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Corporate Insights

Addressing the Increasing Risks of US Export Controls/ Sanctions in Mergers and Acquisitions (M&A) Transactions

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Over the past several years, the US government has intensified its efforts to restrict exports of sensitive technologies by using export control restrictions and economic sanctions as tools to address national security concerns.

What this means is that export controls and sanctions compliance present a material issue for companies with business activities with entities or individuals outside the US and, consequently, material issues in the M&A context. This alert summarizes some of these risks in the M&A context, the diligence necessary to appreciate them and potential strategies to mitigate or address them.

Export Controls and Sanctions Compliance in the M&A context

Several US regulatory regimes apply to the control of exports, reexports and transfers of certain items. The most prominent is the Export Administration Regulations (EAR), 15 C.F.R. 730-780, as authorized pursuant to the Export Control Reform Act of 2018. However, other regulatory regimes could apply depending on the item being exported, such as the International Traffic in Arms Regulations (ITAR) for the export of defense articles or services. Depending on the export classification of any particular item, and whether any of the parties to a transaction are on "restricted party lists" (e.g., the "Entity List" of the Department of Commerce), restrictions or license requirements could apply. The US export control laws have extraterritorial reach and can apply to items produced outside the US under certain circumstances. Recent regulatory changes have expanded this extraterritorial jurisdiction, for example as it relates to certain semiconductor devices.

Sanctions compliance goes beyond US export controls and prohibits US persons from any dealings with sanctioned parties. Certain jurisdictions, and their residents and companies, are subject to comprehensive sanctions (currently: Cuba, Syria, Iran, North Korea, and the Crimea, Donetsk and Luhansk regions of Ukraine), but numerous other sanctions programs exist, such as those against Russia and Belarus. Like export controls, US sanctions laws have an extraterritorial reach, applying to US persons globally, and to any foreign person that causes or "facilitates" a violation by a US person (e.g., if a foreign-to-foreign transaction having a US sanctioned party uses a US financial intermediary).

US export controls and sanctions laws could apply to both US and non-US targets, depending on their business activities. Violations of these laws can result in substantial fines, and could subject companies to burdensome investigations and criminal charges. This means that non-compliance with applicable export controls and sanctions laws presents a material successor liability issue in the M&A context. In addition to successor liability, non-compliance with export controls can present a business continuity risk post-closing: if the target lacks required export licenses, or if an acquirer needs to get new export licenses to replace the target's existing ones, the business of the newly-acquired target could be significantly disrupted.

	Export Control (ITAR and EAR)	Economic Sanctions (OFAC)
Targets	US Content (Goods, Equipment, Software and Technology)	Persons; Countries; Activities and Transactions
Implication	Sourcing, Sales and Co-development, etc.	All kinds of activities, including financial
Application	• All exports from the US • Certain, not all, reexports and retransfers of US content • Certain foreign made items	• Primarily US person • Sometimes Non-US person (e.g., for causing or facilitating a US person violation)
Blacklists	• Entity list • Military end user list • Unverified list	• Specially Designated Nationals and Blocked Persons list (SDN List) • Non-SDN List
Violation Consequence	• Blacklisted (interruption of supply chain, both US and non-US) – recently, more commonly used for Chinese companies • Fines (e.g., up to US$1 million per violation under ECRA) • Imprisonment	• Blacklisted (blocked from transactions involving US persons) • Fines (currently US$377,700 per transaction) • Imprisonment

When and How to Address Export Controls and Sanctions Due Diligence

Deal teams have limited time to assess a target's compliance risks in the M&A process. Compounding the challenges of limited time, often potential M&A targets are not able to provide complete historical documentation on export controls and sanctions compliance, and relevant compliance personnel are often unavailable to be questioned. Given the limited time and information available in the M&A context, we recommend a risk-based due diligence strategy to assess key risk areas and focus increased diligence on areas of higher risk. The factors reviewed in assessing the level of risk consist of:

- The industry in which the target operates and its customer base. Are export controls likely given the items traded by the business (e.g., semiconductor devices or production equipment, industrial equipment)? In what industry do the customers operate (e.g. aerospace, defense)?
- The applications for the products/services. What are the relevant products/services traded, and what are their applications? Are there any military applications, or are the applications purely commercial?
- Relationships with other business partners. Does the target have or rely on business partners (e.g. distributors, agents or collaborations)? What country are they in, and do any present compliance concerns (e.g., foreign governments, restricted parties)?
- Whether the target has activity in or with high-risk countries. Does the business have no sales outside the US, only a few sales to lower-risk allied countries or does it have sales into numerous countries including high risk jurisdictions (e.g., Russia)?
- The compliance functions of the target. Does the target business have any compliance policies or internal controls? Or does it outsource compliance to third parties? How are its business partners screened? Is there a history of compliance or non-compliance?

Following an understanding of the above risk factors, diligence teams can take a risk-based approach to tailor diligence questions on the areas determined to be of higher risk. Typical diligence requests, relating to key risk areas, are included below.

Potential or actual violations	Details of any prior, pending or expected issues or allegations raised, internally or externally, including any past, ongoing or imminent government or regulatory investigations or proceedings (civil, criminal or administrative).
Sanctions	Details of prior dealings in any "Sanctioned Country," such as any physical locations (offices/branches/operations), assets or investments or any buying, selling or otherwise dealing in or financing products, merchandise, commodities or services or if any director, senior officer or shareholder is a citizen, resident or governmental agency/authority of a Sanctioned Country. • Sanctioned Country typically means jurisdictions subject to comprehensive US sanctions: Iran, Syria, North Korea, Cuba or the Luhansk, Crimea and Donetsk regions of Ukraine • Since April 24, 2019 (Sanctions Lookback)
Export Activity	Did the target have sales outside the US? In what countries were those sales?
Export Classification	The export classifications under the US laws for each of the target's products, software and technology, for example as listed on the Commerce Control List (applicable to items subject to the EAR), or the US Munitions List (applicable to items subject to the ITAR). Whether the target self-classified these items or obtained a commodity classification request (CCATS) determinations by the Bureau of Industry and Security (BIS) of the Department of Commerce?
ITAR	Is the company registered with the directorate of Defense Trade Controls (DDTC) of the State Department, which manages the ITAR? Does it have ITAR compliance policies? How does it manage ITAR-controlled customer data?
China, Russia, other High-risk Countries	Understand the target's business activities to high-risk jurisdictions: what items are sold in/into the jurisdiction, for what application the products are used and how are they classified? Does the target have other business partners in the jurisdiction?
	Has the target been contacted by any US government officials, or received any "is informed" letters with respect to sales or service of its products to or in China or other high-risk jurisdiction?
	How are these activities compliant with the extensive sanctions and export controls? For example, if any of the new China related advanced semiconductor rules apply, how does the target ensure compliance?
Compliance	What resources are used to comply with laws? How does the business screen customers, suppliers, partners, and vendors against Restricted Parties Lists? Does the target have written policies or procedures governing the screening process?

Common Strategies to Address Identified Risks or Liabilities

Given the limited time to assess compliance in the M&A context, buyers often insist on the target and seller making specific representations and warranties concerning export controls and sanctions compliance. These representations and warranties can be a subject of negotiation but generally seek to cover the following points:

- Material compliance with applicable laws by the target and, as applicable, its directors, employees or any other persons acting on its behalf, for a specified lookback period. This could be the statute of limitations period or another negotiated period.
- Possession of all applicable authorizations under export controls and sanctions.
- Compliance procedures in place for screening against restricted party lists (including Entity List and sanctions lists) under applicable export controls and sanctions laws.
- No prior claims, complaints, charges, investigations or proceedings and no known threatened actions, conditions or circumstances, pertaining to a potential, alleged or actual violation of export controls and sanctions laws.

Along with these representations, the seller or target may be required to make disclosures as informed by the risks areas identified in diligence. For example, a disclosure schedule could list all the target's items that are classified on the Commerce Control List (for items subject to the EAR), or the US Munitions List (for items subject to the ITAR) or could list prior voluntary disclosures for potential non-compliance.

If potential liability is an identified risk, an acquiror may want to address specific liability prior to closing or adopt other mitigation strategies to minimize the impact of a potential violations. The following are typical strategies employed in the M&A context:

- **Voluntary Self-Disclosure (VSD)** – A VSD to the relevant US authority could be an option to address identified instances of potential violations (i.e., not just for high-risk areas, but for specific transactions). VSDs for potential violations are looked upon favorably in M&A and can result in reduced penalties or none at all. A VSD could be required before closing, which is best to mitigate an acquiror's risks, but could create transaction timing issues. If submitted after closing, the VSD does not create timing issues for the transaction but would result in the acquiror assuming the risk of any penalties. This option is often used in conjunction with indemnity and insurance tools – see next bullets.
- **Special Indemnity Agreement** – This is a negotiated line-item indemnity to resolve potential violations identified in diligence. A special indemnity agreement could address the risk of penalties arising from a post-closing VSD strategy or, depending on the relevant statute of limitations, provide cover for the acquiror in case an investigation is launched.
- **Representations and Warranties Insurance (RWI)** – RWI products would protect the acquiror when violations are discovered post-closing in violation of a representation and warranty. This insurance product can be costly and also imposes a level of pre-closing diligence obligations that, if issues are identified, could result in exclusions from the coverage.

Conclusion

A proactive export control compliance review during the M&A due diligence process helps uncover hidden liabilities and prevent potential successor liabilities. As enforcement of export control laws and regulations by the US government continues to increase, parties involved in cross border M&A transactions should ensure that appropriate export controls and sanctions compliance due diligence reviews are conducted by experienced counsel to mitigate the potential financial, operational and reputational risks from violations of US export control restrictions and sanctions.

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