LETHAL WEAPONS

In the third in the series, LARRY E. CHRISTENSEN examines the challenges posed by US export-control laws intended to address national security, counter-terrorism, and nuclear non-proliferation objectives.

When UK defence contractor Ferranti acquired International Signal and Control (ISC), a supplier of missile, fuses and grenades, it did so for the US company's technology. However, much of ISC's revenues were actually driven by illegal arms sales, which evaporated the moment Ferranti took control.

That was back in 1987. Today, regulations are much tougher and Ferranti might find itself in the line of fire as a result of ISC's transgressions, in addition to the accounting fraud at ISC that ultimately led to Ferranti's demise.

Any company purchasing a defence contractor, anywhere in the world, needs to employ more rigorous due diligence than Ferranti did. However, they might also face a number of other challenges posed by US regulations – which are becoming ever tougher – intended to protect the country against perceived threats to national security.

For investment bankers, there are two major challenges in structuring and closing any acquisition – clearance and valuation. The risks that the deal will not be cleared by government agencies are based upon review by the Committee on Foreign Investment in the United States (CFIUS) and the potential that US export control agencies will revoke licences for technology held by a target firm anywhere in the world.

There are also two types of valuation risks. The first is 'successor liability' for violations of the target firm committed prior to the closing. This risk is caused by the failure to identify prior violations during the due diligence phase and the consequent failure to account for those liabilities in the fair value determination for the acquisition price. The second pitfall is the failure to identify streams of earnings, which will disappear on the day of the closing, and the failure to adjust the acquisition price accordingly.

> 'Letters of credit, structured supply-chain finance and lease financing are all products that present potential for violations.'

CFIUS review

The purpose of CFIUS is to review direct investments in the US by non-US investors, to guard against an acquisition that could potentially jeopardise the national security of the US. For decades, one of the most significant considerations of the CFIUS review has been to assess the national security significance of the controlled technical data of the target firm in the US and its vulnerability.

In turn, the national security agencies of the CFIUS evaluate the risk of the non-US acquiring firm circumventing the technical-data export licensing requirements of the US State Department and the US Department of Commerce and secreting the technical data out of the United States – either by accident or design.

The CFIUS analysis considers other possible threats presented by the foreign acquirer and the potential consequences to the US national security if the vulnerabilities were exploited.

The central role of the national security analysis in the CFIUS process is underscored by the recent legislation and a more recently proposed regulation, which shapes the notifications to the CFIUS by the parties to an acquisition and the deliberations of the CFIUS.

The proposed CFIUS regulation will increase the amount of information required in the notification to the CFIUS regarding an acquisition. It requires a list of the items that the target firm produces or trades in, which items may be subject to the International Traffic in Arms Regulations (ITAR), the category of each item subject to the ITAR, and the classification of every item subject to the Export Administration Regulations (EAR).[1]

A future CFIUS filing is likely doomed unless the parties submit complete jurisdiction and classification information. In addition, the parties must be prepared to defend the adequacy and accuracy of that information to the licensing agency and the US Department of Defense. This demonstrates the importance of technology transfer regulations in the CFIUS review process.

Third country target firm holding licensed technology

In acquisitions by non-US firms of targets in third countries outside the US, the export licensing agencies also evaluate the risk of diversion of US-controlled technology in the hands of the target company. If US authorities see an unacceptable risk of diversion of such technical data, they can revoke the export licences authorising the export of US technical data. This may

lower or destroy the market value of a non-US target firm engaged in research and development with a US company.

Telling the compliance story and building trust
In both preparation for a CFIUS review and the acquisition of a third-country firm holding export-controlled technical data, it is often important to approach the US licensing authorities early to build a level of trust. The goal is to establish to the satisfaction of regulators that the acquiring company understands the US export rules and will encourage its future subsidiary to abide by those rules.

This campaign may include presentations regarding the benign business plans of the acquiring firm, the compliance skill sets of each firm and a technology control plan to provide assurance that technology will not move to the acquiring firm without an appropriate export or re-export licence.

Above all, the acquiring firm must convince the authorities that it does not labour under the delusion that mere ownership of controlled technical data trumps the US export and report licensing requirements. It does not. Failure to take these steps to build trust with the export control authorities and reviewing agencies can make the difference between success with CFIUS and licensing agencies versus failure.

> ‘The banking of the proceeds of an export-control violation is one of the many offences a prosecutor can prove to establish a money laundering offence.’

The Titan case and the SEC
The failure to comply with trade laws and misrepresentations regarding compliance can put the closing of an acquisition agreement at risk. In the case of Titan, a large US defence contractor agreed to acquire all the publicly traded stock of The Titan Corporation, a US corporate.

The parties issued a proxy statement that included a representation that, to their knowledge, Titan and its officers, employees, agents and subsidiaries had taken no action in violation of the Foreign Corrupt Practices Act (FCPA) or similar laws.

Later, the acquiring company learned that Titan was unsuccessfully negotiating with the US Department of Justice regarding allegations of a $2m payment to the president of Benin at a time when Titan was seeking a large contract with the Government of Benin.

The acquiring company finally learned of the violation and withdrew from the transaction. The shareholder value of Titan plunged by $50m the next day. There can be no doubt the acquiring firm recognised that it would face successor liability for the acts of Titan in violation of the FCPA. The US export-control laws also provide for successor liability.

In the Titan case, the US Securities and Exchange Commission (SEC) found that the representation by Titan to the investing public constituted a material misrepresentation, even though the misrepresentation may not have actually influenced the value of Titan.

In a white paper, the SEC stated that actions of this type in the future by other firms would be violations of its Rule 10b-5. This would open a violating company to class actions by shareholders. The SEC added that it would make criminal referrals to the US Department of Justice in future for similar violations. The SEC fined Titan $28m and a distinguished FCPA practitioner was named as an independent monitor of Titan.

The lessons are that pre-acquisition due diligence and boiler-plate language in communications with stockholders concerning compliance both matter. They affect value and the ability to close a deal.

Disappearing streams of earnings – embargoed countries
Investment bankers also risk valuation mistakes for failure to identify streams of earnings, which will disappear if a US company acquires a certain type of foreign target. Those are target firms that deal with Cuba, Iran and/or Sudan, which are fully embargoed by the US.

In this regard, Cuba is unique. Under the Cuban Assets Control Regulations (CACR), a controlled-in-fact corporation is considered a ‘US person’. For example, if a US company acquires a corporation in Spain, that Spanish corporation is defined to be a US person under the CACR. The Spanish corporate subsidiary may not deal with Cuba on day one of the acquisition and, thereafter, in any items, even those of 100% Spanish content. If the Spanish firm had a stream of earnings from Cuba prior to the closing of the acquisition, that must end on day one. Moreover, it may not even collect debts from Cuba without a licence from OFAC.

Under the Iranian Transaction Regulations, a US corporation may not approve or facilitate trade between its newly acquired Italian subsidiary, for example, and Iran. In this instance, the acquiring company may leave the Italian subsidiary perfectly independent from day one and, in that narrow context, the independent subsidiary may continue to deal with Iran in items not subject to US list-based controls.

However, if that is not the preferred management style of the US firm, the stream of earnings from dealing with Iran will end on day one of the acquisition if the acquiring firm in any way approves or facilitates the trade between Iran and its subsidiary. Moreover, the acquiring firm may not change its internal business processes to enable more trade with Iran.

Disappearing streams of earnings – China
The US acquisition of a non-US company may raise valuation issues because of US technology transfer rules regarding China. For example, a US company may choose to acquire a firm in France in order to combine and commingle complementary technologies for development of ITAR-controlled commercial satellites.

If the French firm had a stream of earnings from satellite technology sales to China, that stream of earnings will end if the US technical data becomes

commingled with the French technical data. Under the International Traffic in Arms Regulations, the release of satellite technical data is a defence service and exports and re-exports of defence services to China are prohibited.

Consequences range from bad to horrific
Almost every major acquisition involves international trade issues. The lesson for investment bankers is that failure to perform due diligence and failure to understand the impact of trade laws may have consequences ranging from bad to horrific.

In short, the bad consequences are that the deal does not close, you as the investment banker do not get paid and the client is unhappy. The horrific consequences include the acquiring firm being held liable for the fines and defence fees related to the violations of the acquired firm. This has happened all too often. The future threat is that the SEC will open the company to Rule 10b-5 actions – commonly referred to as securities fraud – by shareholders challenging misrepresentations regarding compliance.

Commercial bankers' risks in general
Non-US commercial bankers are not without challenges under the US export control laws. The major prohibitions are:

a. Financing or otherwise causing an export or re-export with reason to know that a violation is about to occur;
b. Banking the proceeds of an export control violation, which is regarded as money laundering under US law; and,
c. Failure to register and obtain licences for providing lease financing or other secure financing of US-controlled munitions items, both US and foreign.

Financing or otherwise causing an illegal export or re-export
In the second article in this series, we discussed the long reach of US export laws into the economies of other countries. Re-export controls provide significant risks of liability for commercial bankers. Letters of credit, structured supply-chain finance and lease financing all present potential for violations.

Prosecutors have frequently charged non-US persons in criminal cases for providing false end-use statements. As I noted in an earlier article, prosecutors have a strong incentive to bring cases against financial institutions, which finance illegal re-exports. Most diversion is done for a profit incentive and such illegal shipments will end if parties cannot receive and bank the payments from such sales.

Banking the proceeds of illegal exports and re-exports
Under the US Patriot Act of 2001, the banking of the proceeds of a US export or re-export control violation is a predicate offence to a money laundering charge. In other words, the banking of the proceeds of an export control violation is one of the many offences a prosecutor can prove to establish a money laundering offence.

The Multicore case, discussed in the first article in this series, illustrates the ability and willingness of US agencies to seize the funds derived from an illegal re-export deposited in a UK bank. In future, I believe prosecutors will allege money laundering violations by banks that fail to determine whether the proceeds of a client's transaction are derived from illegal exports or re-exports. Any US financial institution also has an obligation to submit suspicious activity reports with the US government when it discovers an export control violation.

Did you know that lease financing is brokering?
ITAR applies to non-US lenders and other institutions providing lease financing for items subject to the regulations. The obligations of these so-called brokering rules include registration, licensing, notifications and annual reporting. While part 129 of the ITAR is referred to as the brokering chapter, these rules extend to certain sales, financing and other services, which the business community does not typically think of as brokering.

As for financing, the State Department likely intends these regulations to cover structured supply-chain finance or other types of finance in which the lender takes a security interest other than title. However, the face of the regulations is not clear in this regard. The brokering rules exclude financing in the form of letters of credit and/or so-called standard commercial lines.

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The reach over non-US lenders covers an item or service with any ITAR-controlled content whatsoever. US lenders are captured when providing lease financing to US-origin defence articles and services, as well as foreign defence articles and services.

The State Department expects registration and compliance, as do major defence contractors. As a practical matter, one good reason to comply with the rule, among others, is to maintain a solid reputation of compliance with major defence contractors.

> If US authorities see an unacceptable risk of diversion of such technical data, they can revoke the export licences authorising the export of US technical data.

Process and vetting solutions

Commercial banks can substantially reduce the risk of financing illegal exports by asking applicants for export financing to provide the jurisdiction, classification, end use and authority to make the export or re-export under the US regulations and under the regulations of the other countries.

Banks therefore need to train staff and implement well-crafted business processes so that clients are properly vetted. This is necessary because the bank will be depending upon compliance information only from companies that do indeed know how to determine the jurisdiction, classification, end use and authority to export.

The other challenge is to avoid taking deposits that are the proceeds of an illegal export or re-export. This requires an extension of the main task in an anti-money laundering (AML) strategy. This process is, quite simply, to establish that the funds are not from an illegal export or re-export. Once again, the commercial bank can manage such risks by creating information requests or checklists, training commercial bankers to watch for red flags and using traditional AML strategies to determine the actual source of funds.

Banks have not always recognised US export and re-export controls under ITAR and EAR. This is, in part, due to the understandable emphasis of banks on compliance with the traditional AML regulations of many countries and the blacklisting of parties.

However, in my experience, a bank can expect far greater liability for fines and damage to its reputation if it in any way finances the development of weapons of mass destruction, illegal re-exports to embargoed destinations, unlicensed exports for munitions items, and other such shipments and releases of technology.

Moreover, the overlap of export controls and AML regulations is now clear. Authorities will be unforgiving towards a financial institution that has AML processes that correctly identify and avoids deposits of the proceeds of illegal drugs, while accepting without question the profits of exporters making and shipping arms to embargoed countries.

Putting the bank's reputation at risk

Banks are institutions built on trust, so a loss of that trust with clients or regulators can be damaging. The enforcement environment is becoming ever-tougher, as we noted in the first article in this series. However, a bank faces yet another, perhaps more compelling, incentive to avoid violations of national security-based rules.

The financing of items that may support terrorism, nuclear proliferation, chemical and biological proliferation, missiles or illegal arms transfers can result in damaging, negative publicity.

Major exporters deal with financial institutions with stellar reputations and may shun institutions that do not have such good reputations. Without doubt, compliance processes for a bank are a bargain compared to the consequences of violating US export, re-export and sanctions laws.

For investment bankers, the overall goal of international trade due diligence is to avoid an acquiring company paying too much for the target. For investment bankers on both sides of the table, such due diligence is often necessary to close the deal, receive payment for fees and keep a client happy so that it returns for its next deal. ❑

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References

1. See proposed Section 800.402(c)(4) at 73 Fed. Reg. 21861 (April 23, 2008). Note that a full discussion of the proposed regulatory changes for CFIUS reviews is well beyond the scope of this article.