# Unmasking the myths

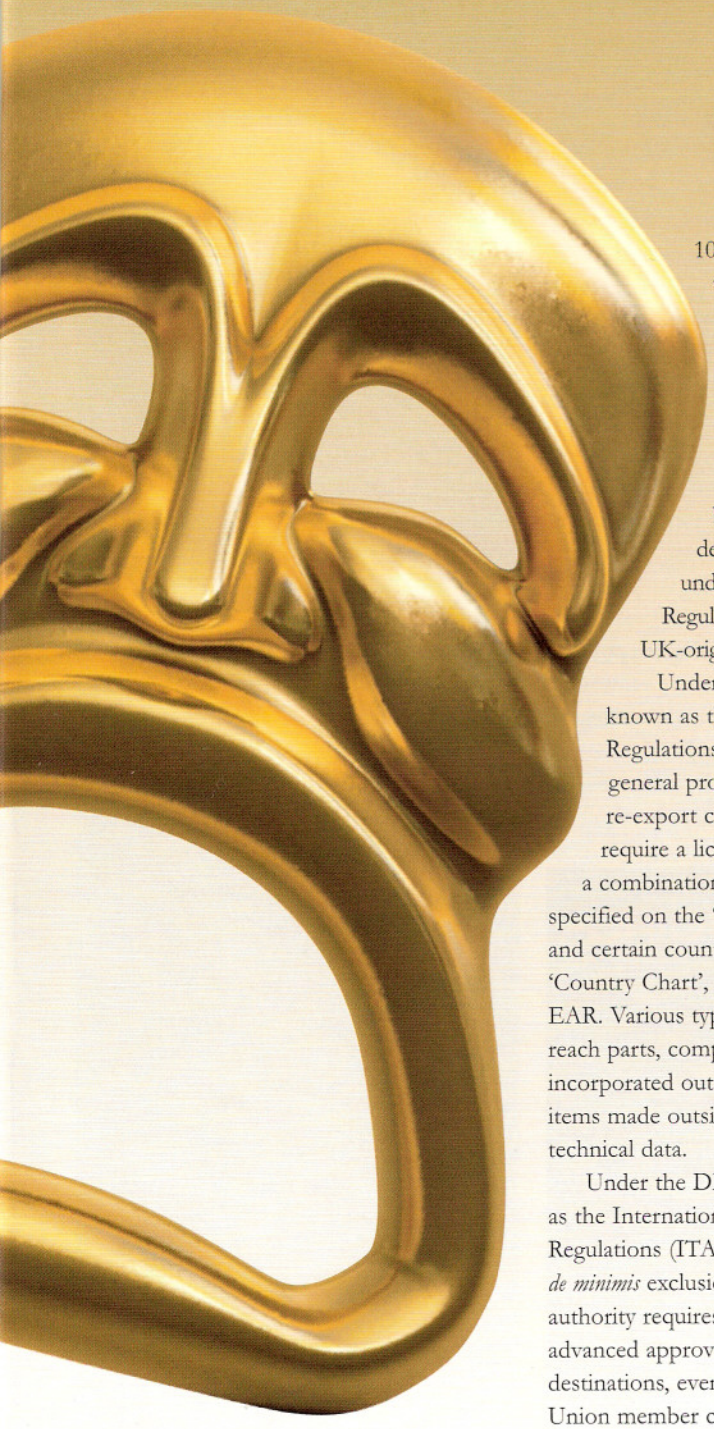
**LARRY E. CHRISTENSEN** dispels the myths surrounding US re-export controls and economic sanctions.

**United States re-export controls and economic sanctions regulations reach right into the economies of non-US countries. National security concerns, non-proliferation of weapons of mass destruction and counter-terrorism efforts are the primary reasons for these strategic controls. US foreign policy also imposes embargoes on countries such as Iran, Sudan and Cuba for non-proliferation and counter-terrorism reasons[1].**

Such re-export controls are the essence of US foreign policy and are enforced under civil and criminal penalties, which include significant files, denial of export privileges, and debarment orders. As noted in the first article in this series, the criminal fines and jail terms imposed under US export controls and economic sanctions regulations are severe and increasing in severity. Often, both the regulations and the sanctions for their violation are quite different than those under the national export rules of the non-US countries that they reach.

### What are re-export controls?

Simply defined, a re-export is the export of a product, software, or technology (collectively, an 'item') from one non-US country to another non-US country. This may be most easily considered as a



jurisdictional 'string' that attaches to a US-origin item as it leaves the US. This string remains attached as the item, which may be a part incorporated into a foreign-produced item, moves from country to country.

The string remains attached unless broken by regulations issued by the Office of Foreign Assets Control (OFAC) of the US Treasury Department and/or the Bureau of Industry and Security (BIS) of the US Commerce Department. This string is never broken if the item is subject to the jurisdiction of the Directorate of Defense Trade Controls (DDTC) of the US State Department.

Comprehensive embargoes are imposed by OFAC on Sudan, Iran and Cuba. The Cuban embargo is the most restrictive. It extends both to a foreign-made item with 10% or more US content and to completely foreign-origin items exported to Cuba for a company that is wholly-owned or controlled by a US person. For example, a corporation organised in the UK and controlled by a US corporation is itself defined to be a 'US person' under the Cuban Asset Control Regulations and may not trade in UK-origin items with Cuba.

Under the BIS regulations, known as the Export Administration Regulations (EAR), there are 'ten general prohibitions' that apply to re-export controls. Countries that require a licence are designated by a combination of reasons for control specified on the 'Commerce Control List' and certain countries designated on the 'Country Chart', found at Part 748 of the EAR. Various types of re-export controls reach parts, components and materials incorporated outside the US and certain items made outside the US with US-origin technical data.

Under the DDTC regulations, known as the International Traffic in Arms Regulations (ITAR), there is no so-called *de minimis* exclusion. ITAR re-export authority requires a licence or other advanced approval for export to all ultimate destinations, even from one European Union member country to another.

## The rationale for US re-export controls

Some countries oppose or resist the application of US re-export controls and criticise them as extra-territorial controls. The strongest opposition from other countries is drawn by US unilateral sanctions on a country.

In addition, US firms find re-export controls difficult to administer in their supply chains and require due diligence to vet each buyer to avoid sales to those who would divert their products. So why does the US enforce re-export controls that reach into the economies of other countries despite such opposition and difficulty in administration?

The US imposes re-export controls to prevent circumvention of its export control strategy. Without re-export controls, a country lacking effective export controls of its own (referred to as a 'non-cooperating country') that declines to participate in the multilateral control regimes and organisations would become a diversion point.

Here, a person or corporation intent on avoiding US controls can establish a corporation in a non-cooperating country for a few hundred dollars, take ownership and possession of US-origin goods, and ship them to a destination contrary to US policy. As such, US re-export controls exist to prevent parties from doing indirectly that which they may not do directly.

The US also views re-export controls as a legal, enforceable, long-standing and politically popular foreign policy. The US export control system has included re-export requirements since as early as 1949 when the modern EAR began. Additionally, re-export controls have considerable support among members of the US Congress. Above all, re-export controls are based on a principle of British common law that is embedded into the US legal system – broadly, that you may not do indirectly that which you may not do directly.

## Re-export controls and banking

The practical significance of US re-export controls and economic sanctions regulations to the commercial banker is that international trade finance offerings entail due diligence of the client's transactions and trade lanes, and such financial due diligence may reveal re-exports requiring re-export licences from BIS, OFAC or the DDTC.

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An investment bank will give an excessive valuation if it fails to perform trade due diligence that, if done with sensitivity to re-export controls, would reveal that certain streams of earnings will be lost

to the target business on day one of the acquisition by a US person.

In such circumstances, the buyer pays for a future stream of earnings that cannot be realised. Therefore the failure of investment bankers to understand US re-export restrictions, embargoes and licensing policies may result in liability for excessive valuations. In addition, the mere financing of an illegal re-export is itself a violation.

For a non-US exporter, the primary message is that it must learn the agency jurisdiction and classification of items imported from the US.

## Six myths and realities regarding US re-export controls

**Myth one:** US re-export controls only apply to US-based firms.
**Reality:** US re-export controls often apply to all persons, including foreign persons not affiliated with a US corporation.

**Myth two:** US re-export controls cannot be enforced against foreign parties.
**Reality:** EAR denial orders can blacklist a foreign firm and prohibit all others from dealing with that party in items subject to the EAR. Denial of export licences required under the ITAR can have a devastating impact upon many non-US companies.

**Myth three:** It is possible to make an in-country transfer in a non-US country without concern for the US blacklists.
**Reality:** In-country transfers to denied parties and parties restricted by Treasury, for example, are restricted as for items subject to US controls.

**Myth four:** If the country of origin is not US, then the US export controls never apply.
**Reality:** US list-based re-export controls extend to non-US made items at or above 10% US content, and all USML items and selected CCL items are captured by the US list-based controls no matter how small the US content and no matter the country of origin for import purposes.

**Myth five:** The OFAC rules apply only to US persons, so foreign corporations do not need not to be concerned with the embargoes imposed by OFAC.
**Reality:** Such rules apply to US citizens serving as your employees and or directors, such rules prohibit collaboration between a US person and a foreign firm, certain items are subject to re-export controls by foreign persons under various OFAC rules, and approval and facilitation by a US person will extend liability to the whole enterprise for acts taken by the non-US company.

**Myth six:** If it is the policy of my country to permit or require me to fill an order from a country embargoed by the US, then I am not subject to US re-export rules and penalties.
**Reality:** That is not correct; however, blocking statutes and conflicts of law are beyond the scope of this article.

### Assessing re-export controls

*US re-export jurisdiction?*

There are three types of jurisdictional power exercised by the US, two of which reach into the economies of non-US countries:

List-based jurisdiction reaches certain defined items on control lists that require a licence for export and re-export to designated countries (for example, country/product pairings). List-based controls usually apply to all parties, both US and non-US, and certain US controls restrict in-country transfers within the borders of another country;

US citizen-based jurisdiction usually involves activity, such as supporting the sale/export of weapons of mass destruction. US citizen-based controls usually apply regardless of whether US origin items are involved and regardless of whether the US citizen is an employee of a non-US corporation;

Territorial-based jurisdiction is used to regulate persons and activities within the borders and territorial waters of the US. This includes controls on non-US citizens in the US. By definition, territorial-based jurisdiction does not reach into foreign countries.

*Types of re-export controls:*

US re-export controls reach trade in non-US countries in several ways. The first control is over the re-export of an item in the form received. For example, a UK company imports a US-origin item, makes no modification to the item, and then exports the item from the UK to China.

This is a re-export and may or may not require a licence depending on the US agency jurisdiction, classification and ultimate end-user in China. It is important to note that the US maintains arms embargoes against China and other countries which totally prohibit exports and re-exports of ITAR controlled items to these countries.

The second type of regulated re-export is of a US-origin part incorporated into another item made in a non-US country and the export from abroad of the second item. This is known as the 'parts and components rule'. For example, a company in France incorporates a US-origin component into a French-made fork lift and then exports that fork lift from France to Sudan.

This is a regulated re-export if the US-content is 10% or more of the value of

# References

1. This is the second in a series of four articles on US strategic trade controls, sanctions and other trade controls with an emphasis on the liability for financial institutions as facilitators in restricted transactions. The first article in this series appeared in the November 2007 issue of *TFR* and addressed the enforcement environment under US strategic controls and trade sanctions;
2. The following is a sample list of items that do not enjoy the *de minimis* exclusion from the parts and components rule: any item on the ITAR United States Munitions List; a foreign-made computer with an adjusted peak performance (APP) exceeding 0.75 weighted teraflops (WT) containing US-origin controlled semiconductors (other than memory circuits) classified under ECCN 3A001 to Computer Tier 3; or exceeding an APP of 0.002 WT containing US-origin controlled semiconductors (other than memory circuits) classified under ECCN 3A001 or high-speed interconnect devices (ECCN4A994.j) to Cuba, Iran, North Korea, Sudan and Syria; foreign produced encryption technology that incorporates US-origin encryption technology controlled by ECCN 5E002 is subject to the EAR regardless of the amount of US origin content; certain items incorporating the QRS11-00100-100/101 Micromachined Angular Rate Sensors; hot section technical data ECCN 9E003.a1 to a.12 and f.; technical data and software containing any US content, unless a one-time report has been filed and not rejected; all items exported from a foreign country to Iran for nuclear, chemical and biological weapons, and missile end uses; and all items exported from a foreign country to Iran that do not benefit from an EAR or ITAR *de minimis* rule. In addition, unique *de minimis* rules apply to data security and encryption. Note, also, the OFAC embargo rules on Iran and Sudan contain *de minimis* exclusions different than the EAR *de minimis* rules.

the fork lift. In another example, a Swedish firm acquires a component designed for a military application for $2,000 and incorporates the component into a non-US made fighter aircraft with a total value of $20m. Under this example, the part is subject to ITAR re-export controls regardless of the percentage of value of US content in the fighter aircraft.

The third type of regulated re-export from abroad is for foreign-produced direct product of US-controlled technology. This applies to non-US made items controlled for national security reasons only and made with certain technology that requires the consignee to sign a written assurance against the re-export of the technology and its direct product.

To determine the applicability of the foreign-produced direct-product rule, it is essential to know the classification of the technology exported from the US and the classification of the foreign-made item. In addition, provisos, terms, and conditions of licences often provide for additional types of restrictions.

*The 'de minimis' exclusion from the parts and component rules, and exceptions from the exception.* Under the EAR, the reach of the parts and components rule on exports from abroad is usually limited by the *de minimis* rule. Before 1987, a foreign-made item that contained any US-origin part, component or material of any kind was subject to the EAR re-export restrictions.

In that year, the-then Secretary of Commerce, Malcolm Baldridge authorised an exemption to the parts and components rule. As a result, the EAR today does not reach a foreign-made item that contains 10% or less US-controlled content and a validated licence for direct export to the ultimate country of destination is not required for the re-export of such items.

The *de minimis* exclusion from the EAR does not apply to software and technical data unless you submit a one-time report that contains your calculations and methodology. At the time of writing, BIS is reviewing the question of whether firmware – software built into a microchip in an item of technology hardware – counts as software or hardware.

The question is quite significant because the answer will determine whether or not a one-time report to BIS is required to establish whether the foreign-made code is outside the scope of the EAR. Of course, a re-exporter may also find permissive re-export authority under the EAR and conclude that it can conduct its business without defining the outreach of US re-export controls.

Over the two decades the *de minimis* exclusion has been in place, policy makers have eroded its simplicity and scope. Several types of controlled content no longer enjoy *de minimis* treatment. The exclusions from *de minimis* treatment are quite complex and a complete discussion of them is beyond the scope of this article[2].

## Lessons learned

At a recent seminar on export controls by the US-based Practising Law Institute, in-house counsel for Citi Group advised that the bank requires export-control licensing information as a precondition to extension of trade finance.

Consistent with this approach, to avoid liability related to violations of US re-export controls, commercial bankers must ask their potential trade finance borrower for the US agency jurisdiction, classification, licence requirements and export authority applicable to the borrower's items.

The lesson for investment bankers is that valuations are not accurate or fair unless they take into consideration:

a. Streams of earnings that will not survive day one of the acquisition;
b. Restrictions on the re-transfer of valuable assets to the buyer in countries such as China;
c. Successor liability for export control violations of the target.

In future articles in this series, we will discuss the impact of export controls and economic sanctions regulations on technology transfers and implications for foreign direct investment, mergers, and acquisitions; blacklisting; rules against the bribery of foreign officials; and technology transfer restrictions via server access and the release of technology to foreign persons. ❑

**Larry E. Christensen is a member of the US law firm Miller & Chevalier Chartered in Washington, DC. He heads the national security practice covering export control, embargoes and direct investment reviews. He is also an adjunct professor at Georgetown University School of Law where he teaches export controls and embargoes. Christensen has practiced in this field for 28 years, 11 of which were with the US Department of Commerce.**