

INTERNATIONAL TRADE ALERT

INTERNATIONAL TRADE DUE DILIGENCE IN MERGERS & ACQUISITIONS: MECHANISMS TO AVOID LIABILITY UNDER U.S. INTERNATIONAL TRADE LAWS



With the U.S. economy poised for recovery and an upswing in corporate transactions on the immediate horizon, companies contemplating mergers, acquisitions, joint ventures or other business activities with international implications must be mindful of new U.S. homeland and national security laws that impact the viability of proposed transactions. Compliance is obligatory, and evaluation of potential international trade compliance issues should be standard practice in corporate transactions. Even inadvertent violations of U.S. export controls, economic sanctions and customs laws can lead to significant fines and penalties; negatively impact share value; and impair government, investor and customer relations. Moreover, government agencies enforcing these laws now uniformly impose successor liability for past violations.

These problems can usually be identified, and then resolved or mitigated prior to closing a deal, by including international trade compliance questions in routine due diligence reviews of proposed corporate transactions. This Alert provides an overview of the impact of the new regulatory and enforcement environment on international trade due diligence. In addition, to assist in the due diligence process, this Alert offers recommendations and provides a model international trade due diligence checklist.

THE NEED FOR INTERNATIONAL TRADE DUE DILIGENCE

The purpose of international trade due diligence is, foremost, to identify existing or potential compliance problems with the various laws that U.S. agencies enforce with respect to international trade and commerce, including U.S. export controls, sanctions, and customs laws and regulations. In this regard, there are at least four overarching reasons for international trade due diligence:

- *Minimize potential liability for past activities of the target.* The violation of these laws can result in substantial duty liability, in addition to criminal and civil penalties or denial

of export privileges. As discussed below, U.S. government agencies have imputed liability to an acquiring company for activities of the target company occurring prior to a merger.

- *Ensure proper valuation and minimize disruption to the transaction.* The failure to discover compliance problems during due diligence may trigger indemnification provisions of agreements and require expensive post-closing remedial actions. Conversely, discovery of these problems will assist in ensuring proper valuation of the target company.
- *Identify and avoid future compliance issues.* Effective due diligence will also highlight a target company's compliance program, exposing poorly structured programs that may require significant post-closing resources to remedy.
- *Assist in integrating the businesses.* A thorough due diligence examination helps the acquiring company integrate the target company's business into its existing international trade compliance programs.

NEW CONCERNS

The need for international trade due diligence, though not new, is increasingly important in the post-9/11 environment. "Homeland security" issues have impacted international commerce through both an emerging legal framework and increased enforcement by the numerous U.S. agencies charged with administering international trade laws. From a due diligence perspective, these issues are further compounded by the disclosure requirements of the Sarbanes-Oxley Act.

Emerging Legal Framework

Even the most conscientious companies involved in international commerce are struggling to remain current in the face of new homeland security programs. For example, U.S. agencies have launched various new initiatives in the past three years intended to address issues of supply chain security in international trade, including:

- multi-agency requirements for the advance electronic presentation of cargo information pursuant to the Trade Act of 2002
- Food and Drug Administration (FDA) bioterrorism measures for food safety enacted in accordance with the Bioterrorism Act of 2002
- U.S. Department of Agriculture (USDA) requirements, including those implemented under the Agriculture Bioterrorism Protection Act of 2002
- the Bureau of Customs and Border Protection (Customs) Customs-Trade Partnership Against Terrorism (C-TPAT).

Similarly, the Treasury Department's Office of Foreign Assets Control (OFAC) continues to expand its anti-terrorism sanctions programs, including ongoing review and enlargement of the list of persons and entities that are "specially designated nationals" with whom U.S. companies cannot transact business. Moreover, companies have had to keep

pace with the creation of new governing entities, such as the Department of Homeland Security, which synthesized many — but not all — existing international trade enforcement functions from other agencies, and the new Transportation Security Administration.

Increased Enforcement and Successor Liability

At the same time as the regulatory environment has grown increasingly complex, enforcement efforts of international trade agencies have increased dramatically. For example, in addition to the publicized efforts of agencies such as Customs, OFAC and FDA, it is notable that the Bureau of Industry and Security (BIS) — one of the agencies responsible for administering and enforcing U.S. export control laws — has imposed significantly higher fines and penalties since 9/11:

- BIS criminal fines in FY 2003 exceeded those issued in FY 2002 by 300 percent.
- Similarly, civil penalties issued by BIS in FY 2002 and FY 2003 increased by over 300 percent as compared to the preceding two years.

In this environment, acquiring companies clearly have cause for concern regarding the compliance efforts of their possible targets or partners. This concern is compounded by the expressed intent of certain agencies to impose liability on acquiring companies for violations committed by predecessors, even in transactions not traditionally viewed as qualifying for successor liability. For example, in 2002 BIS imposed penalties against Sigma-Aldrich as the successor of a company that committed export violations prior to the purchase of partnership interests in the target. Sigma-Aldrich ultimately agreed to pay BIS \$1.76 million to settle the case. Since that decision, other agencies responsible for administration and enforcement of international trade laws have signaled their agreement with that approach to the issue of successor liability, including OFAC and the Directorate of Defense Trade Controls (DDTC).¹

The Impact of Sarbanes-Oxley on International Trade Due Diligence

Expanded Securities and Exchange Commission (SEC) disclosure requirements under Sarbanes-Oxley further underscore the need for effective international due diligence mechanisms in mergers and acquisitions. CEOs and CFOs must now certify to the accuracy and completeness of information contained in companies' periodic reports filed with the SEC, including Forms 10-K and 10-Q and, with respect to foreign private issuers, Forms 20-F and 40-F. In particular, officials must certify, among other things, that the report "fairly presents" the company's condition and does not contain material misstatements or omissions.

¹ Please see "Successor Liability In Enforcement Actions Involving International Trade Law" (Akin Gump April 2003 Client Alert), available at <http://www.akingump.com/docs/publication/554.pdf>, for additional information.

As a result, it is essential that corporate officers ensure that their company financial statements reflect all “material” issues impacting the company’s financial situation. This includes potential liability arising from proceedings before international trade agencies based on the target company’s past activities, or significant future expenditures necessary to bolster the target company’s import/export compliance program. Appropriate international trade due diligence can help identify these concerns, enabling a company to assess possible “material” issues, identify and determine the costs of potential solutions and the ability of the company to solve the issues prior to closing the transactions, and, to the extent necessary, set aside reserves to handle any potential exposure arising from such issues. It also allows a company to evaluate the extent to which such issues should be reflected in the company financial statements.

In addition to these reporting requirements, the SEC is enlarging its enforcement staff to implement a reporting requirement for foreign companies seeking financing in U.S. capital markets. The SEC now requires clear disclosure of the nature and extent of a foreign company’s activities in or with U.S.-sanctioned countries in registration statements filed with the SEC. The purpose of this reporting requirement is to prevent companies with business interests in sanctioned countries from benefiting from access to U.S. financing. The SEC has indicated that it will transmit to OFAC any relevant information it collects.

RECOMMENDATIONS

Companies should incorporate international trade due diligence mechanisms as part of their comprehensive review of a target or partner, whether in the United States or abroad. These mechanisms should account for the target’s or partner’s international activities and its compliance with various international trade laws. Although any due diligence inquiry should be specifically tailored to the parties and transaction at issue, most international trade due diligence should seek to analyze the following general areas:

1. International Commercial Activities

Acquiring companies should first identify the scope and nature of the international commercial activities conducted by, or connected with, the target company. This includes, among other things, identification of the target’s importing and exporting practices, supply sources, markets, distribution networks and scope of business. For example, due diligence should identify whether the target (a) is compliant with relevant customs laws, including those impacting duty liability, (b) transfers products or technology regulated by Customs, BIS or DDTC and (c) has obtained the appropriate licenses or complied with existing license exceptions. Review of export/import documents for compliance purposes is integral to these efforts.

2. Affiliates, Customers, Agents, Distributors and Export Destinations

Acquiring companies should understand the breadth of the target’s operations, structure, financing and geographic areas of business. In particular, the acquiring company should review affiliates/related parties, customers (persons and entities), suppliers, agents, distributors, etc. to ensure that none is: (a) included on OFAC’s list of denied persons or Specially Designated Nationals, (b) a person denied export privileges by BIS or DDTC or (c) identified as a “BIS entity” involved in weapons proliferation. In addition, the acquiring company should determine whether any affiliates or customers are located in restricted or embargoed countries.

3. Past Enforcement Actions, Prior Disclosures and Legal Advice

The acquiring company should also review all past and present enforcement actions, prior disclosures, internal investigations, or audits or inquiries by Customs, BIS, OFAC or DDTTC involving the target company. In addition, the acquiring company should review any legal advice obtained by the target in the areas of customs, export controls and sanctions.

4. Compliance and Recordkeeping Programs

The acquiring company should understand the target's current international trade (import and export) compliance programs. The existence and quality of these compliance programs will indicate potential risk of past, present and/or future violations. In addition, reviewing the target's compliance programs will help the acquiring company integrate its own program and existing import/export practices with those of the target company. Examination of the target's recordkeeping procedures for the proper maintenance of customs forms, Shipper's Export Declarations (SEDs), and other entry- and export-related documentation is also important in ensuring compliance.

As this suggests, there are certain minimum inquiries that should be made whenever conducting international trade due diligence in a merger or acquisition. In this regard, we attach a basic model checklist, based on the general areas outlined above, that is intended to serve as a starting point in assessing the issues that should be considered and reviewed. Each of the areas identified in the attached checklist is supported by a significant and extensive legal framework. Thus, it is important to emphasize that this checklist is only a general guide, and should be modified for the transaction and parties involved — both before and, importantly, during the review to focus on identified areas of activity and concern.

Finally, we note that, while these recommendations and the attached checklist focus on U.S. regulation of international trade, companies must also consider the regulation of international trade by foreign governments in conducting due diligence for mergers, acquisitions and similar business transactions with international implications.

DUE DILIGENCE CHECKLIST — INTERNATIONAL TRADE ISSUES

CUSTOMS COMPLIANCE

Customs Reports, Applications or Requests

- customs reports or applications filed in the last five years
- ruling requests filed with Customs' Office of Regulations and Rulings
- C-TPAT Agreement and supply chain security information

Customs Proceedings/Enforcement/Prior Disclosures

- pending/threatened enforcement actions
- concluded enforcement actions
- changes in import procedures following an investigation or enforcement action
- prior disclosures filed in the last five years

Compliance Program/Recordkeeping

- internal customs compliance and training manuals
- policies or procedures related to customs recordkeeping requirements (or exemption from such requirements)
- policies on the retention of (A)(1)(a) entry documents

Importing

- importing activity as the importer of record
- policies and procedures for HTSUS classification and country of origin marking
- policies and procedures for ensuring duty compliance
- NAFTA compliance
- imported commodities and country of origin of those goods
- authorized customs brokers
- surety bonds currently in force

EXPORT CONTROLS

Export Activities and General Compliance

- internal procedures and safeguards for ensuring compliance with the requirements of the Export Administration Regulations, Foreign Trade Statistics Regulations, International Traffic In Arms Regulations
- screening of customer lists, including “foreign principal parties in interest” and “order parties” to identify possible “denied persons” and “Specially Designated Nationals”

Export Licenses

- export licenses and license applications for the last five years
- classifications for exported items

AES/SED Compliance

- procedures for AES compliance
- recordkeeping policy
- policy for ensuring the continuing accuracy and completeness of SEDs/AES filings
- procedure for ensuring that an SED is filed when the product to be exported requires a license

Investigations/Enforcements/Disclosures

- government audits or investigations in the last 10 years
- internal investigations and reports
- voluntary disclosures
- administrative, civil or criminal export enforcement actions taken within the last 10 years

Controlled Technology

- “deemed export” compliance for technology controlled under the export control laws

Antiboycott

- instances in which the target or parent company (including subsidiaries or affiliates) received requests to comply with the Arab boycott of Israel and reports filed with the U.S. government concerning such requests
- antiboycott enforcement actions taken within the last 10 years

U.S. SANCTIONS LAWS

U.S. Operations

- activities through a company's subsidiaries, branches, affiliates, employees, agents or distributors in any countries subject to U.S. sanctions laws
- inquiry, investigation or enforcement action by OFAC within the past five years, pertaining to a possible violation of a U.S. embargo
- notification to OFAC within the past five years relating to a possible violation of a U.S. embargo
- compliance manuals, training materials, policy statements and similar items intended to promote compliance with the U.S. sanctions laws

Foreign Operations

- compliance by foreign subsidiaries, branches and other affiliates with the U.S. sanctions laws
- controlled foreign subsidiaries, affiliates, branches, joint ventures, agents or distributors that have done business of any type, within the past five years, with countries subject to U.S. sanctions laws or with their representatives and/or nationals
- investigation or other enforcement action by OFAC against the foreign subsidiaries, branches, joint ventures, affiliates, agents or distributors of a company within the past five years

FOREIGN CORRUPT PRACTICES ACT

U.S. Operations

- internal manuals and procedures for compliance with the Foreign Corrupt Practices Act (FCPA) and any similar laws of foreign jurisdictions
- possible violations of the FCPA discovered but not reported to the U.S. government during the last five years
- investigation, penalty or other enforcement action in which the target or partner company or any of its subsidiaries or affiliates, or any of their respective employees or agents, has been the subject
- request for information, warning letter or other correspondence from a government authority pertaining to the FCPA during the past five years
- SEC audit during the past five years

Foreign Operations

- compliance manuals, instructions, guidelines or other communications given to employees, agents or distributors abroad with respect to compliance with the FCPA, the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions and any similar foreign laws
- national laws of countries in which the target or partner company operates regarding bribery or similar payments
- communications between government authorities in any foreign country and the target or partner company or its subsidiaries, branches or affiliates regarding the laws of any foreign country pertaining to bribery.

The international trade group at Akin Gump — comprising lawyers, economists and other professionals in the United States as well as Moscow, Brussels and London — is skilled in all laws and regulations that apply to cross-border transactions. We have extensive experience in antidumping and countervailing duty litigation, customs and homeland security laws, exports controls and economic sanctions, WTO dispute resolution proceedings, foreign market access disputes and other trade proceedings. For other International Trade Alerts and for more information about our international trade practice, please visit our Web site at <http://www.akingump.com/practice.cfm>.

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