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Record Setting Penalty In ITT Case Shows Risks Of Outsourcing For Defense Contractors

On March 28, ITT Corp., the 12th-largest defense contractor in the world, pleaded guilty to illegally transferring classified and export-controlled night-vision technology to foreign countries, including the UK, Singapore, Japan and China. This is the first conviction of a major defense contractor for violating the U.S. Arms Export Control Act (AECA).

Penalty of Historic Proportions—As part of this plea, ITT's night-vision business division (ITT NV) is debarred from participating in the export of defense articles for three years. In addition, ITT will pay \$100 million in criminal fines, penalties and forfeitures as follows: (1) a \$20 million monetary penalty to the State Department, (2) a statutory maximum fine of \$2 million, (3) a \$28 million forfeiture to the U.S. as the proceeds of its illegal activities, and (4) a deferred \$50 million penalty. This \$50 million penalty will be forgiven if the company spends at least \$50 million over the next five years to develop and produce even more advanced night-vision goggles. A U.S. military laboratory will supervise the spending, and the U.S. will retain the right to share any newly developed technology with other manufacturers.

In addition to the guilty pleas and monetary penalties, the U.S. directed ITT to pay for an independent monitor and staff, selected by the U.S., to monitor ITT's compliance with this agreement and federal law.

ITT's three-year debarment is subject to certain limits: (a) the debarment is limited to the business unit responsible for the AECA/International Traffic in Arms Regulations (ITAR) violations—ITT NV, (b) the State Department will consider reinstatement requests one year after the date of debarment, and (c) the State

Department may grant "transaction exceptions" to the debarment on a case-by-case basis. See Bureau of Political-Military Affairs; Statutory Debarment of ITT Corporation Pursuant to the Arms Export Control Act and the International Traffic in Arms Regulations, 72 Fed. Reg. 18310 (April 11, 2007) (debarment notice).

According to the debarment notice, transaction exceptions have already been granted for "certain existing authorization and pending authorizations for key programs involving [ITT NV] that have been identified as being necessary to U.S. national security and foreign policy interests." The debarment notice further states that approvals of future requests for authorizations may be granted "after a full review of all circumstances to include law enforcement concerns and whether an exception is warranted by overriding U.S. foreign policy or national security interests, or whether an exception would further law enforcement concerns that are consistent with foreign policy or national security interest of the United States." Given the importance of night-vision devices to the U.S. military, some future approvals likely will be granted. Thus it is not clear how significant the impact of the debarment will be on ITT's operations.

Many Violations Result from ITT's Outsourcing Activities—This case illustrates some of the pitfalls for defense contractors that outsource. ITT ran afoul of the AECA and ITAR largely because it outsourced the development of night-vision technology and production to companies in Singapore, the UK and Japan. The violations arose from the development and production of night-vision equipment, light interference filters (LIFs) (which counter the effect of laser weapons on night-vision equipment) and the Enhanced Night Vision Goggle System (ENVG). On several occasions, ITT NV (1) provided export-controlled technical specifications and drawings for these U.S. military devices to foreign companies; (2) collaborated with the engineers in these foreign companies to develop designs for these U.S. military night-vision devices, using export-controlled technical specifications and drawings; and (3) purchased the finished assemblies or components for the U.S. military devices from these foreign companies. Each of the actions would have required approval from the State

Department, given the controlled technology involved, and ITT did not obtain the necessary licenses.

Even when ITT did obtain specific export licenses or technical assistance agreements (TAAs), the company violated the restrictions and provisions on the licenses. ITT exceeded the limited “build to print” relationship that was authorized by the licenses. Build to print means producing an end item (i.e., system, subsystem or component) from technical drawings and specifications (which contain no process or know-how information) without the need for additional technical assistance. Build to print does not include the release of any information which discloses design methodology, engineering analysis, detailed process information or manufacturing know-how. ITT also engaged in a collaborative design relationship far exceeding the TAA authorization, and directed the foreign producer to produce product.

One of the most egregious violations occurred when an ITT NV employee illegally transferred to a UK company classified military technical data designated “Secret-No Foreign” relating to the LIFs. The “No Foreign” designation means that this information is not to be shared with any foreign company or person, including our closest allies. This illegal transfer was done to find a new and cheaper manufacturer for the LIFs. ITT NV subsequently placed a purchase order with this UK firm for LIFs—again without the requisite permission from the U.S. State Department. See Statement of Facts, Appendix A to ITT’s Plea Agreement, (statement of facts) at 15–23.

Problems Compounded by ITT’s Failure to Control Actions of Foreign Contractors—Not only did ITT violate the law by sending export-controlled technical specifications and drawings without authorization to business partners in Singapore, the UK and Japan, but it compounded these violations by neglecting to notify its foreign subcontractors that the materials provided were export controlled and not preventing them from subcontracting the work elsewhere. For example,

- ITT’s business partner in Singapore exported a controlled drawing to an optics company located in the People’s Republic of China (PRC). The Singapore company also issued a purchase order for the production of thousands of LIF substrates in PRC. PRC is a prohibited destination pursuant to the ITAR.
- Among the Singapore company’s optical designers working collaboratively with ITT NV on the ENVG design and development were two optical

designers who were citizens of the PRC, a prohibited destination for export-controlled information.

- ITT NV turned to a Japanese company to manufacture the ENVG switch. The Japanese company specifically informed ITT NV that it intended to use a sister company located in the PRC during the manufacturing, assembly and testing process to reduce production costs. ITT NV made no effort to prevent the Japanese company from exporting the ENVG switch designs to PRC. The PRC switch company ultimately produced hundreds of ENVG switches, which were shipped to the Japanese company and then to ITT NV.

False and Misleading Statements Relating to Temporary (Consignment) Exports—Part of ITT’s penalty arose from filing false and misleading statements. In particular, count two of ITT’s plea related to ITT’s representation that it only recently had discovered certain violations when, in fact, it had known about the violations at least two years earlier and the violations extended back over 10 years. These violations related to ITT’s failure to ensure the return of night-vision equipment within the validity period of the applicable four-year license period. Also, ITT did not take significant corrective action to stop the ongoing violations until shortly before it informed the State Department about the violations. Most of these statements were made in the context of ITT’s 2004 voluntary disclosure to the State Department.

In 2004, the State Department entered into a consent agreement under which ITT was required to pay an \$8 million monetary penalty and did not have to admit any wrongdoing. State entered into this consent agreement because ITT represented that it had disclosed voluntarily all information concerning the alleged violations and promised to clean up its operations and comply with ITAR obligations.

According to the statement of facts in the appendix to ITT’s plea, the “reality, however, was just the opposite. As the Government’s subsequent investigation would establish, counsel for ITT Defense and the outside attorneys intentionally withheld material facts, information and circumstances about the consignment violations from the U.S. Department of State in an effort to limit the potential penalties and consequences that might be imposed by the government.” Statement of facts, at 6.

Why Criminal Conviction—The Government’s choice of a criminal sanction instead of a civil sanction demonstrates the tough enforcement climate for ITAR violations having significant national security implica-

tions. The criminal sanction also was attributable to the willful character of the violations and the length of time over which they occurred. According to the statement of facts accompanying the ITT plea agreement, ITT's managers willfully and repeatedly violated the AECA over 25 years. The statement of facts also indicates that, at least initially, ITT did not cooperate with the Government investigation.

The criminal investigation began on Aug. 1, 2001, when special agents from the Department of Defense Criminal Investigative Service discovered that ITT NV employees had illegally sent a classified U.S. military document relating to night-vision technology to foreign nationals in the UK. See Statement of U.S. Attorney John Brownlee on the Guilty Plea of ITT Corp. for Illegally Transferring Classified and Export Controlled Night Vision Technology to Foreign Countries (March 27, 2007) (Brownlee statement) at 5.

According to the statement of facts, ITT did not return the classified LIF specifications when requested to do so by the Department of State and continued to issue purchase orders for items produced using the unlawfully exported specifications and drawings. ITT NV never told the Government that the UK company retained a copy of the classified LIF specifications, and the Government has been unable to recover it.

It was not until Aug. 9, 2001, that ITT NV asked the UK company, at the specific direction of the Government, to stop producing the LIFs. By then, the UK company had delivered 20 completed LIFs to ITT NV, manufactured 518 LIFs that passed testing standards and generated a significant amount of new classified test data related to LIF testing. On Feb. 6, 2002, ITT NV finally put the LIF purchase order on "hold indefinitely." By that time, the UK company had illegally produced at least one thousand coated LIF filters, and the Singapore company had manufactured in the PRC as many as 20,000 LIF substrates.

This initial lack of cooperation combined with the false statements, described above, were probably significant factors in the decision to pursue a criminal prosecution, and impose a significant penalty.

Lessons to be Learned from the ITT Case—U.S. Attorney John Brownlee summarized the Government's findings with respect to ITT NV as follows: "During the course of the criminal investigation, the government discovered that ITT NV managers created an atmosphere where U.S. export laws were viewed as obstacles to getting business done. As a result, grossly inadequate resources were devoted by ITT to ensuring compliance

with U.S. export laws. The combination of grossly inadequate resources and a negative attitude toward export compliance led to a regular pattern of export violations and misrepresentations to the government from 1980 to 2005." Brownlee statement at 5.

The remedial action plan imposed on ITT as part of its plea agreement was designed to address these problems and is a useful template for other companies to follow to ensure that they do not find themselves in similar circumstances. The plan requires:

- The executive manager of export compliance (EMC) should report directly to the chief executive officer and have access to the board of directors.
- The EMC should be given adequate authority and resources to ensure full compliance with export laws.
- All export compliance managers should be supervised and evaluated, and report directly to the EMC to ensure full compliance with the export laws, without fear of adverse action.
- All employees who have access to export-controlled or classified materials should receive adequate annual training.
- The company should require prompt reporting of any violations.
- The company should conduct periodic export compliance audits.

Conclusion—ITT's \$100 million penalty, combined with its three-year debarment, indicates how serious the Justice and State departments are about enforcing AECA/ITAR obligations and should encourage defense contractors to ensure that their outsourcing arrangements are carefully controlled and comply with U.S. trade laws.



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