

Sanctions, Export Controls and Supply Chain Due Diligence

International supply chains depend on relationships between a variety of intermediaries, some of which may have physical control of goods and others that “merely” have the ability to direct how and to where goods are distributed. The use of intermediaries provides obvious benefits to the well-run logistics system. Exporters can leverage the economies of scale that come from using third party logistics providers and can use the intermediary’s network to reach areas of the world where it may not otherwise have a presence. The full benefits of using third party logistics services providers can only be realized, however, if the relationship is also structured to leverage the systems of all parties to enhance compliance.

The affirmative duties imposed by the sanctions and export control laws of the United States create intertwining compliance obligations among the intermediaries to an international transaction and the principals. While it is, perhaps, a tautology to state that each party is responsible for its own actions, in the international trade environment, each party is best served by exercising due diligence over its trading partners and formalizing coordination with their compliance systems. If compliance concerns are integrated into the principal/intermediary relationship, the intermediary may serve as the “first line of defense” for the principal in assuring compliance with international trade regulation. Absent such integration, the intermediary may create gaps in an otherwise coherent and effective compliance program. Similarly, confidence in the principal’s compliance program will facilitate the intermediary’s ability to assure compliance, the opposite creating the potential for substantial risks.

In this article we suggest that it is not only important for a party to “know its customer,” but it also must know its logistics chain. In order to reduce compliance risks, compliance considerations should be integrated into the logistics business process and, like other factors, compliance should be part of the matrix used to measure the performance of the logistics chain. We conclude by recommending steps to take in establishing and maintaining a principal/intermediary relationship that reduces the risk of having compliance costs eliminate the benefits gained by maximizing logistics opportunities.

Sanctions and Export Control Considerations for the Principal/Intermediary Relationship

In order to maintain an effective export compliance system, one must understand the nature of the product, end use, end user and destination. While the exporter is in the best position to understand these four elements, the logistics services provider is likely to be the last party able to screen the parties to the transaction against various sanctions lists—prior to the goods actually being shipped—and is often in the best position to know if the goods have been re-routed.

Diversion is perhaps the biggest supply chain-based compliance risk. While the Department of Commerce's "Know Your Customer" Guidance and Red Flags provide a good starting point for identifying potential diversion issues, these tools focus primarily on the end user and end use of the product. Guidelines other than those incorporated in the Export Administration Regulations suggest that one should deploy a broader view of the Red Flags. See 75 Fed. Reg. 53639 (September 1, 2010). Best practices suggest that integrating the compliance programs of the logistics services provider and the principal can provide significant additional protection against being caught in the diversion trap.

Procedures to guard against diversion are perhaps no more important than when goods are sold on an Ex-Works basis or where the Foreign Principal Party in Interest ("FPPI") is otherwise responsible for the export formalities and transportation (i.e., routed export transaction). A routed export transaction avoids some of the redundancies that help to assure compliance with sanctions and export control laws. The U.S. Principal Party in Interest ("USPPI") still has export compliance concerns but, for commercial reasons, may not have access to all of the information that would otherwise be available and necessary to assure compliance. Furthermore, the forwarder upon whom the USPPI may rely to report its export information is typically nominated by the FPPI. The USPPI does not often have privity of contract with the forwarder and has very little ability to exercise control over its actions.

For these reasons, we generally advise our clients to avoid the use of the routed export transaction. We understand, however, that the ability to enter into routed transactions is sometimes a commercial necessity. In those instances where routed export transactions are unavoidable, we suggest that the USPPI and the forwarder establish procedures for managing the transaction to enhance compliance.

As permitted by the regulations, the USPPI should require that the designated forwarder provide confirmation that the USPPI-provided information has been faithfully relayed to the government, regardless of whether or not the shipment is a routed export transaction. But the request of such confirmation provides only the minimum of due diligence. It does not serve to enhance the compliance system.

To assure that the supply chain intermediaries enhance the "first line of defense" and are not a source of liability, we suggest that principals integrate export control due diligence procedures into their freight forwarder selection and management program. Such due diligence should be deployed regardless of whether the freight forwarder is selected by the purchaser of the goods (i.e., routed transaction) or by the seller. As discussed below, this due diligence can be accomplished with the issuance of a simple questionnaire to the forwarder before the establishment of the relationship, and by having the USPPI and forwarder enter into a formal agreement regarding their operations, including compliance responsibilities. Finally, we have observed that the forwarder selection process is often handled by a company's sales or logistics organizations, while compliance is under the auspices of the legal department. We suggest that, at a minimum, the forwarder be provided with a "dotted line" reporting responsibility to the Compliance Officer.

Forwarder Selection and Management

The following steps serve to maximize the compliance benefit of the principal/forwarder relationship, turning this relationship into a strategic asset regardless of whether or not the shipment is a routed export transaction. This list of considerations is intended to be illustrative, and not necessarily all inclusive. It is anticipated that the parties will develop their practices as an extrapolation of the following:

1. **Forwarder Qualifications and Management**—Develop a formalized and documented forwarder approval and management process that can be used regardless of whether or not the shipment is a routed export transaction.
 - a. Have all forwarder candidates complete a compliance questionnaire that answers, at a minimum, the following questions:
 - i. Has the forwarder previously been subject to any sanctions or penalties?
 - ii. Does the forwarder have a written compliance program?
 - iii. When in the process does the forwarder screen the parties to the transaction against the various sanctions lists?
 - iv. How does the forwarder select and monitor the foreign-affiliated parties with whom it works?
 - v. Does the compliance program have a process for informing the principal of any Red Flags or other compliance concerns that are identified?
 - b. Require the forwarder to provide the USPPi with copies of all information filed with the government regarding the exported merchandise, as permitted by the regulations.
 - c. Require the forwarder to provide the exporter with the identification of the foreign affiliate in advance of the shipment, if permissible under the commercial agreement.
 - d. Establish a system that will not allow the issuance of a power of attorney to any forwarder for which a compliance questionnaire has not been issued, returned and approved.
 - e. Restrict the effective duration of all powers of attorney in order to force the forwarder to renew the same on a periodic basis.
 - f. Establish a system for reporting requests to have goods re-routed, if commercially feasible.
 - g. Identify a principal point of contact at the forwarder who will be responsible for addressing compliance concerns.
 - h. Develop a written agreement with the forwarder that includes compliance expectations and performance measurements.
2. **Qualifying the Principal**—the forwarder should also deploy a process to manage principal-based compliance risks and to document its process.
 - a. What is the compliance history of the principal?
 - b. Does the principal know and communicate the intended destination of the goods regardless of whether the shipment is routed by the foreign purchaser?
 - c. Does the principal know the control status of the goods being shipped?
 - d. Require the principal to provide the Export Control Classification Number ("ECCN") or U.S. Munitions List ("USML") category on all goods, regardless of the classification and reason for control.
 - e. Require the principal to provide the anticipated destination for the goods, regardless of whether or not the shipment is a "routed export transaction."
 - f. Does the principal have documented compliance procedures?
 - g. Has the agreement between the forwarder and the principal identified the compliance officer to whom concerns should be raised? Is this compliance officer in the sales department?

Conclusion

A failure to coordinate the compliance systems of the principal/exporter and the logistics services provider creates a substantial missed opportunity for enhancing compliance and invites liability that can be easily avoided. We suggest that the parties establish clear compliance objectives and measure the performance of the parties against those objectives. Both the principal and the logistics services provider should conduct regular gap analyses to identify and address issues that come up. While supply chain due diligence does not relieve the exporter of the responsibility to be vigilant in the operation of its export control compliance program, pushing export control compliance through the supply chain can provide a significant additional layer of protection and control over the supply chain.

If you have questions on this or any international trade topic, you may contact your Thompson Coburn attorney or Robert A. Shapiro at the contact information listed below.

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