in an electronic data room, during plant tours, or otherwise. Such technical information may itself be subject to export controls, and require a license or other government authorization to share with these parties.

Finally, when responding to due diligence requests, it may be advisable to try to narrow requests that are overbroad or otherwise unreasonable, such as a request for information about a company's ITAR- or EAR-controlled activities during a time period that is outside of the five-year statute-of-limitations period applicable to civil and criminal violations of the ITAR and EAR.

Negotiating the Deal

When negotiating a purchase agreement for a merger or acquisition, or contract governing some other significant international transaction, it often is beneficial to include provisions specific to trade controls compliance in the contract. Most commonly, such provisions are added to an agreement's representations and warranties section. While companies sometimes rely on boilerplate trade controls representations and warranties for this purpose, a better practice is to tailor such provisions to the risks presented by the transaction, and, if necessary, to update them as more information is learned about the transaction's risk profile over the course of due diligence. The following are some types of trade controls representations and warranties commonly found in purchase agreements for M&A deals:

- *Representation and warranty that the target is not sanctioned:* Such provisions are most useful when they extend to those who own and/or control the target, especially where ownership and control structures are difficult to evaluate from public sources or investigation reports. Note that such a representation and warranty should not be viewed as a substitute for conducting due diligence about transaction counterparties; rather, this is a supplemental measure to such diligence.
- *Representation and warranty that the target does not engage in unauthorized business in sanctioned countries:* Such provisions may be overbroad if their focus is on *all* business in sanctioned countries rather than just *unauthorized* business. U.S. companies are sometimes authorized to engage in certain activities in countries subject to comprehensive sanctions, such as licensed exports of food, medicine, or medical devices, or other humanitarian activities; in addition, some countries are only the subject of limited sanctions programs (such as Burma and Belarus) that do not broadly prohibit U.S. persons from trading with the country.

[40] When reviewing the target's disclosure record, a best practice is to look for patterns that suggest systemic problems, since unresolved systemic problems may lead to further violations and penalties.

- *Representation and warranty that the target is in compliance with trade controls laws, and has necessary licenses, registrations, and permits*: Such provisions are typically limited as to time, and may be overbroad if they require certification of compliance for more than a five-year time period, which is the statute of limitations period for most trade controls violations.

The second and third types of representations and warranties identified above are sometimes bounded by "materiality/material adverse effect (MAE)" qualifiers. While activities that are prohibited under U.S. trade controls constitute trade controls violations regardless of their materiality, such a qualifier may be necessary for a buyer to accept, or advisable for a seller to offer, depending on commercial considerations in the particular transaction. In addition, "knowledge" qualifiers are sometimes used for all three of these types of representations and warranties. However, as previously noted, civil violations of U.S. trade controls are generally strict liability in nature, and are not limited to knowing violations.

In addition to representations and warranties, it also may be advisable to include other trade-controls-specific provisions in the governing contract. In the M&A context, such provisions may include:

- agreements to cooperate on filing required notifications (*e.g.*, with DDTC) and securing transfer of export licenses from DDTC and BIS; such provisions may be accompanied by schedules that list active licenses/agreements to be transferred; and

- a requirement that the target disclose known trade controls violations prior to closing, accompanied by a schedule of disclosures in the trade controls area.

Finally, when negotiating such provisions, it is important to consider their relationship to the contract's indemnification provisions. This includes the burden of proof for making a claim for breach of a trade controls representation and warranty, the timing requirements for doing so, and whether there is a cap on the amount that will be indemnified.

Third Parties

M&A deals are not always just between the buyer and seller. Insurers, underwriters, and especially lenders are playing an increasingly active role in diligence. In light of the major enforcement cases brought against financial institutions in recent years for sanctions violations and the significant penalties imposed,[41] banks are particularly interested in understanding the sanctions risks posed by transactions they are financing, and frequently will have their own extensive lists of sanctions-related questions focused on their concern about facilitating sanctions violations. Banks, underwriters, and insurers also may require diligence calls and/or diligence reports, and banks may require "use-of-proceeds" clauses when they are providing lending in support of a transaction or opening a line of credit. For example, a "use of proceeds" clause in a credit agreement may require that the borrower agree not to use the funds in dealings with sanctioned parties or persons. Some such clauses are drafted very expansively and should be carefully reviewed for over-breadth. Banks also may require non-U.S. borrowers to commit that less than a certain, small percentage of their revenue is derived from activities or operations in U.S.-sanctioned markets.

In addition, government regulators may put conditions on closing the deal, such as in the context of CFIUS or the mitigation of foreign ownership, control, or influence ("FOCI") under the National Industrial Security Regulations administered by the U.S. Department of Defense's Defense Security Service.

Post-Acquisition/Transition Issues

After a merger, acquisition, or other significant transaction closes, there may still be a number of trade controls issues to consider. In the sanctions area, acquisitions of non-U.S. companies can create difficult sanctions compliance issues. For example, the acquired company may have been active in U.S.-sanctioned countries prior to acquisition in compliance with its local laws, but as a result of the acquisition has become subject to U.S. sanctions laws and prohibited from transacting business in that country. More specifically, this issue can arise when an acquired non-U.S. company has operations or business dealings in or with Iran or Cuba, since as noted above U.S. sanctions against those countries reach non-U.S. subsidiaries of U.S. companies. (This issue can be particularly difficult to navigate when the acquired company has business dealings involving Cuba, since some jurisdictions, such as the EU, Canada, and Mexico, have "blocking" laws intended to restrict

[41] *See, e.g.*, *BNP Paribas Agrees to Plead Guilty and to Pay $8.9 Billion for Illegally Processing Financial Transactions for Countries Subject to U.S. Economic Sanctions*, Department of Justice Press Release, June 30, 2014, *available at* http://www.justice.gov/opa/pr/bnp-paribas-agrees-plead-guilty-and-pay-89-billion-illegally-processing-financial.

compliance by their nationals with the U.S. sanctions against Cuba.)

Further, even if the acquired non-U.S. company is not itself automatically prohibited from continuing to do business in or with a sanctioned country as a result of an acquisition, its new U.S. parent(s) and U.S. affiliate(s) will be prohibited from facilitating such transactions. As a practical matter, this may mean that it is impossible for the acquired company to continue such business. Notably, since U.S. sanctions may diminish the business that the acquired company can lawfully conduct post-acquisition, they may also impact the transaction's valuation.

U.S. sanctions also can complicate efforts to wind down an acquired company's business in a sanctioned country. In particular, unless licensed to do so by OFAC, U.S. persons are prohibited from facilitating the wind-down, both pre- and post-acquisition, of non-U.S.-company business activities in or with a U.S.-sanctioned country. OFAC authorization also may be necessary to receive post-acquisition payments for sales made in the sanctioned country prior to acquisition, or to meet ongoing service or warranty/repair obligations in a sanctioned country.

In the export controls area, export licenses and agreements may need to be transferred, novated, or amended following acquisition. It also may be necessary to apply for new export authorizations in order to carry out export transactions required to integrate the acquirer and target, such as if the integration efforts will involve cross-border transfers of controlled software or technology, or the release of controlled technology to non-U.S. nationals in the United States.

If the acquirer or acquired company is operating under a consent decree with a government regulator stemming from a trade controls enforcement action, there also may be special compliance obligations to consider. First, if the acquired company is operating under a consent decree, then its compliance obligations will typically transfer to the buyer. Second, if the acquirer has entered into a consent agreement with DDTC, the acquirer typically will be obligated to extend within six months all required compliance measures to an acquired company that engages in defense trade.[42]

Finally, the acquired company's export compliance program may need to be updated, revised, supplemented, or even overhauled and/or integrated into the acquirer's program, and trade controls records will need to be transferred. The seller should, however, retain copies of such records to the extent it is able to do so, since they may be important to defend against a breach of warranty claim in the trade controls area.[43]

CONCLUSION

When pursuing a merger, acquisition, or other significant transaction with an international dimension, it is important to understand the potential impact of U.S. trade controls on the transaction and perform trade controls due diligence that is tailored to the transaction's risk profile. While such diligence requires advance planning, time, and resources, it can help companies avert significant legal exposure. ■

[42] *See, e.g.*, DDTC, Consent Agreement: Aeroflex Incorporated at § 4 (Aug. 6, 2013), *available at* https://www.pmddtc.state.gov/compliance/consent_agreements/pdf/Aeroflex%20Executed%20CA.pdf ("Respondent agrees that these measures will be incorporated into any of Respondent's future business

footnote continued from previous column…

acquisitions that are involved in the design, manufacture, sale, export, brokering, or re-export or retransfer of ITAR-controlled defense articles, technical data, and defense services within six months of that acquisition, unless the Director, DTCC approves an exception to this requirement.").

[43] If the transaction at issue is not an M&A deal but rather a more confined transaction with an international dimension, such as for the sale and export of goods, various of the transactional stages described above still will be relevant, including assessing the counterparty and negotiating trade controls compliance provisions in the relevant contract. In addition, of course, it will be important to consider the need for and prospects and timing of securing any necessary export licensing for the export or reexport of controlled items.

APPENDIX A

	ITAR[1]	**EAR and Economic Sanctions**[2]
Maximum civil penalty	$500,000 per violation	$250,000 per violation or twice the value of the transaction, whichever is higher[3]
Maximum criminal fine	$1 million per violation, or twice the value of the gain, or loss from the transaction	$1 million per violation, or twice the value of the gain, or loss from the transaction.
Maximum jail time	20 years	20 years

[1] Penalties for ITAR violations are codified in the Arms Export Control Act, 22 U.S.C. § 2751 *et seq.*, at Section 2778(c) (criminal penalties) and Section 2778(e) (civil penalties). The Alternative Fines Act, 18 U.S.C. § 3571(d), also applies to criminal violations of the ITAR, and allows for fines in amounts equal to twice the value of the gain or loss from the transaction.

[2] Penalties for civil and criminal violations of the EAR and most U.S. sanctions programs are codified at Section 1705 of the International Emergency Economic Powers Act, 50 U.S.C. §§ 1701-1707. The Alternative Fines Act also applies to criminal violations of the EAR and U.S. sanctions programs.

[3] The maximum civil penalties in force for violations of U.S. sanctions against Cuba are somewhat lower, and higher civil penalties are applicable for dealing with designated narcotics traffickers.

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