

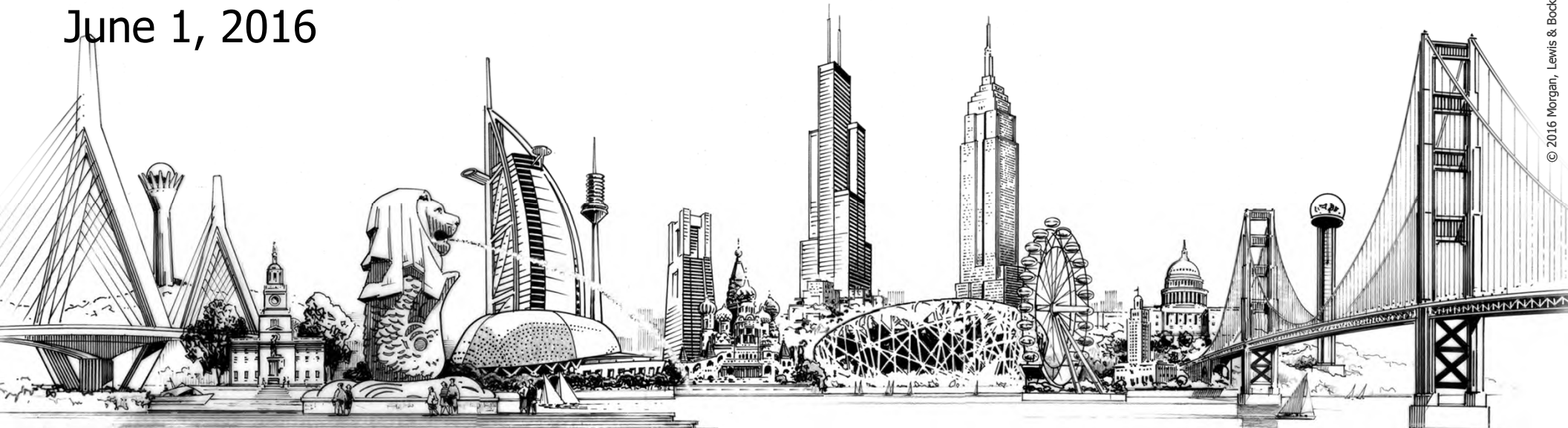
Morgan Lewis

**IMPORT/EXPORT AND OTHER
INTERNATIONAL RISK AREAS IN
M&A TRANSACTIONS**

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OUTLINE

- Specialized Due Diligence and Representations and Warranties
- Successor Liability
- Import Due Diligence for M & A Transactions
- Export Due Diligence for M & A Transactions
- Sanctions Due Diligence for M & A Transactions
- Use of Due Diligence
- Sell-Side Considerations
- Buy-Side Considerations
- Questions & Answers

Specialized Due Diligence

- **International trade due diligence should encompass review of seller's compliance with:**
 - US Customs & Border Protection (CBP) Regulations;
 - The International Traffic in Arms Regulations (ITAR)
 - The Export Administration Regulations (EAR)
 - Office of Foreign Assets Control Regulations (FACR)

Specialized Due Diligence

Threshold issues can affect:

- **The due diligence review process**

Export licenses under ITAR and/or EAR may be required before a technical data/technology review is conducted by buyer if buyer is a non-US entity or if buyer who is a US entity assigns foreign nationals to conduct the technical data/technology review

- **The structure of the transaction to possibly exclude divisions or business units that are not in compliance with import, export, and/or sanction regulations**

- **M & A timing if any foreign ownership or control is contemplated when**

target has security clearances

target is subject to ITAR

target is subject to consent agreement (ITAR violations)

buyer desires to pursue CFIUS review

Specialized Due Diligence Considerations

- Statutes of Limitations (SOL) is five years for violations of all international trade regulations
 - Tolling agreements to extend the five-year SOL are often requested if the government commences an investigation close to the expiry of the SOL. Signing a tolling agreement is a mitigating factor in penalty assessment.
 - Government can “direct” a disclosure if the government detects violations.
 - Voluntary (prior) disclosures can be submitted before the government commences an investigation or issues a directed disclosure notice (mitigating factor in penalty assessment).
 - Mandatory disclosures are required for certain ITAR violations.
 - Customs-based FCA claims by qui tam relators are on the rise and gaining momentum. Virtually any international trade compliance lapse that results in the failure to pay the full amount owed to the U.S. government can lead to claims of FCA liability.

Importance of Specialized Representations and Warranties

- Specialized representations and warranties are important in providing the buyer contractual relief against monetary and other penalties arising from a target's violations of international trade regulations, but they do not protect the buyer from being charged by the government on a successor liability basis for the target's violations of international trade regulations.
- We have a standard set of representations and warranties that should be customized to the transaction in question.

The Transaction May Affect the Target's Business Prospects

- Large penalties
- Loss of import privileges
- Debarment under ITAR
 - No direct exports
 - No indirect exports
- Denial under EAR
- Requirement to be bound by the terms and conditions of consent agreements applicable to the target

Successor Liability

- Successor liability will apply when:
 - There is an agreement to assume liability, explicit or implicit
 - There is a government-required mandate to assume liability for the target's liabilities and violations (DDTC)
 - The transaction is a de facto merger;
 - The transaction is a mere continuation of the predecessor business
 - The transaction was fraudulent and used to escape liability
- Successor liability applies to equity deals as well as asset deals

Successor Liability in Customs Law

Successor liability in customs law is entirely a creation of case law. There are no statutes.

- *United States v. Shields Rubber Corp* (1989)
 - US Supreme Court found that the principles of merger law applied, and that the successor was liable for the violations of the predecessor
- *United States v. Ataka America* (1993)
 - The CIT recognized that liability could attach only under the doctrine of a de facto merger or a continuation of the business

Successor Liability in Customs Law

- *United States v. Adaptive Microsystems* (2013)
 - The CIT applied mere continuation doctrine and the successor purchaser of a bankrupt company was held liable
- *United States v. CTS Holding, Inc.* (2015)
 - The CIT applied mere continuation doctrine and held that the successor purchaser of a defunct predecessor corporation was liable for the predecessor's customs violations in misclassifying products

Law of Successor Liability Under US Export Law

- Largely a creature of decisions of agency administrative tribunals or agency policies
- Courts and agency tribunals are generally left to their own devices to fashion standards for successor liability
- Few US statutes imposing a regulatory regime expressly mention successor liability

How Successor Liability in Export Actions Began

- AECA, EAA, IEEPA, and TWEA don't specifically deal with USG enforcement via successor liability
- Prior to 2002, successor liability in export transactions was not a critical issue
- Enforcement agencies generally pursued remedies/penalties against violators themselves

How Successor Liability in Export Actions Began

- Prosecuting actual violator only is currently no longer the case
- BIS, OFAC, DDTC, now impose successor liability for violations of the export/sanctions statutes and regulations they respectively enforce
- Successor liability trend started for BIS with admin case *Sigma-Aldrich* in 2002

How Successor Liability in Export Actions Began

- ALJ in admin *Sigma-Aldrich* case established landmark export agency precedent
- Agency ruled that BIS can pursue enforcement via successor liability under the EAR
- ALJ applied general federal rules of construction applicable for all federal statutes – not just export control

Successor Liability

- *Sigma-Aldrich* – ALJ ruled that “innocent” asset-purchaser can be penalized for EAR export violations committed by an unrelated seller before the asset sale occurred
- Respondent did not challenge this ALJ holding in US courts
- Respondent agreed to settle for more than \$1M

Successor Liability

- Nov 2002 BIS *Sigma-Aldrich* press release:

"A company will be held accountable for violations of US export control laws committed by companies that they acquire."



Successor Liability

OEE Director also said:

"[It is the] position of BIS and Dept. of Justice that private parties cannot contract around such liability."



Successor Liability

- BIS has charged respondents since 2002 and obtained settlements from companies where the respondents either:
 - Purchased an ownership/equity interest in an offending exporter, or
 - Purchased assets only of an offending exporter

Successor Liability

- DDTC mandates notification from registrants of an acquisition: ITAR § 122.4
- DDTC requires the acquiring registrant to state that it “assumes all rights, responsibilities, liability, and obligations that existed, exist, or may develop regarding licenses, agreements, or other approvals [of the acquired entity]”

Common Import Violations

- Successor liability can be imposed for:
 - Undervaluing imported merchandise
 - Erroneous HTSUS classification
 - Improper claim for duty exemption
 - Improper claim for duty preference
 - Failure to perform antidumping/countervailing duties

Common Import Violations

- Successor liability can be imposed for:
 - Failure to obtain import licenses
 - Incorrect country of origin
 - Sourcing conflict minerals
 - Reasonable care failure
 - Recordkeeping violations

Due Diligence for Import Violations

- Potential areas of inquiry
 - CBP enforcement activity, including prior disclosures, investigations, penalties
 - Audit results, whether CBP, internal, or third-party
 - Related party transactions
 - Antidumping/countervailing duty
 - Duty drawback
 - NAFTA/FTA
 - Products subject to special entry requirements
 - Customs compliance program, including written procedures and automated processes

Common Export and Sanction Violations

- The following are susceptible to imposition of successor liability:
 - ✓ Exporting and reexporting without a product-specific license
 - ✓ Exporting and reexporting goods, technologies, or services to a prohibited country
 - ✓ Exporting and reexporting goods, technologies, or services to blocked a Specially Designated Nationals or denied or debarred party

Export Issues - Major Topics

- Commodity Jurisdiction
- Commodity Classification - Formal and Self-Classification
- Exports
- Deemed Exports
- Reexports
- Intersections with Sanctions Regulations & *De Minimis* Rules

Export Issues - Licensing

- Licenses Are Needed to Export Technical Data, Services, and Products That Are on the ITAR List and Are Not Subject to Exemption
- Licenses May Be Needed to Export Technology and Products That Are on the EAR List and Are Not Subject to Exception
- Physical Export Not Necessary
 - Transfer of Technology to a non-US Person in the United States Could Be a “Deemed Export”
 - Transmission of Technology in Telcons, by Email, etc. Could Require a License

Export Issues - Sanctions

- OFAC is the Major Player
 - Regulations govern the actions of US persons in connection with sanctioned countries and individuals.
- Department of Commerce – BIS
 - In some cases, approval from both OFAC and BIS are required in order to export or re-export an item to countries subject to US sanctions.
- Department of State – Directorate of Defense Trade Controls (“DDTC”)
 - There are ITAR embargoes on 26 countries, including China

Export Issues - Sanctions

- Can Reach Any Entity or Person Subject to US Jurisdiction Whether Located In or Outside the United States
- Affect Re-export of US Items
- OFAC's Administration of Regulations Can Be Based on Unpublished Policy Interpretations
- List of SDNs Is Revised Regularly and Includes Thousands of Entities and Individuals

Export Issues - OFAC Sanctions

- Country-Based Sanctions Affect Iran, Syria, Cuba, Crimean Region of Ukraine, Sudan, North Korea
 - Some relaxation of Cuban and Iranian sanctions but relaxation has been very limited
- “Subject Matter Sanctions” (e.g. Anti-Terrorism, Anti-Drug Trafficking) Are Not Country Specific
- Blocked Persons and SDN List

Export Issues - Licensing

- M&A Transaction May Result in Need for New or Transferred Licenses
 - There can be Long Lead Times, Which Could Disrupt Business or Delay Closing
 - Notice to the State Department Is Required for ITAR-Registered Companies (Longer Notice Is Required in Connection with Transfers to Foreign Entities)
 - Export License Issues Can Be a Relevant Factor in Exon-Florio Approval

Notice to DDTC of Change of Control

- A registrant under ITAR must notify DDTC within five days of the event, if there is a material change in its Statement of Registration, including:
 - A change in senior officers (e.g., directors, officers, partners, owners);
 - The establishment, acquisition, or divestment of a subsidiary as foreign affiliate or a merger; and
 - The dealing in an additional category of defense articles or defense services.
- A registrant must notify DDTC “at least 60 days in advance” of any intended sale or transfer to a foreign person of ownership or control of the registrant or any entity thereof.
- Notices to other agencies such as ATF may also be required.

Use of Due Diligence

Once the risk-based international compliance due diligence is concluded, you need to assess the effect of what you have found on the overall transaction.

Options include:

(a) proceeding as planned or renegotiating to account for risks,

(b) delaying closing until further due diligence is done or active cases/investigations/voluntary disclosures are resolved and then reassessing or renegotiating, or

(c) walking away.

Use of Due Diligence

Questions to consider include:

1. How much of the target's revenue stream could be affected?
2. How many key employees, intermediaries, or customers may be affected or need to be retrained or terminated?
3. Is the target's business model/culture so different that it will be difficult to integrate it into your compliance program without the business being materially affected?
4. How much uncertainty is there concerning whether you have had sufficient time to assess compliance risks or to resolve known compliance issues and quantify associated costs and liability?
5. Can identified risks be addressed through contractual provisions or revaluation? Or are they so serious that they should be resolved prior to closing? Note the difference between public- and private-company transactions.

Considerations for Sellers

Sellers should consider the following with respect to international compliance issues:

1. Prepare due diligence for buyers by doing a self-assessment of ongoing compliance issues, including hotline complaints, internal investigations, or external enforcement cases.
2. Prepare any required disclosure information and determine at what time and in what manner to disclose it to buyers.
3. Be prepared for a discussion with buyers concerning the potential materiality of international compliance issues in terms of purchase price adjustments in public deals where representations, warranties, and indemnities do not survive the closing or special escrows in private deals where they do.
4. Be prepared for a requirement by buyers that the international compliance issues be disclosed to enforcement authorities as a condition of closing.

Considerations for Buyers

Buyers should consider the following with respect to international compliance issues:

1. Prepare a due diligence plan and allow for adequate time where possible; do not let the sellers delay disclosure until the 11th hour.
2. Adjust the due diligence plan and resources depending upon what is learned.
3. Discuss with sellers' and buyers' own counsel the potential materiality of international compliance issues and level of uncertainty.
4. Consider international compliance representation and warranty insurance products.
5. Consider adequacy of proposed special escrows in private deals where issues have been identified.
6. Consider whether forcing disclosure to enforcement authorities will lead to timely resolution of international compliance issues before closing.
7. Prepare pre-acquisition the post-acquisition international compliance integration plan.

Biographies



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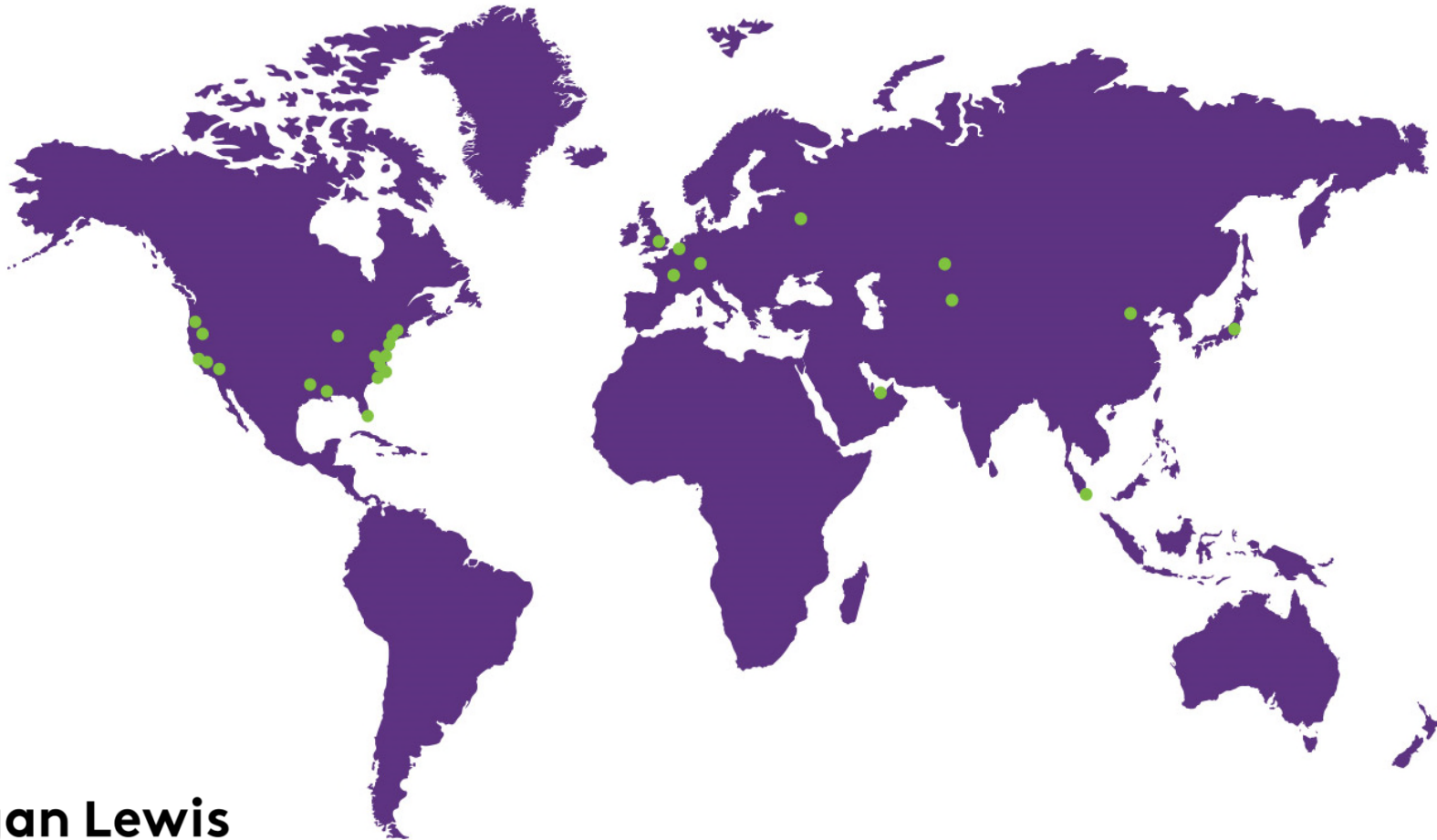
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Our Global Reach

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Asia Pacific
Europe
Latin America
Middle East
North America

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