Audit thyself: new mandatory compliance measures in BIS civil settlement agreements


BIS has adopted several new civil enforcement measures against parties settling export enforcement cases, including mandatory audit and export compliance training. Michael Burton and Regan Alberda examine what looks to be a growing trend.

While a great deal of attention has been paid to the promised fruits of the U.S. export reform initiative, export compliance practitioners are all too aware that some of the more significant changes of late are in the area of enforcement. Better coordination among the agencies, more criminal cases, and higher penalties (imposed retroactively, no less) have all been enforcement trends for the past several years. It is no secret that penalties for export controls and sanctions violations are on the rise – across all the primary enforcement agencies, the Bureau of Industry and Security ('BIS'), the Directorate of Defense Trade Controls ('DDTC'), the Office of Foreign Asset Controls ('OFAC'), Census, Customs and Border Protection, and the Department Of Justice – with a growing list of cases resulting in multi-million dollar settlements and increasingly expensive collateral consequences.

Though perhaps less obvious than its levying significant monetary penalties, a review of recent published civil settlement agreements indicates that BIS has adopted several new civil enforcement measures against parties settling export enforcement cases. These mechanisms include: mandatory audit and reporting requirements; mandatory export compliance training; and pursuing separate civil enforcement actions against individual company employees alleged to have violated the U.S. Export Administration Regulations, in addition to the possibility of a criminal referral.

Following a brief summary of a line of recent BIS civil settlements, we analyze specifically the audit and compliance training mandates, and identify several issues in the hope of generating awareness, debate, and perhaps some shared expectations between industry and government on whether, when, and how to apply such remedial measures – in a neutral environment rather than during harried settlement negotiations.

Recent BIS civil settlements

Several recent BIS civil settlement agreements made publicly available not only include the monetary penalties routinely imposed for violations of the U.S. Export Administration Regulations ('EAR') but also illustrate a potential trend toward the use of additional mandatory compliance measures – particularly, outside independent audit requirements and mandatory export compliance training of employees.

It is no secret that penalties for export controls and sanctions violations are on the rise.

The first instance of a mandatory outside audit requirement in a BIS civil settlement agreement appears to have been in *PPG Industries, Inc.*, which was settled in late December 2010. Since that time, there have been a number of additional settlements mandating an outside audit as part of the settlement, including *Flowserve Corporation; Texas Armoring Corporation; A.M. Castle & Co.; Polar Star International Co., Ltd.; and SZY Holdings, LLC.* Two settlements with companies in the last year also included mandatory export compliance training for employees: *Texas Armoring Corporation* and *Vytran, LLC.*

It is noteworthy that this trend is not is limited to U.S. exporters. In settling with Flowserve Corporation, BIS entered into separate settlement agreements with each of the company's foreign affiliates alleged to have acted in violation of the EAR, each of which was separately mandated to complete an outside audit. The *Polar Star International Co., Ltd.* settlement also involved a Hong Kong company.

During the past year, however, a number of BIS civil settlements have been concluded where monetary fines were imposed without any audit requirement. Thus, while this practice seems to be escalating, it is not yet a condition of all settlements.

Audit provision specifics

In each of the settlements, the audit requirement language is essentially the same. The provisions state in relevant part:

> Company shall complete an external audit of its export compliance program. Company shall hire an unaffiliated third party consultant with expertise in U.S. export control laws (including recordkeeping requirements), with respect to all exports and re-exports that are subject to the Regulations. The results of the audit, including any relevant supporting materials, shall be submitted to BIS/Office of Export Enforcement (OEE) Field Office.
>
> The audit shall cover the 12 month period beginning the date of this Order [the date of settlement], and the related report shall be due to the BIS OEE Field Office no later than 15

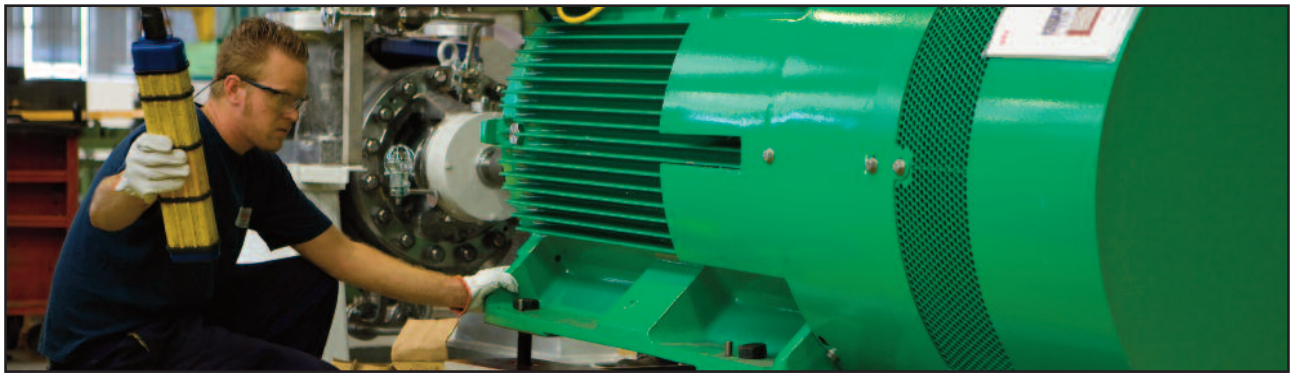
> months from the date of the Order. Said audit shall be in substantial compliance with the EMS [export management system] sample audit module, and shall include an assessment of the Company's compliance with the Regulations. In addition, where said audit identifies actual or potential violations of the Regulations, the Company must promptly provide copies of the pertinent air waybills and other export control documents and supporting documentation to the OEE Field Office.

The civil settlements also provide that the failure to conduct the audit and submit the results in a timely manner may lead to the issuance by BIS of an order denying the subject company's export privileges. In other words, the settling party may not export or receive items subject to the EAR until the denial order is lifted.

The civil settlements also provide that the failure to conduct the audit and submit the results in a timely manner may lead to the issuance by BIS of an order denying the subject company's export privileges.

We note several observations about the specific audit provision language, contrasting it with DDTC audit requirements observed in the past:

- It does not appear that the auditor must be approved by BIS. In contrast, most DDTC audit mandates require that the auditor be reviewed and approved by DDTC. DDTC typically also requests evidence of the qualifications of the proposed auditor conducting the audit.
- The language does not preclude the settling party from hiring an auditor it has previously engaged. DDTC's audit provisions do not allow for the use of a consultant or counsel previously engaged by the company, presumably to ensure the independence of the auditor and audit process. Given the relatively small pool of counsel and consultants with in-depth experience in U.S. export controls, the DDTC provision can pose difficulties for some companies, particularly larger companies that regularly engage outside consultants for compliance assistance. The BIS provision does allow for more flexibility in this regard.
- The audit review period is the year after the date of the settlement agreement. While audits mandated pursuant to DDTC consent agreements will often have annual audit requirements post settlement, DDTC audit requirements outside of formal consent requirements will have varying deadlines, and sometimes are required to be completed very shortly after the submission of a disclosure. DDTC often uses the audit to assess more immediately whether the company has a compliance programme in place and whether the incident is an isolated error, as well as that immediate remediation measures have been implemented. Essentially, the audit is part of DDTC's overall case review and determination of whether further action is warranted, whereas the BIS audit is post civil settlement and also seems to be more in the vein of a corporate probation measure.
- The audit is required to follow BIS's Export Management System ('EMS') sample audit module in substantial part. This module contains an extensive review process for all aspects of an export compliance programme, including export classification, end-user and end-use screening, anti-boycott compliance, and record-keeping, among other areas. Thus, the audit is a broad programme review and not necessarily focused on the compliance weakness that led to the violations. In contrast, while DDTC does mandate audits to review compliance with the ITAR generally, DDTC in some cases will focus the audit requirement to cover the specific compliance areas that are the subject of the potential violations and to assess whether remedial actions identified by the company are functioning.
- The audit provision also imposes a requirement that documentation relating to actual or *potential* violations of the Regulations uncovered during the audit be provided to the OEE Field Office. DDTC audit provisions in our experience generally do not include such a requirement. In our experience, with both DDTC audits as well as internal company audits, when an auditor discovers a violation or potential violation, it is generally addressed in the audit report. However, the company has the opportunity to review the matter further to confirm whether a violation occurred and, if so, whether to file a voluntary disclosure regarding the matter. If the violation was discovered as part



of a DDTC-mandated audit, it is more likely that the company would concurrently file a disclosure regarding the matter. In the case of the BIS provision, it seems that the reporting of the violation may not be treated as a voluntary disclosure, and thus the company would lose out on significant mitigation of any penalty. Additionally, the reporting of potential violations in this manner seems somewhat overreaching, as opposed to focusing limited OEE resources on actual violations.

A few other general observations are:

- The audit requirement was imposed in cases involving both voluntary disclosures and non-voluntary disclosures. Thus, the submission of a voluntary disclosure does not preclude the imposition of an audit requirement.

Much of the final settlement amount is a result of negotiation between BIS and the company, with certain factors taken into consideration.

- The facts and circumstances of each of the settlement agreements where audits have been mandated are very different. Additionally, only the information made publicly available in the proposed charging letter and settlement agreement are available to review, making it difficult to infer whether certain factors lead to the imposition of an audit requirement. Certain cases did seem to have aggravating factors, such as the presence of embargoed countries in *Flowserve*, while in *Texas Armoring*, it was noted that the company acted with knowledge of the licence requirements. In others, such as *A.M. Castle*, and in particular, *Polar Star* – a settlement of only one unlicensed re-export to a restricted party – it is unclear what factors contributed to the audit requirement.

- Yet another possibility is that the parties negotiated the audit requirement in exchange for reduced penalty amounts. While BIS has published certain guidance as to how fines and penalties are calculated – including certain automatic calculations, such as the mitigation of the maximum penalty amount by 50% for cases voluntarily disclosed to BIS – much of the final settlement amount is a result of negotiation between BIS and the company, with certain factors taken into consideration such as harm to national security, past history of compliance, and the existence of a compliance programme. As we do not have insight into the negotiation process behind these settlements, we cannot assess whether the total fine amount was decreased to take into consideration the imposition of the audit requirement, whether there were other incentives/disincentives to agreeing to the audit requirement, or even if it was a truly negotiable point. Given the high costs that can be incurred in engaging an outside auditor, we would hope that the total amount of any corresponding monetary penalty assessed in the settlement would be reduced in recognition of such costs and effort. When asked this question recently at an export compliance conference, the Director of the Office of Export Enforcement and a representative from BIS's Office of Chief Counsel only noted that the assessment of penalties is considered on a case-by-case basis.
- BIS imposed audit requirements on a number of non-U.S. entities; however, it did not seem to alter the scope of the audit requirements to take into account that those companies' compliance programmes may be more narrowly tailored to specific re-export requirements imposed under the EAR. Additionally, the costs for these companies to have the audit conducted likely will be higher, given the auditor travel requirements. Further, there may be privacy law considerations in a number of jurisdictions that must be navigated. We believe BIS should consider tailoring the scope of audits for non-U.S. entities to target *relevant* aspects of U.S. export controls compliance.
- The audit requirement is intended to replicate the EMS Guidelines in substantial part. Many elements of the EMS Guidelines audit the existence and functioning of a company's export compliance system rather than identifying individual violations. Yet, there is no affirmative regulatory requirement to adopt an EMS. Is the audit requirement an extra-regulatory means of forcing this requirement?
- Is statistical sampling permitted in auditing large volumes of transactions? If so, what methodologies may be employed?
- Would there be any possibility of agreeing to an audit, and if the audit report revealed a solid compliance programme with no systemic issues or glaring compliance errors, avoiding a civil settlement all together?

Mandatory export compliance training

As noted here, in addition to the audit requirement and monetary penalties, in two cases in the past year mandatory export compliance training for specified employees was also imposed. In *Texas Armoring*, the CEO and the employee in charge of export compliance for the company were mandated to attend an export training programme within six months of the settlement. In *Vytran, LLC*, the company's export controls compliance manager was required to complete an export controls compliance training programme, also within six months of the settlement. We note that several settlements with individuals also imposed export training requirements.

While the focus on training as a remedial measure is an important tool to improve compliance, as with an audit, there are costs associated with such training, which should be taken into account when calculating the imposition of monetary penalty. Further, the content and provider of the training is critical.

Conclusion

The trend toward imposing measures designed to improve an exporter's compliance going forward generally represents a positive step toward reaching the U.S. government's ultimate goal of decreasing export violations and protecting national security and non-proliferation interests. The emerging BIS audit requirement in current form, however, does raise a number of issues worthy of debate.

Other U.S. government agencies, most notably the Department of State, Directorate of Defense Trade Controls DDTC, have used mandatory internal audits as a tool in addressing export violations for a number of years. Yet those audits typically have been imposed without the addition of monetary civil penalties, provided the audit findings did not reveal ongoing compliance concerns or a pattern of repeated violations. Conversely, BIS seems to have imposed these measures without a concomitant decrease in civil penalties. Will the audit requirement evolve into just an additional form of penalty, or will the costs associated with the audit factor into a reduced monetary penalty?

What's more, these audit requirements mandate reporting of 'potential violations', including the provision of relevant shipment documents, which exceeds the scope of the typical audit requirements imposed by DDTC. In other words, the exporter is essentially placed on civil probation and afforded the privilege of paying for it, ostensibly without being able to avail itself of the benefits of a voluntary self-disclosure. What is the effect of the audit provision on voluntary disclosure, and what should it be? In addition, should the audit be tailored to key areas of weakness identified in connection with a company's alleged prior violations, as the audit requirements imposed in the past by DDTC?

These equitable remedies are fashioned on a case-by-case basis where BIS is in a position to assert disproportionate leverage over the settling party. The use of these types of remedial measures would benefit from published regulations or formal agency policy to ensure fairness, consistency, and ideally an opportunity for public notice and comment. One need look no further than the example of Foreign Corrupt Practices Act deferred prosecution agreements for a cautionary tale of the perils of law-making through settlement agreements. Will BIS update its civil penalty guidelines to address these new settlement practices?

While this trend raises many questions, at least one question can be answered clearly: 'What does this mean for my company as an exporter?' Get your compliance house in order now because, if ever you are the target of an export enforcement action, you almost surely will have to – on the government's terms rather than your own.

Michael Burton is a partner and Regan Alberda an associate in the International Trade team at the Washington D.C. office of Arent Fox.

burton.michael@arentfox.com

alberda.regan@arentfox.com