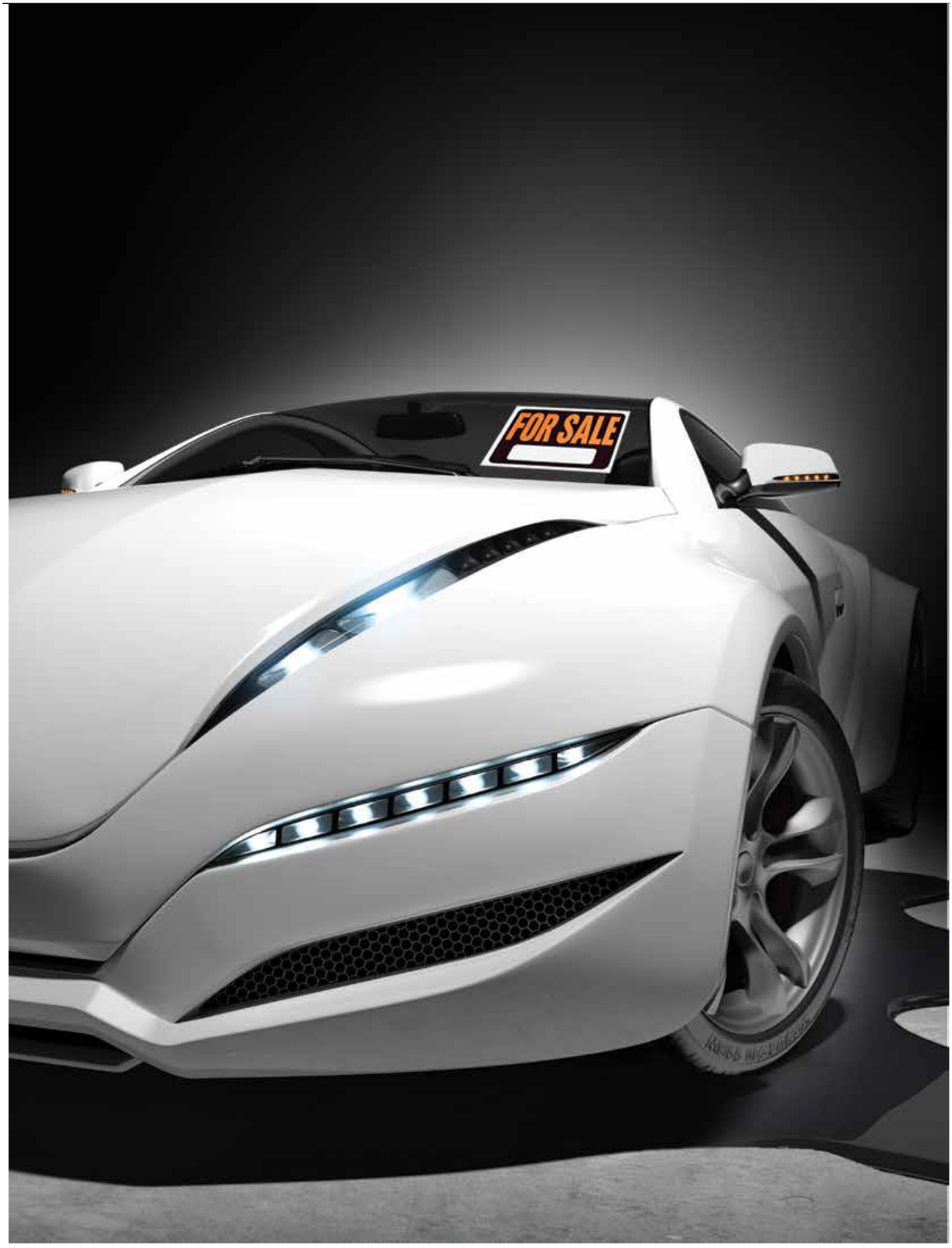
The Missing Topic on Your M&A Due Diligence Checklist: Successor Liability for Export/Import and Sanctions Violations

Compliance and Ethics

Corporate, Securities, and Governance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CHEAT SHEET

- The best way to avoid the unpleasant surprise of an inherited liability before an international merger or acquisition is to conduct due diligence on export compliance with various government agencies that oversee trade and with those of other governments where the target company does business.
- A company's ability to minimize any potential short- and long-term damage to its business depends on the amount of time and effort devoted to such due diligence, and the extent to which these efforts are carefully documented to serve as evidence of your compliance efforts.
- Penalties for so-called successor liability can often be minimized by cooperation with government investigations, remedial measures an acquirer takes and voluntary disclosures.

In today's globalized world, an ever-increasing number of companies are involved in cross-border trade and transactions in some capacity. International business is no longer reserved for the large multinationals — it now involves small and medium-sized companies across nearly every sector of the global economy. Whether you receive raw materials or goods from China, provide services to foreign clients, or ship products to customers around the world, your company is subject to an intricate system of overlapping laws that control the movement of goods, information and services, and regulate cross-border transactions. The laws cover everything from importing products that don't conform to electrical standards to exporting products to an entity on a government restricted party list to accepting funds from a sanctioned country.

Unsurprisingly, this complex web of rules and the agencies that enforce them create the potential for inadvertent yet costly infractions. These inadvertent errors can affect your company's bottom line, severely limit its ability to export or import, or even bankrupt the company. For instance, you may inherit a significant violation or unknown, ongoing and unpaid dumping duties. It may take years for a violation to be discovered. In addition, established principles of strict successor liability and fairly long statutes of limitations in this area of the law mean export and import compliance issues are indispensable when performing complete and effective due diligence on a merger or acquisition. In fact, US officials regularly request a voluntary waiver of any applicable statute of limitations at the outset of an investigation. Since a company that refuses to comply with such a request is seen as uncooperative, the company is effectively forced to grant the request to preserve the possibility of lower fines for being a cooperating company. This severely limits the ability to defeat an inherited violation on the grounds that the statute of limitations has expired.

In light of these potentially costly dangers, a review of a company's records, policies and programs regarding international trade compliance is no longer a concern of secondary importance: Export/import compliance has the potential to make or break your M&A deal.

This is because the violations are interesting and often make great headlines. No corporate counsel wants to explain to the board how the liability was missed during due diligence. Too often, outside counsel do not have these issues on their M&A checklists. Additionally, private equity firms have developed a no tolerance attitude that shows they do not want to purchase any liability or risk stemming from sanctions and global transactions.

In this article, we will explain the various regulatory regimes that impose successor liability for trade-related violations, provide specific examples of these types of violations and the government enforcement actions and penalties they generated, and create a checklist to help structure the export/import aspect of your M&A due diligence review. These steps will highlight red flags so that you will be more cognizant of the risks associated with a potential partner or acquisition target company.

Unwelcome surprises: inheriting liability for violations long-passed

Picture this: Your company is in the midst of an acquisition. During negotiations, a standard due diligence process is followed, including reviews of financial statements, contracts, accounting policies, corporate documents, employee benefits and insurance. The deal ultimately goes through. Months later in the post-acquisition transition it is discovered that the acquired company violated both US and foreign trade laws. It may have happened years ago, but your acquiring company can still be held liable. Perhaps the acquired company was shipping dual-use goods without the required export licenses, shipping to a debarred party on one of the many government lists of debarred parties and specially designated persons, or shipping to a third-party that then transshipped the products to an embargoed or sanctioned country. It is equally problematic if you later discover that the acquired company, a manufacturer, broker, exporter or re-exporter, exported products specially designed for military use without the proper license. Worse yet is finding out that the acquired company had a foreign “consultant” who made a significant charitable donation to the favorite charity of a foreign government official in order to convince her to help it obtain new business. Goodyear’s recent $16.2 million settlement with the SEC over liability it inherited as a result of two African subsidiaries’ past misconduct evinces the government’s increased willingness to punish companies for such pre-acquisition bribery-related violations.

Even if your company was not aware of any of these actions, it may have inherited criminal and civil liability under US law. If the acquired company’s presence in a foreign country or the fact that your product originated in that country also places the transaction under the jurisdiction of that foreign country’s government, fines imposed by the US government might just be the tip of the iceberg.

What complicates the situation is that no single US government department, and for that matter, no one government, has jurisdiction over all of the various violations described above. In the United States, the agencies that have a hand in administering and enforcing export/import and sanctions regulations include the Department of Commerce, the Department of State, the Department of the Treasury, the Department of Justice, the Securities and Exchange Commission, and Customs and Border Protection. The principal regulations governing trade-related violations and prescribing liability for such acts are Commerce’s Export Administration Regulations (EAR), 15 C.F.R. §§ 730–80; State’s International Traffic in Arms Regulations (ITAR), 22 CFR §§ 120–130; Treasury’s Foreign Assets Control Regulations, 31 C.F.R. §§ 500–99; and Justice’s Foreign Corrupt Practices Act (FCPA), 15 U.S.C. §§ 78dd-1 to -3. Most foreign governments have corresponding government organs and regulatory regimes that mirror that of the United States, so it is equally important to consult the rules of other jurisdictions involved in the transactions you are reviewing as part of your due diligence to determine whether or not the company you are thinking of acquiring has satisfied all of its export licensing requirements.

Violations giving rise to successor liability

Inherited export violations can be incredibly time consuming and expensive, and, in rare cases, can

restrict future exporting and government contracting. FCPA and parallel anticorruption enforcement by foreign governments has become a hot topic and can bring in settlements in the hundreds of millions of dollars. In 2014, the government of China handed UK drug maker GlaxoSmithKline a fine of nearly $500 million (the highest corruption-related fine ever imposed on a private company) because its local subsidiary was found guilty of bribing Chinese doctors. The company is still dealing with similar charges relating to bribes in Iraq, Jordan, Lebanon and Syria, and is under criminal investigation by the United Kingdom's Serious Fraud Office. It still remains to be seen whether the United States Department of Justice will begin a similar investigation, but with intergovernmental cooperation on the rise, harmonized investigations and the potential for carbon-copy prosecutions in multiple countries are quickly becoming the norm.

Export enforcement matters and sanctions violations are also reaching the top of news feeds as more and more companies ship or send products and information across borders despite ongoing international disputes that necessitate the implementation of sanctions to keep sensitive materials and information out of the wrong hands. For example, the sanctions implemented (and periodically strengthened) by the Treasury Department in response to the conflict in Ukraine now require companies to include procedures that vet all potential Russian business partners to make sure transacting with them is currently lawful. These Treasury Department regulations tend to change rapidly as the political debate as well as the situation on the ground evolve, which means companies must constantly re-run parties against the various prohibited parties lists and update their procedures to ensure the right transactions get flagged. The fact that the European Union has implemented its own set of Ukraine-related sanctions further complicates the situation: if your company does business in the European Union you may be required to reevaluate a given transaction with respect to the European Union's set of unique sanctions as well.

Enforcement

Export control and sanctions violations are routinely found together with FCPA and global anti-corruption violations during investigations. Even if all of these actions happened long before the acquirer took over the business, as far as liability is concerned, that does not matter. For these reasons, international trade due diligence is now a necessary part of the premerger and acquisition due diligence process. And it isn't just exports. It is recommended that companies add import issues to their list as well. You can inherit import duties when products are wrongly classified or violate US Customs and Border Protection regulations for improper country of origin and package labeling. Incorrectly calculating the transaction value of imported products, particularly for intra-company transfers, is another common issue.

The government often considers each piece of paper as a separate violation, so a single transaction can turn into multiple violations resulting in unexpectedly higher fines. When a violation is found, the government considers certain mitigating factors when assessing fines and penalties, such as the company's cooperation, whether the company voluntarily disclosed the violation, and evidence of an internal compliance program and training.

Once you discover a violation, you may decide to undertake your own internal investigations or hire an outside attorney to investigate in the hope that such actions will avoid more intense government inspection and scrutiny. Remember that using an attorney rather than a consultant gives your company the attorney-client privilege.

There are also aggravating factors such as failure to disclose, willful blindness, intentional actions to work around the prohibitions and a culture of non-compliance. So the only way to protect your

company and its senior management is to invest in trade compliance before a violation occurs. If a violation is discovered, companies can reduce or defer criminal and civil fines and penalties by convincing the government that the company will begin to invest in compliance. Today, more and more enforcement divisions are focusing on compliance. The government truly wants companies to self-police. This means you must have the requisite management commitment in addition to adequate funding and compliance policies and procedures.

Increasing successor liability for Commerce Department violations

Successor liability under the EAR was firmly established in the 2002 case of Sigma-Aldrich Business Holdings (Sigma) where an administrative law judge at the Commerce Department's Office of Export Enforcement held that Sigma, the buyer, was indeed responsible for the pre-acquisition export violations of the seller. Particularly noteworthy is the fact that Sigma's argument that successor liability could not be imposed on the buyer where the seller remained a viable enforcement target (Sigma had merely purchased its assets) did not convince the judge that the enforcement action against the acquiring firm was unwarranted. Thus, even in a mere transfer of assets, where the seller continues to do business as it had before the transfer, the buyer is still susceptible to enforcement actions under the successor liability doctrine. Later the same year, Sigma settled the 318 charges of unlicensed exports of biological toxins, false statements and failure to retain records for $1.76 million.

Since establishing successor liability, BIS has not taken pity on the unsuspecting acquirers. In fact, it continues to impose the harshest penalties on acquirers not withstanding their lack of culpability. In 2010, BIS imposed the maximum civil penalty of $250,000 per violation when it fined Sirchie Acquisition Company, LLC $2.5 million for 10 export violations based on an acquired company's previous violations of a denial order against its CEO. Yes, the CEO was on a denied parties list!

In a more recent case, an administrative law judge granted BIS's motion to add C.A. Litzler Co. Inc. of Cleveland, Ohio (Litzler), to a pending export violation case against the firm that Litzler had recently acquired a substantial interest in. The fact that the acquisition of assets came after BIS had initiated its enforcement action did not prevent the judge from adding Litzler to the case as a successor in interest. In April of 2014, the judge ordered Litzler to pay a civil penalty for the inherited violations.

Successor liability and mitigation for State Department violations

In 2009 Qioptiq S.a.r.l (Qioptiq), a Luxembourg-based company, agreed to pay a fine of $25 million to the Directorate of Defense Trade Controls (DDTC) at the Department of State. The fines were primarily based on past ITAR violations of a company it acquired and concerned unlicensed exports of night vision items. Although the Department of State considers a buyer strictly liable for a seller's export violations, they do take mitigating factors into account. The Qioptiq case illustrates how important such factors can be in minimizing penalties.

Ultimately, $10 million of the $25 million fine was suspended in consideration of the cost of the compliance initiatives that Qioptiq had already undertaken and the cost of future government-mandated compliance initiatives. Moreover, DDTC explained that in charging Qioptiq with 163 export violations it had considered its voluntary disclosures, the pre-acquisition nature of the violations, and Qioptiq's remedial measures as mitigating factors. Without these measures DDTC indicated that additional violations and more severe penalties would have been pursued.

Successor liability after due diligence for Treasury Department violations

In 2010, Hilton International (Hilton) paid a $735,407 penalty to the Treasury's Office of Foreign Assets Control (OFAC) after disclosing Sudanese Sanctions violations that it found during pre-acquisition due diligence on seller Hilton Group plc. The penalties were downgraded from $250,000 per violation to just $11,000 because of Hilton's self-disclosure, its voluntary waiver of the statute of limitations, and the company's continued cooperation with the government's requests for additional information once the investigation was formally initiated.

Due diligence in a time of transition: export control reform

Sometimes, it is not obvious if the company you are looking to acquire has committed a trade-related violation. Let's consider the potential impact of the Export Control Reform (ECR) initiative, which began in 2013 and continues to be rolled out in stages. The reform initiative's ultimate goal is simplifying the regulatory regime in order to clarify and consolidate license requirements and make it more straightforward and less costly for American exporters to do business competitively while remaining compliant with each set of government regulations.

In the new world of ECR, whether a product falls under the State Department's ITAR can often be determined simply by consulting the United States Munitions List (USML). The basic principle is that if an item is specifically enumerated on the USML, it is controlled by ITAR. However, sometimes it isn't so cut and dry, and an item may be subject to ITAR because it is "specially designed" under a particular category of the USML, requiring the application of the new "specially designed" definition in order to make that determination. Regardless of how an item is captured on the USML, it follows that an item controlled by ITAR cannot be exported from the United States or subsequently re-exported from one foreign country to another without prior approval from the Department of State in the form of a license or other authorization.

The ongoing ECR requires companies to update their procedures while keeping up with the day to day grind and, in some cases, learn a new set of rules. The ECR changes have complicated the export control review process in the short term. Determining whether a product falls under this new and fairly complicated "specially designed" definition and is therefore under State Department jurisdiction, or if it is "released" under the definition and therefore subject to the Commerce Department's jurisdiction, is both crucial to exporting lawfully and relatively new and unfamiliar to many in-house export compliance departments. Despite the fact that many responsible companies have taken steps to prepare for such changes and remain abreast of their ramifications, ECR, like all change, unavoidably creates an increased potential for inadvertent violations simply because the system is new to those individuals charged with putting it to use.

The bottom line is that due diligence efforts become all the more important in this environment of transition. In light of the headaches that could result from inheriting inadvertent violations brought about by ECR confusion, counsel may need a more detailed pre-acquisition independent expert review of transactions affected by the ongoing ECR regulatory changes.

Elements of a pre-acquisition international trade review

As with other compliance tasks, the best way to manage such a complex process is to generate a framework checklist for each trade issue and incorporate it into your existing due diligence process. The following is a list of some import and export topics to include in your process. This list is meant

for use in issue spotting. A more comprehensive list should be developed for document review or an audit.

- Export compliance, including an assessment of State and Commerce Department product classifications; risks based on end-use, end-user and export destinations; registration requirements; and export licenses;
- Import compliance, including proper markings, tariff classifications, required accompanying documentation and compliance with applicable quality standards, and import licenses;
- Antidumping and countervailing duty assessments, including inquiries into whether unknown or ongoing unpaid duties exist as a result of transactions with certain foreign manufacturers;
- Re-export risks of product diversion contrary to US and applicable foreign law;
- Deemed export issues concerning the release of controlled goods and technology to foreign nationals inside the United States, or deemed re-export issues concerning activities outside the United States;
- Cloud computing and other network issues creating unintended or unanticipated exports requiring licensing;
- FCPA compliance including an assessment of books and records, risks based on location and nature of business, internal control measures, compliance culture, political activities abroad and third-party actions;
- Anti-boycott reporting requirements and compliance procedures;
- US and EU sanctions and embargos compliance including an assessment of applicable sanctions programs based on product type, shipment destinations, initial buyers, end-uses, and end-users;
- Compliance education and training, including manuals and management support of the overall compliance program assessing the likelihood of violations, ability to provide mitigation of government enforcement, and the need for restructuring to provide effective protection against future violations;
- Due diligence risk assessments and documentation of customers and third-party contractors, vendors, agents, distributors, investors and partners for “know your customer guidelines”;
- Documentation of internal compliance due diligence reviews; and,
- Past violations inquiry to assess target’s relationship with DDTC, BIS and OFAC (in addition to the DOJ and SEC).

Your company’s pre-acquisition due diligence will serve as a mitigating factor in the event that any wrongdoing is actually discovered. How quickly you report the prior violation(s), what training and compliance program you implement upon discovery of the violation(s), and your corporate compliance culture will impact the response you receive from the government. Consequently, your ability to minimize any potential short- and long-term damage to your business will depend on the amount of time and effort that you devoted to the pre-acquisition due diligence process and the extent to which these efforts were carefully documented to serve as evidence of your compliance efforts.

The best way to avoid successor liability is to audit the target company’s trade policies, procedures and practices to determine your import and export risks. The cost to do this will be recouped upon completion of the transaction because the more you learn about the current practices and procedures during the pre-acquisition stage the easier the integration process will be. Going forward, your company will be better positioned to quickly improve internal compliance, reduce risks and liability, and manage trade and logistics on a global basis.

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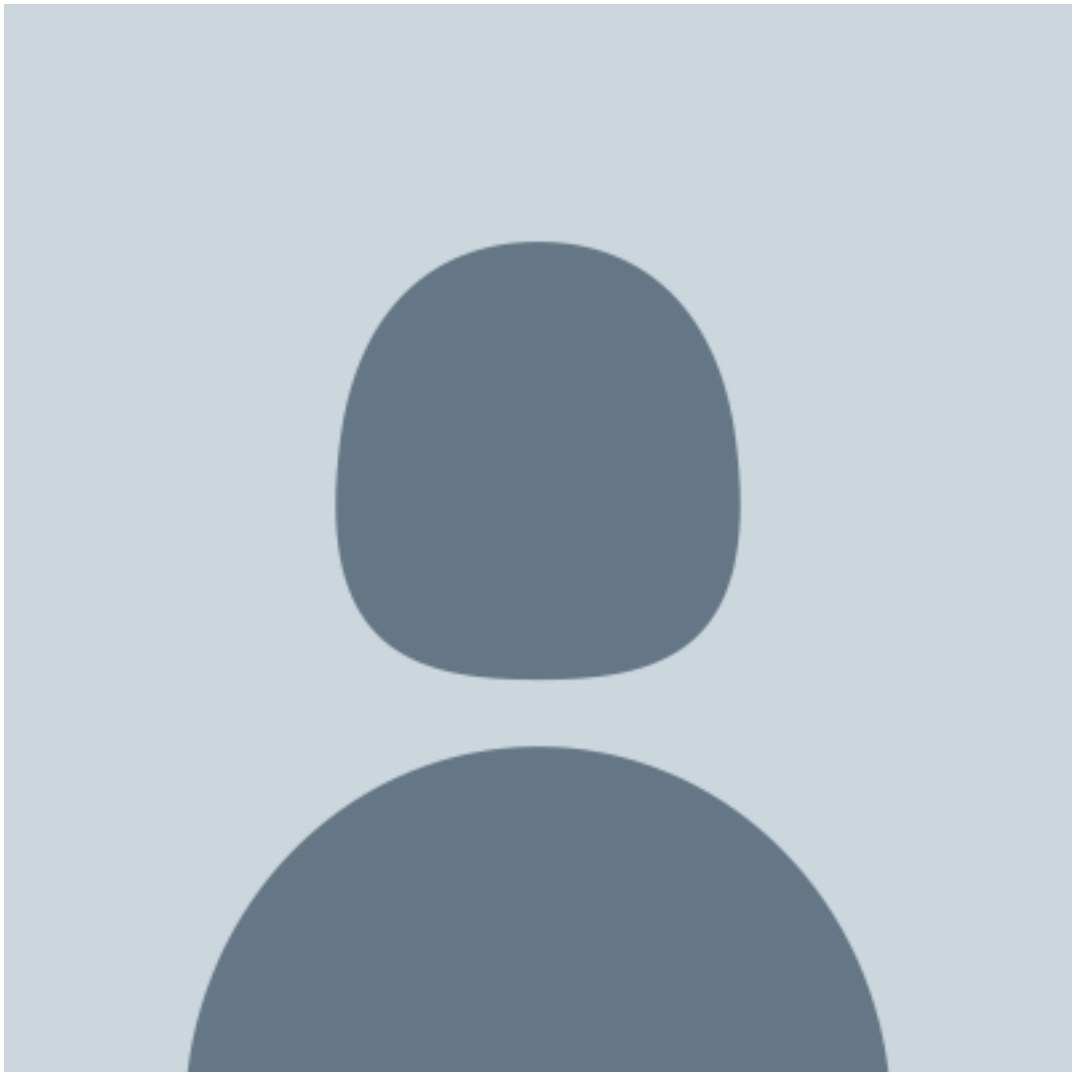

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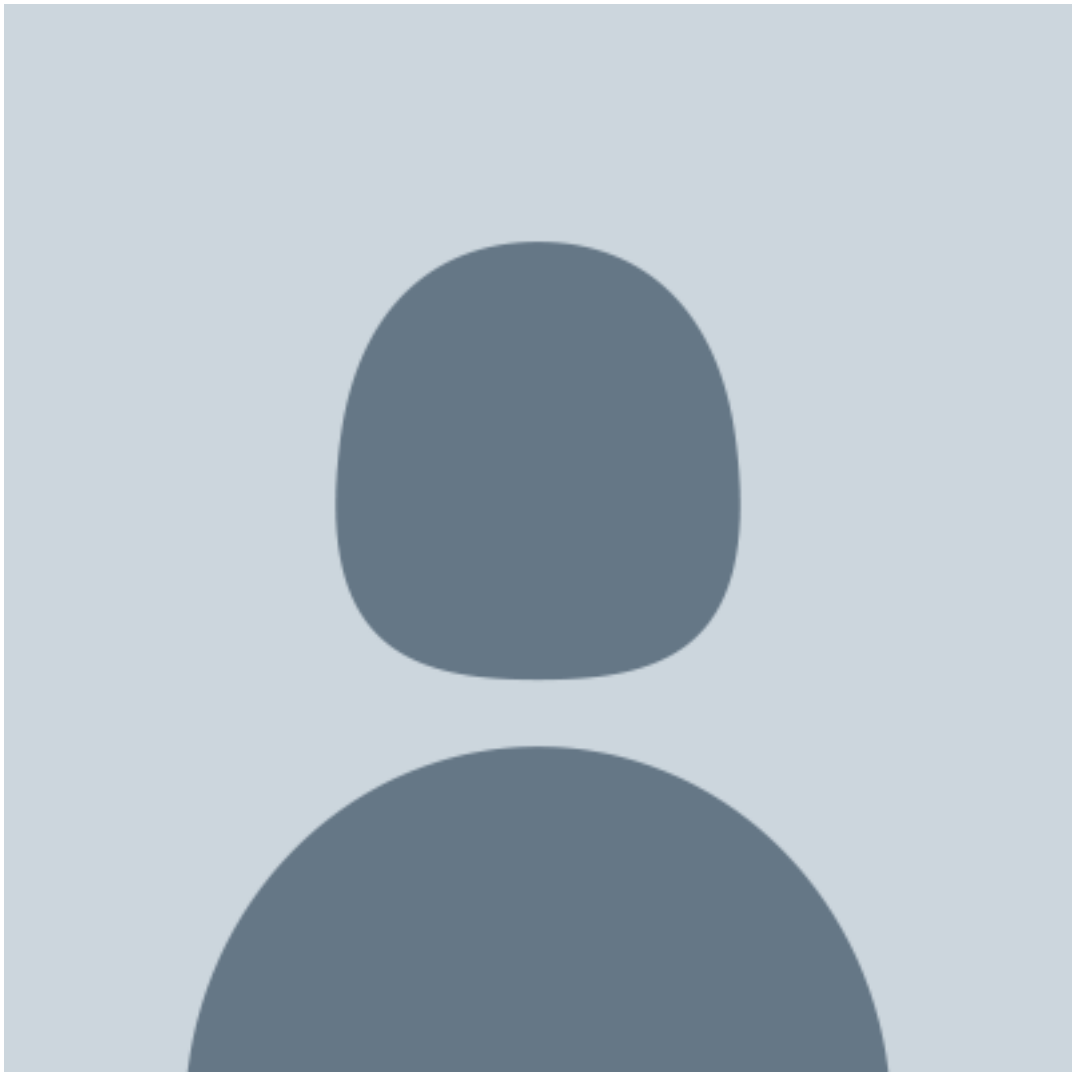

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Doreen M. Edelman is a co-leader of the firm’s global business team. She focuses her practice on international trade and has 25 years of experience counseling companies on import and export matters. A frequent speaker and contributor on international compliance and regulatory issues, Edelman has developed an online, on-demand training module for companies, Export Compliance Tools.