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CORPORATE COUNSEL SECTION

NEWSLETTER

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TOP TEN EXPORT COMPLIANCE NIGHTMARES

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Advising clients on export compliance generally involves routine, albeit important, matters. Sometimes export compliance advice must be provided in the shadow of other pressures, such as the need for quarter-end revenue recognition. The "routine" export compliance issues, such as determining eligibility for license exceptions, are not ones that keep you or your clients up at night. However, export compliance deficiencies that threaten continued business operations with the potential for significant fines and penalties, and which require prompt and dramatic intervention to avoid serious repercussions for your client, are the ones that are the most troubling.

Outlined below are what we consider to be the top ten export compliance nightmares that could confront a company during efforts to comply with the Export Administration Regulations[1] and the International Traffic in Arms Regulations.[2] We also provide suggestions on steps that must be taken to minimize the impact on your clients.

I. Failure to address the "deemed export" requirement and to obtain necessary export licenses for key foreign national employees

The so-called deemed export rule, which states that access to technology within the United States by a non-permanent resident foreign national requires the same export authorization that would be required for an actual export of the technology to the foreign national's home country. If a foreign national employee will need access to technology that would require a license for an actual export to her home country, a license will also be required for access to the technology in the context of her employment in the U.S. Failure to obtain the required deemed export license is a violation of the EAR, which carry maximum civil penalties of $250,000 per violation.

The foreign national's access to the controlled technology must be terminated immediately even if that means paying her to stay home while the matter is resolved. A voluntary self-disclosure to the Bureau of Industry and Security (BIS) must be considered, and the employer would need to obtain a license to provide the foreign national with continued access to the controlled technology. A voluntary self-disclosure might be prudent because the submission of a license application could be considered acting with knowledge of a violation, which would itself be a violation of the Export Administration Regulations.

II. Movement of key products or technology from Commerce Department export jurisdiction to State Department export jurisdiction as a result of a Government Jurisdiction request

The Directorate of Defense Trade Controls (DDTC) at the State Department has sole authority to determine if a product or technology falls under the ITAR as a defense article or under the EAR as a dual-use item. The exercise of that authority can result from a request made by another government agency, typically the Department of Defense. The only possible appeal of a DDTC jurisdiction determination is to the State Department itself.

A prerequisite to applying for licenses from DDTC is the submission of a detailed registration package to DDTC, as well as payment of an initial registration fee of $2,250 for the first year. The registration must be renewed on an annual basis, with the annual registration fee based on the number of licenses submitted and processed each year for the company.

Customer relations will also need to be addressed. Customers used to rapid fulfillment of orders will need to understand that additional processing time will be required for future orders. License applications are processed by DDTC in an average eighteen days, but at least a full month will be required to collect the information needed for the applications, to prepare and submit applications, and to receive approved licenses.

III. Incorrect filings of Electronic Export Information (EEI) in the Automated Export System (AES) by a freight forwarder

Exporters frequently rely on freight forwarders to make their EEI filings. Failure to provide adequate oversight and quality control can result in multiple violations of the Foreign Trade Regulations,[3] with maximum civil penalties of $10,000 per violation.

The exporter would need to make a prompt voluntary disclosure to the Census Bureau. In order to resolve that disclosure, the Census Bureau will require the company to implement corrective actions to ensure the mistakes are not repeated. Additionally and potentially far more burdensome and disruptive to normal business operations, Census will require identification and correction of all inaccurate filings of EEI for the past five years. That presupposes, of course, that all necessary records have been retained and are readily retrievable.

IV. Unlawful re-exports to embargoed destinations by a company's overseas subsidiaries

The company will need to consider whether to make a voluntary disclosure to BIS and to the Office of Foreign Assets Control (OFAC) at the Treasury Department. Depending on the facts of the violations, the disclosure might also be referred to the Justice Department for review and potential prosecution of criminal violations.

The company will need to engage in a detailed investigation of the violations, including sending teams to each of the subsidiaries involved to determine how and why the violations occurred. Thorough corrective actions will need to be implemented. Settlement negotiations will need to be conducted between the company, BIS, OFAC and, potentially, the Justice Department.

Once the case is settled, the company might be obliged, as a condition of the settlement, to pay for annual compliance reviews for the next three years. Those reviews must be conducted by an independent third party, and the results will be reported directly to the government.

V. A company's foreign sales representative is sanctioned by the U.S. Government because of export violations, but local law restricts the company's ability to terminate the relationship, and the contract with the representative does not condition termination of the relationship on the basis of compliance with U.S. sanctions

There is no easy solution for this predicament. If the company wishes to continue doing business in the sales representative's country, it might be required to make payments to the sales representative. The only exit strategy would be to negotiate a termination agreement with the sales representative that would be acceptable under local law. The negotiation and implementation of that termination agreement would itself have to be approved by OFAC prior to implementation.

VI. Failure to consider export compliance requirements during negotiation of major sales contracts

Communication failures between the sales team and the export compliance department are a frequent source of export compliance headaches. Unlike the ITAR, the EAR do not require a formal order or signed contract prior to submission of an export license application, but receipt of a purchase order or execution of a contract is often the trigger that brings the export compliance group into the game. If the sales team has agreed to delivery terms that do not allow sufficient time for license processing, the result is they often must go back and renegotiate the terms or suffer any penalties built into the contract for failure to meet delivery terms.

Several steps can be taken to avoid this pitfall. First, the sales team should be educated on export compliance requirements, including the time required to obtain licenses, when required. Second, the sales team should advise the export compliance department of potential sales, even well before efforts result in a purchase order or signed sales contract. Third, sales contracts and purchase orders should include terms providing relief from penalties for late delivery resulting from a failure of the Government to issue any required export license.

VII. The research and development team incorporates defense articles into the design of a new commercial product without consideration of the resulting export licensing consequences

The result is that the company will have to register with the State Department and obtain licenses for all exports of the new product, even though it is intended only for commercial uses. This scenario hinges on the ITAR rule that any product that incorporates a defense article is itself a defense article. The only potential remedy is submission of a commodity jurisdiction request asking DDTC to exclude the new product from their export jurisdiction. There is a reasonable chance DDTC will choose not to exercise jurisdiction over the new product if the new product has no strategic military utility and the incorporated defense article cannot feasibly be removed and used for other purposes. In any event, a return of the new product to Commerce Department export jurisdiction will take at least 30 to 60 days.

VIII. A failure to understand the requirements and limitations on use of the "Canadian exemption" for exports of defense articles to Canada

The ITAR's "Canadian exemption" for exports of defense articles to Canada without a license is limited to use for shipments to "Canadian registered persons." If shipments are made to parties who are not registered, those shipments are in violation of the ITAR.

In such a situation, a company would need to consider the submission of a voluntary self-disclosure to DDTC with respect to the shipments made in violation of the Canadian exemption.

The initial disclosure notification must be made immediately and supplemented by a final disclosure within 60 days. The disclosure must include information about why the violations occurred, corrective actions taken, and any additional mitigating information. Mitigating factors include whether the exports would have been authorized if application had been made to DDTC, whether the violations were intentional or inadvertent, the existence of an export compliance program at the company, and the lack of previous violations.

IX. Reliance on a freight forwarder to determine ECCNs and Schedule B numbers for exports

Freight forwarders do not know a company's products as well as the company itself, and reliance on a freight forwarder for ECCN and Schedule B classifications often results in submission of incorrect EEI and potential failure to obtain proper export authorization. The company must address two major issues in this situation. It must ensure that its ongoing and future exports are in compliance with the requirements of the EAR and the FTR, and it must address past violations. The company will need to determine the correct ECCNs and Schedule B numbers and enter them into its internal systems. The company will also need to research the transactions with incorrect information and, armed with information on the nature and extent of the violations, consider submitting voluntary disclosures to both the Census Bureau and the BIS. Should a decision be made to disclose, the Census Bureau will require correction of any incorrect EEI filings over the past five years.

X. Diversions and unauthorized exports of equipment by company employees result in a raid by OEE special agents, including seizure of records and computers

While relatively rare, this type of full-blown enforcement investigation occurs in the most serious instances of export violations. It generally happens when there is a complete lack of management oversight that allows the improper exports to occur. As part of the settlement of such cases, the company sometimes must agree to a denial of its export privileges for a specified period.

This is the ultimate nightmare scenario, involving the so-called exporter's death penalty, the denial of export privileges. When the facts of a case result in a denial of export privileges, there really is no reasonable option for relief. Denial orders are an administrative sanction reserved for the most egregious violations and, if a company finds itself subject to a denial order, it is generally because of a perceived reckless or intentional disregard for the requirements of the EAR. If the denial is imposed after a proceeding before an administrative law judge rather than as part of a settlement agreement, it may be appealed on limited grounds to the Under Secretary of Commerce for Industry and Security, but the prospects for relief are slight at best.

The common themes in these situations are either an abdication of an exporter's compliance obligations to a third party (e.g., freight forwarder), or a failure to devote sufficient personnel and management oversight to internal compliance activities. In light of the potential penalties involved, possible business interruption, and reputational risk, and in view of increased export enforcement activities from a variety of federal agencies, it is apparent that adequately resourcing export compliance is a sound investment that will pay off in the ability to get products to market in a timely fashion with low risk for export violations.

ENDNOTES

[1] The Export Administration Regulations (15 CFR Part 730 *et seq.*) are administered by the Bureau of Industry and Security at the Department of Commerce and govern the export and re-export of dual-use goods and technology.
[2] The International Traffic in Arms Regulations (22 CFR Parts 120-130) are administered by the Directorate of Defense Trade Controls at the Department of State and govern the export, re-export and re-transfer of defense articles and defense services, as well as the brokering of defense articles and services.
[3] The Foreign Trade Regulations (15 CFR Part 30) are administered by the Census Bureau. They require the filing of certain information for most export shipments from the United States. That information is used for the compilation of trade statistics and for export enforcement purposes.

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