International Trade Due Diligence: Protecting the Value of Your Transaction

by Megan A. Gajewski, Susan M.C. Kovarovic, Michael D. Mellen and Christina A. Zanette

You just closed a deal for your client, a U.S. company, which acquired another company. The target company is located in the United States but sells some products overseas. The target company’s documentation indicates that there are other opportunities to expand sales of its products in markets around the globe. Shortly after the closing, your client receives an administrative subpoena from the Department of Commerce. The subpoena states that your client is under investigation for suspected exports without obtaining the required licenses; the exports were conducted by the company just acquired by your client prior to the closing. Your client learns that the actions by the target, prior to its acquisition, potentially subject your client to civil penalties equal to the greater of $250,000 (for each item exported without a license) or twice the value of the transaction.

The above scenario illustrates the consequences of not conducting comprehensive due diligence in connection with mergers and acquisitions — to include international trade regulatory matters. U.S. export, import, anti-corruption, trade sanctions, and anti-boycott laws affect a broad range of transactions. As such, due diligence is important where any portion of the target has an international component. This may include:

• A merger with a target that sells products or provides services overseas and that uses local sales agents in the overseas markets;

• An acquisition of a target that is a U.S. company with subsidiaries or affiliates in other countries or where the target is a foreign company;

• A stock purchase of a target that imports items manufactured in other countries;

• An acquisition of a company that employs foreign persons in the United States; and

• An asset acquisition of a target that provides financing for international transactions.

Effective international trade due diligence can mitigate the risks associated with the target’s prior business activities and help ensure future business activities will have the best chance to generate expected value.

What Laws and Regulations Should be Considered?
The U.S. government enforces laws and regulations that promote the national security, foreign policy, and economic interests of the United States, including those related to exports, imports, trade sanctions, requests to comply with certain boycotts, and bribery. Civil and criminal penalties
may be imposed for violations of these laws and regulations. This section provides an overview of these laws and regulations that may be the subject of your international trade due diligence.

Export Controls
There are two primary U.S. export control regulations: the International Traffic in Arms Regulations (ITAR) and the Export Administration Regulations (EAR). The Department of State controls the export of defense articles (items specifically designed or modified for military applications) and related technical data and defense services pursuant to the ITAR. Defense articles controlled for export under the ITAR are detailed in the U.S. Munitions List (USML). All items subject to the ITAR need a license or other authorization from the Department of State prior to their export or re-export. The ITAR also requires exporters, manufacturers (even if they do not export) and brokers of defense articles and services controlled under the ITAR to register with the Department of State annually.

The Department of Commerce administers the EAR, which currently control the export of purely commercial items and “dual-use” items. Dual-use items consist of commodities, software, and technology which have a predominantly commercial use, but which also may have military applications. Items controlled under the EAR are listed on the Commerce Control List. A license may be required for the export and re-export of an item subject to the EAR based on the type of item, the country of destination for the transaction, the parties involved, and the intended end-use.

Trade Sanctions
The Office of Foreign Assets Controls (OFAC) of the U.S. Department of Treasury administers and enforces trade sanctions imposed by the U.S. government. OFAC’s sanctions programs include broad-based prohibitions that impact entire countries (e.g., Cuba, Iran, Sudan, and Syria), as well as narrower programs focused on specific individuals, activities, or regimes (e.g., the Balkans, Belarus, Iraq, and Somalia). The restrictions under the different sanctions programs vary widely. Among other limitations, various economic sanctions programs restrict imports from or exports to a country, prohibit dealings with governments or nationals of a country, and prohibit financial or other transactions with government and private entities, as well as individuals. Specific targets of the various sanctions programs are identified on the “Specially Designated Nationals and Blocked Persons List” (SDN List) administered by OFAC. The restrictions imposed under the sanctions for Cuba and Iran extend not only to U.S. entities, but also to all foreign owned or controlled subsidiaries of U.S. entities, making the reach of the sanctions broad.

Imports
U.S. Customs and Border Protection administers and enforces laws and regulations related to imports into the United States. These laws and regulations govern the classification, valuation, country of origin, and marking requirements of items to be imported, as well as set forth the requirements for certain duty preference programs (NAFTA and other free trade agreements).

Anti-Boycott
The departments of Commerce and Treasury each administer and enforce separate anti-boycott laws and regulations. The anti-boycott laws and regulations prohibit or penalize participation in boycotts that are not sanctioned by the U.S. government. The primary target of these antiboycott requirements is the Arab League Boycott of Israel. Accordingly, this creates a compliance concern

The restrictions under the different sanctions programs vary widely.

Anti-Corruption
The United States and many other countries have anti-bribery and anti-corruption laws that make bribery of foreign officials illegal. The Foreign Corrupt Practices Act (FCPA) prohibits the payment of bribes to foreign officials in order to obtain or retain business. This prohibition applies
to U.S. citizens, U.S. companies, foreign subsidiaries of U.S. companies, and in some cases, third party agents, distributors and others acting on behalf of a U.S. person or company. The FCPA also requires issuers to maintain accurate books and records as a means to encourage transparency in their business dealings.

The fines that can be levied are significant and arise in many contexts.

Why Should My Client Be Concerned With International Trade Due Diligence?

The Costs of Successor Liability
As a general legal matter, when one company acquires another, the successor company assumes the liability of the predecessor company. Under this theory of successor liability, a buyer can be held liable for violations of laws and regulations committed by the target—even if the violations occurred entirely before the buyer’s acquisition of the company. The fines that can be levied are significant and arise in many contexts. Conducting due diligence to determine whether violations exist is critical so that the overall impact to the transaction can be measured. If the buyer believes violations have occurred, it will want to assess whether an amount should be placed in escrow to cover the potential costs of the violations. The buyer will also want to ensure that it includes in its final term sheet indemnification language to allow for the potential recovery of costs relating to the investigation, potential disclosure, and remediation of violations committed by the target. Finally, conducting due diligence may help to mitigate violations that are uncovered and disclosed to government agencies.

Due Diligence to Ensure the Acquisition is Valued Correctly
In addition to being exposed to liability for the past actions of the target, inadequate due diligence can put the buyer at risk of paying too much for a number of reasons associated with international trade regulatory matters. The following are examples of how trade regulatory issues may impact the price of the transaction, the value of the ongoing business, or cause disruption to the business post-transaction:

- Possible loss of revenue streams from countries subject to U.S. trade sanctions. If the target does business with countries subject to U.S. trade sanctions, those business activities may not be able to continue following the closing of the transaction (even if the target is not a U.S. entity). Particularly transactions involving Cuba or Iran would need to cease if the acquirer is (or has) a U.S. parent; other transactions would need to be reviewed for compliance on a go-forward basis.

- Corruption risk may result in the need to terminate certain employees, sales agents, distributors, or other business partners. If such parties were key to getting business or maintaining existing contracts in a particular country or region, the future revenue stream there may be diminished for some period. Existing contracts believed to be obtained through corrupt payments would need to be scrutinized closely.

- There may be a loss of export or government contracting privileges. Violations of export or anti-corruption laws and regulations may result in a loss of government contracting or export privileges. Hence, in addition to the possible successor liability risks associated with payments of fines, business opportunities with international or government customers may be lost.

- Poor import compliance can disrupt the supply chain. Misclassified goods could result in the need to pay unpaid duties and related fees associated with the correct classification of goods imported previously by the target (in addition to any penalties). Imported goods may be subject to greater scrutiny by customs, resulting in delays to get needed goods.

- Delays can occur with transition of licenses and other authorizations. Will the transaction result in the buyer being required to register with the Department of State under the ITAR? Planning for this in advance of closing is key to minimizing delays post-closing for transition of export...
authorizations to the buyer. Also, working with the acquired business to plan shipments around the time of closing to minimize the impact on customer deliveries while authorizations are transferred by the relevant agencies.

All of the above scenarios (some of which could result in penalties under successor liability principles) should be of an immediate concern as they influence the ability of the buyer to carry on business post-acquisition, thus directly affecting the value of the transaction.

**What Types of Due Diligence Requests Should I Make?**
The following lists include samples of key requests for each of the major international trade topics described here that may be necessary as part of a due diligence review:

**Export Controls**
- Provide a list of countries to which the target or its affiliates have exported any goods, services, software, or technology within five years.
- Provide a description of the jurisdiction and classification process employed by the target for its goods, services, software, or technology, and provide a copy of any classification matrix.
- Does the target employ any individuals in the United States who are not “U.S. Persons” (i.e., citizens or permanent residents of the United States)? If yes, to what types of technology or technical data do such persons have access?
- Provide copies of all Department of State and Commerce licenses obtained by the target or its affiliates and that were valid at any point during the last five years.

**Imports**
- Provide a list of countries from which the target or its affiliates have imported goods within the past five years.
- Provide a list of the Harmonized Tariff Schedule (HTS) codes for the items imported by the target during the past five years.
- Provide a representative sample of customs entry documentation for shipments imported within the past five years.
- Provide a description of your company’s activities involving duty-free imports and activity under the North American Free Trade Agreement (NAFTA) or other applicable duty preference programs.

**Trade Sanctions**
- Does the target or its affiliates conduct any activities, directly or indirectly, with Cuba, Iran, North Korea, Sudan, or Syria? If so, describe the activities.
- Provide copies of all Department of Treasury licenses obtained by the target or its affiliates and that were valid at any point during the last five years.
- Does the target or its affiliates screen the end use and end users for international transactions against U.S. government prohibited lists such as the Specially Designated Nationals and Blocked Persons List? If so, how?

**Anti-boycott**
- Does the target or its affiliates conduct business in Iraq, Kuwait, Lebanon, Libya, Qatar, Saudi Arabia, Syria, or Yemen?
- Has the target or its affiliates ever received a request to furnish information or otherwise cooperated in a foreign boycott such as the Arab League Boycott of Israel?
- Provide copies of any reports or related filings with government agencies related to anti-boycott matters.

**Anti-Corruption**
- Provide a list of countries in which the target does business.
- Does the target or its affiliates utilize consultants, agents or distributors to assist with its business activities outside the United States? If
so, does the target or its affiliates conduct due diligence on such parties prior to engaging them? If so, describe the due diligence process. Provide a list of these parties.

**General Requests Applicable to All Transactions**

In addition to the above targeted requests, the following general requests apply to all international trade related due diligence:

- Provide copies of all export, import, trade sanctions, anti-boycott, and anti-corruption compliance processes, procedures, or manuals.

- Has the target or its affiliates filed a disclosure with or been investigated or penalized by the government relating to a potential violation of any export, import, trade sanctions, anti-boycott, or anti-corruption law or regulation? If so, provide a copy of all correspondence to or from the government.

- Does the target or its affiliates provide training to employees regarding export, import, anti-boycott, economic sanctions, or anti-corruption laws and regulations? If so, provide copies of training materials during the past five years.

**Summary**

Due diligence focused on international trade regulatory matters can help the buyer in a transaction maximize the value of the transaction. By identifying regulatory risks prior to closing, one can structure the transaction to provide adequate holdback to cover possible regulatory penalties stemming from prior non-compliance by the target company. One can also ensure that the price for the acquisition adequately reflects the value of the business going forward, accounting for changes that may need to be made to continue the business in a compliant manner.

Endnotes:

1. In addition to the controls described herein, specific export controls administered by the Nuclear Regulatory Commission and the Department of Energy also apply to exports of equipment and technology used in nuclear applications, including commercial nuclear applications.

2. 22 C.F.R. Parts 120 through 130

3. 22 C.F.R. Part 121.

4. 15 C.F.R. Parts 730 through 774

5. Current Export Control Reform efforts are likely to result in certain items currently controlled under the ITAR being moved to control under the EAR. At such time, there will be some military items that are controlled under the EAR, in addition to the commercial and dual-use items currently regulated thereunder.

6. 31 C.F.R. Parts 500 through 599.


10. See, “FCPA, A Resource Guide to the Foreign Corrupt Practice Act,” p.28, available at http://www.sec.gov/spotlight/fcpa/fcpa-resource-guide.pdf (Stating that DOJ and SEC encourage companies to conduct pre-acquisition due diligence and improve compliance programs and internal controls after acquisition for a variety of reasons and further noting that “[i]n a significant number of instances, DOJ and SEC have declined to take action against companies that voluntarily disclosed and remediated conduct and cooperated with DOJ and SEC in the merger and acquisition context.”)
Megan A. Gajewski, an associate at Bryan Cave in Washington, D.C., focuses her practice in international trade and antitrust/consumer protection matters. She counsels clients on matters involving the International Traffic in Arms Regulations, Export Administration Regulations, sanctions administered by the Office of Foreign Assets Control, U.S. anti-boycott laws, and the Foreign Corrupt Practices Act. She assists clients with obtaining export licenses and agreement approvals from the departments of Commerce, State, and Treasury, with commodity jurisdiction and classification requests, and with assessing compliance with export and defense trade controls, trade sanctions, anti-boycott, and anti-corruption laws and regulations. She also handles antitrust and consumer protection issues, including data collection and security, and advises clients on matters relating to consumer protection investigations brought by the Federal Trade Commission.

Susan M.C. Kovarovics, partner at Bryan Cave, counsels foreign and domestic parties regarding international business regulatory matters. Her practice focuses the International Traffic in Arms Regulations, Export Administration Regulations, sanctions administered by the Office of Foreign Assets Control, U.S. anti-boycott laws, and the Foreign Corrupt Practices Act. She designs and implements compliance programs and provides training sessions on export and defense trade controls, trade sanctions, customs, anti-corruption, and anti-boycott matters. She also designs and leads internal audits and reviews to assess compliance in these areas. She assists clients with all aspects of the export license and agreement approvals processes at the departments of Commerce, State and Treasury.

Michael D. Mellen, associate at Bryan Cave, focuses his practice on international trade compliance, with a particular emphasis on export controls and economic sanctions. He represents clients in a wide range of industries with issues relating to the International Traffic in Arms Regulations, Export Administration Regulations and the various embargoes and sanctions administered by the Office of Foreign Assets Control, including representation of clients before U.S. governmental agencies in investigations and administrative proceedings. He also has experience with U.S. anti-boycott laws, the Foreign Corrupt Practices Act and filings with the Committee on Foreign Investment in the United States.

Christina A. Zanette, associate at Bryan Cave, focuses her practice on a wide range of global trade issues and export control matters, with an emphasis on the International Traffic in Arms Regulations, Foreign Corrupt Practices Act, and Export Administration Regulations. She has provided guidance to the defense industry on government contracts issues and the U.S. security assistance program, retransfer/re-export of ITAR and EAR goods and services, and has played a key role in the preparation and successful resolution of voluntary self-disclosures with the departments of State and Commerce. She is proficient in written and spoken Spanish.

Join the VSB International Practice Section

The global market has changed drastically since the formation of the International Practice Section in 1978. Now, more than ever before, Virginia lawyers encounter matters that are international in nature or which have transnational implications, and their clients require proactive expertise to meet the dramatic opportunities and challenges of this dynamic and complex business and regulatory environment.

The expertise and network of resources represented by the board and section members are valuable resources to practitioners. The section strives to provide timely continuing legal education programs as well as alerts via newsletters or other communications to topics of importance. The board also serves as a valuable network to identify and refer practitioners to colleagues in the section with the specialized expertise required for specific client matters.

We invite you to become an active member of our section and to let us know how we can serve you.