

# The Metropolitan Corporate Counsel®

www.metrocorp-counsel.com

Volume 19, No. 10

© 2011 The Metropolitan Corporate Counsel, Inc.

October 2011

## Navigating The Complex World Of Defense Exports

*The Editor interviews Zlatko ("Zack") Hadzismajlovic, Special Counsel with McCarter & English LLP.*

**Editor:** Please describe the State Department's Directorate of Defense Trade Controls (DDTC) authority to regulate export items under its International Traffic in Arms Regulations (ITAR) authority.

**Hadzismajlovic:** The statutory authority comes from the Arms Export Control Act of 1976 (AECA), which provides the President with control over the classification, sale, export and retransfer of defense articles and services. Control of said items is reasoned to be an integral part of safeguarding U.S. national security and of furthering U.S. foreign policy objectives. The AECA is promulgated by the ITAR – 22 C.F.R., Sections 120-130 – and the Department of State's DDTC, Bureau of Political-Military Affairs is ultimately charged with controlling and issuing licenses pursuant to the ITAR.

**Editor:** What changes were made recently in exemption of licensing for intracompany transfers of unclassified defense articles (including technical data) by approved end-users and consignees to their employees who are dual- or third-country nationals of certain proscribed countries?

**Hadzismajlovic:** Prior to this week, effecting such transfers was possible via an exemption from licensing; however, that exemption applied only to dual- or third-country nationals from Australia, Japan, New Zealand, Switzerland, NATO member states and the EU (collectively, NATO+). A license usually covers one particular person, and it is a complicated process for the exporter to determine that person's status vis-a-vis prohibited countries – for example, a UK national who was born in the People's Republic of China (PRC). Further increasing the exporter's burden, even a visual release of a controlled defense article to a foreign person is considered an export regardless of where it occurs, including within the U.S.

**Editor:** We understand that the exemption,

22 C.F.R. §126.18, became effective on August 15.

**Hadzismajlovic:** Yes. Now, intracompany transfers of unclassified defense articles, including technical data, can be made to dual- and third-country nationals who are bona fide regular employees or long-term contractors directly employed by or under contract by the foreign consignee or end-user. These transfers are exempt from licensing so long as the transfer takes place within the country where the end-user is located; the transfer is within the scope of the exporter authorization; and the foreign end-user and consignee implement effective procedures to screen for diversion risk. Aside from an export license, authorization types include technical assistance (TAA), warehouse distribution (WDA), or manufacturing licensing (MLA) agreements, which list authorized licensees and sublicensees. There can be more than 20 companies listed in per-transaction or per-item DDTC licenses (purchaser, consignee, intermediate consignee, etc.), which are distinct from authorizations like TAAs, WDAs, and MLAs.

**Editor:** Please describe the specific requirements of the exemption.

**Hadzismajlovic:** Regarded as an extension of national security, defense articles and technology are the crown jewels of U.S. industry, and they are enumerated on the U.S. Munitions List and include items that aren't munitions at all, but are specifically adapted or modified for a military application. Naturally, we reward our allies with greater access and impose tighter controls upon unfriendly countries.

Specific DDTC exemption requirements include a security clearance for employees approved by the source nation or a comprehensive screening mechanism for diversion risk. The latter is cumbersome and difficult to implement, requiring a company to, in effect,



**Zlatko  
Hadzismajlovic**

engage in intelligence gathering to determine whether its employees show allegiance to a proscribed nation.

The DDTC hasn't provided much helpful guidance to companies regarding matters such as "allegiance." For example, the DDTC provided the following sample question as part of its guidance: "Have you ever served in or provided information to the government of another country (e.g., military, foreign ministry, intelligence agency or law enforcement)?"

Well, anytime I fly to London, upon entry into the United Kingdom, I provide information to their Border Agency. What can one infer from that? Thus, if a security clearance is available from the host country, then this is a useful exemption. Using interrogatories to screen for diversion risk isn't within the skill set of most companies and is likely to expose them to local human rights laws violations.

**Editor:** Are there specifically proscribed items for certain countries?

**Hadzismajlovic:** Yes, however, there is no such thing as an airtight embargo. While there are very tight restrictions and a policy of denial for countries like Iran, licenses for exports of medicine are available. To put this in perspective, the full complement of proscribed countries – as many as 25 – constitute roughly one-quarter of the world's population. Countries that we consider state sponsors of terrorism – currently Cuba, Iran, Sudan and Syria – are joined by countries that we simply want to keep embargoed pursuant to UN Security Council resolutions, including the Democratic Republic of Congo, Eritrea, Iraq, Iran, Lebanon, Liberia, Libya, North Korea, Somalia and Sudan. The list is fluid and reflects the Department of State's general carrot and stick approach. If we take Libya as an example, as of September 19, 2011 we've lifted most of the financial sanctions on Libya that were imposed by Executive Order 13566. We did this due to the United Nations Security Council approval of Resolution S/Res/2009 (2011) which lifted most multilateral sanctions on the Libyan government.

*Please email the interviewee at [zhadzismajlovic@mccarter.com](mailto:zhadzismajlovic@mccarter.com) with questions about this interview.*

**Editor: What is the logic behind identifying foreign nationals operating within the U.S.?**

**Hadzismajlovic:** The DDTC deems the release of controlled items to foreign persons in the United States equivalent to an export of said items to that person's home country. It's somewhat counterintuitive to assume that this risk disappears once we obtain a license because hardly anything in the requisite background check and review can sufficiently identify and eliminate diversion risks associated with the subject.

**Editor: What does the DDTC now consider to be effective measures instituted by the host nation in order to withdraw the licensing requirement?**

**Hadzismajlovic:** Effective measures include demonstrating that a security clearance is in place by the host nation or that a comprehensive screening mechanism for determining diversion risk is implemented by the company abroad. Also, the end-user must implement a technology security/clearance plan, maintain records of screenings for a five-year look-back period and require all relevant employees to execute nondisclosure agreements. While the DDTC has provided only cursory guidance, it is critical that companies review this guidance when crafting a compliance program.

**Editor: Is the agency readily forthcoming with guidance?**

**Hadzismajlovic:** No, they're not, and it is a general trend that government is closing off to the public.

**Editor: Yet we understand there is published information regarding a company's ability to go to the DDTC as a last resort. Can you describe what that really means?**

**Hadzismajlovic:** It seems that if companies are having difficulty creating a compliance plan and procedures for effective diversion risk screening, they can ask the DDTC to perform the vetting. It is very likely that the DDTC will err on the side of caution if one happens to be born in or adopted from a proscribed country.

**Editor: Does the DDTC maintain a record of its opinions and rulings to serve as precedent for companies in the decision-making process?**

**Hadzismajlovic:** No, but they do publish consent agreements and charging documents, which some find valuable in a negative assessment of what constitutes a shoddy compliance plan. In my experience, these documents are not useful to large companies

proactively seeking to identify and implement the components of a good compliance program.

**Editor: Can a company approach the DDTC in advance of shipments for an advisory opinion?**

**Hadzismajlovic:** Companies can obtain a commodity jurisdiction assessment, for instance, if they are unsure whether or not a particular item is controlled. Here, the DDTC renders an opinion as to the item's inclusion as a defense article on the U.S. munitions list – thereby requiring export authorization. Completion of this process can take several weeks or even months – depending on how well the company articulates the item's purpose – and it carries the risk of incurring future fines should the description ultimately be found lacking in pertinent detail. Companies have to move very carefully here.

**Editor: Is there any case law relating to DDTC's opinions that were appealed?**

**Hadzismajlovic:** No. The agency has nearly unfettered authority in this domain. It does not disclose the actual determination process, and its determinations as to an item's status are not subject to judicial review. This has tremendous consequences for companies whose product catalogue suddenly becomes subject to the ITAR. Compliance is very costly and time consuming, yet companies at this level have no choice but to comply.

**Editor: Please discuss the interplay between compliance programs and licensing options.**

**Hadzismajlovic:** While there is no regulatory requirement for a compliance plan (its existence is considered a mitigating factor in the event of a violation), a munitions manufacturer, exporter or broker is required to register with DDTC, effectively placing the company on the agency's radar. Companies wishing to export will need a license unless they qualify for exemption, and it would be dangerous for any registered company to opt not to implement a compliance plan. Audits may be triggered by potentially self-interested competitor claims. Sometimes, these claims are not even true, or perhaps the company innocently was part of a supply chain in which a different company was implicated in unauthorized exports.

Noncompliance risks reach beyond penalties or fines to include the possibility of being debarred from obtaining a license – a mortal blow for companies that survive on exports.

**Editor: We understand the Wassenaar Arrangement enables member countries to identify controlled items and to coordinate export controls. Could a company's use of**

**these controls serve as a defense?**

**Hadzismajlovic:** Domestic regulatory agencies are only part of the picture because companies cannot exercise global control without the cooperation of other nations. The Wassenaar Arrangement is a 40-country multilateral control regime that addresses restricted technology. While companies have no control over whether legally exported products are retransferred to a rogue nation, the Wassenaar Arrangement encourages allies to cooperate with restrictions on both dual-use items and munitions.

**Editor: What kinds of penalties can be levied for violations of this and the previous regulation?**

**Hadzismajlovic:** The amount and type of penalty are within the DDTC's sole discretion. There is a ceiling but it is fairly high; for instance, a criminal violation of the ITAR can trigger penalties of up to a million dollars per offense or up to ten years of imprisonment. The DDTC generally views exporting as a privilege that can be revoked through debarment.

The DDTC takes action against small and very large companies. For instance, Blackwater Worldwide (now XE Services) entered into a consent agreement for \$42 million to settle claims and violations of ITAR – in spite of the company's huge compliance component. More damaging, the company was debarred prior to entering into a consent agreement because there was a presumption of denial entered on all of its export licenses or authorizations, except those in direct support of U.S. government contracts.

Boeing repeatedly is hit with multimillion dollar fines, even though the company has a robust compliance plan. The DDTC's website provides details regarding consent agreements, and Boeing's activity is staggering, with agreements dated 1998, 2001, 2006 and then again 2008. This activity highlights that very large companies with complex operations cannot control everything, no matter how hard they try. It's just a difficult system to navigate.

**Editor: Does our system hinder U.S. competitiveness?**

**Hadzismajlovic:** Generally, other countries' rules are more flexible and don't have the long-arm reach of U.S. regulations. The Obama administration is trying to address that inequality via revision and amendments to the export control schemes. It is unclear if these efforts will succeed, but there is progress in the government's recognition that American defense companies have substantial competition worldwide. Overall, it is staggering how much U.S. business is lost every year to this regulatory inequity.