

White-Collar Crime

COMMENTARY

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Unprecedented \$100 Million Penalties In ITT Export Case

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In the first conviction of a major defense contractor for violating the Arms Export Control Act, 22 U.S.C. § 2778, ITT Corp., the 12th-largest defense contractor in the world, recently pleaded guilty to illegally transferring classified and export-controlled night-vision technology to foreign countries, including the U.K., Singapore, Japan and China. The total fines imposed are almost four times the calculated proceeds of ITT's illegal activities. In addition, the company is subject to a three-year partial debarment from participating in the export of defense articles.

As part of this plea, ITT will pay \$100 million in criminal fines, penalties and forfeitures as follows: \$20 million monetary penalty to the U.S. State Department, statutory maximum fine of \$2 million, \$28 million forfeiture to the U.S. as the proceeds of its illegal activities and deferred \$50 million penalty (discussed below). In addition, the U.S. has directed the company to pay for an independent monitor and staff, which will be selected by the government, to monitor ITT's compliance with this agreement and federal law.¹ Also, the litigation has spun off shareholder suits, which remain pending.

Many Violations Result of ITT's Technology Transfer and Outsourcing Activities

Most people think of exports as the physical transport of goods across borders. ITT ran afoul of the export control laws (the Arms Export Control Act and its International Traffic in Arms Regulations, 22 C.F.R. § 120-130) primarily for transmitting technical data, specifically technical data related to night-vision goggles. ITT exported the technical data without a license or authorization from the U.S. State Department. This case illustrates some of the pitfalls for defense contractors that outsource the manufacturing of items subject to U.S. government licensing controls.

The violations arose from the development and production of night-vision equipment, light-interference filters (which counter the effect of laser weapons on night-vision equipment) and the enhanced night-vision-goggle system. On several occasions, ITT's night-vision business division, known as ITT NV, provided export-controlled technical specifications and drawings for these U.S. military devices to foreign companies; collaborated with the companies' engineers to develop designs for the U.S. military night-vision devices, using export-controlled technical specifications and drawings; and bought the finished assemblies or components for the U.S. military devices from the foreign companies. Each of the actions would have required approval from the State Department, given the controlled technology involved, and ITT failed to obtain the necessary licenses.

For example, an ITT NV employee illegally transferred to a U.K. company classified military technical data designated "secret-no foreign" relating to the light-interference filters. The "no foreign" designation meant that this information was not to be shared with any foreign company or person, including our closest allies. This illegal transfer occurred as part of an effort to find a new and cheaper manufacturer for the filters. ITT NV subsequently placed a purchase order with this U.K. firm for the filters, again without the requisite permission from the State Department.²

Even where ITT did obtain specific export licenses or technical assistance agreements, it violated the restrictions and provisions placed on the licenses. TAAs authorize the transfer of controlled data, and the State Department strictly limits the scope of those transfers. ITT engaged in a collaborative design relationship far exceeding the TAA authorization and directed the foreign producer to manufacture products using the controlled technical data.³

ITT Failed to Control Foreign Contractors' Actions

Not only did ITT violate the law by sending export-controlled technical specifications and drawings without authorization to business partners in Singapore, the U.K. and Japan, it compounded these violations by neglecting to notify its foreign subcontractors that the materials provided were export-controlled and letting them subcontract the work elsewhere. For example:

- ITT NV turned to a Japanese company to manufacture the enhanced night-vision-goggle system switch. The Japanese company, apparently with ITT's knowledge, in turn used a sister company in China during the manufacturing, assembly and testing process in an effort to reduce production costs. China is a prohibited destination pursuant to the International Traffic in Arms Regulations. ITT NV made no effort to prevent the Japanese company from exporting the switch designs to China. The Chinese company ultimately made hundreds of switches, which it shipped to the Japanese company and then to ITT NV;⁴
- ITT's business partner in Singapore exported a controlled drawing to an optics company in China and also issued a purchase order for the production of thousands of light-interference filter substrates in China;⁵ and
- Among the Singapore company's optical designers working collaboratively with ITT NV on the night-vision-goggle system design and development were two optical designers who were citizens of China.⁶ State Department regulations prohibit transfers of controlled technical data to Chinese citizens wherever they are located.

False and Misleading Statements

Part of ITT's penalty arose from filing false and misleading statements in connection with temporary (consignment) exports. In particular, the second count of ITT's plea related to the company's misrepresentation that it had only recently discovered certain violations when, in fact, it had known about the violations at least two years earlier and the violations extended back more than 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 failed to take significant corrective action to stop the ongoing violations until shortly before it informed the State Department about the violations. ITT made most of

these false and misleading statements in the context of its 2004 voluntary disclosure to the government.⁷ Such disclosures must be accurate and complete.

In 2004 the State Department entered into a consent agreement under which ITT was required to pay an \$8 million penalty and did not have to admit any wrongdoing. The government entered into this agreement based on ITT's representation that it had voluntarily disclosed all information about the alleged violations and its promise to clean up its operations and comply with obligations under the International Traffic in Arms Regulations.⁸

"[The] reality, however, was just the opposite," according to the statement of facts accompanying the ITT plea agreement. "As the government's subsequent investigation would establish, counsel for ITT ... 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."⁹

Factors Affecting Choice of Penalty

The government's decision to pursue a criminal sanction instead of a civil sanction demonstrates the tough enforcement climate for International Traffic in Arms Regulations violations that have significant national security implications. The record-breaking penalties were a result of repeated willful violations occurring over a long period of time. Specifically, the statement of facts says ITT's managers willfully and repeatedly violated the Arms Export Control Act over 25 years. The statement also indicates that, at least initially, ITT did not cooperate with the government's investigation.¹⁰

For example, the company ignored specific requests from the State Department to return the classified light-interference filter specification that it had unlawfully exported to the U.K. and continued to issue purchase orders for items produced using these specifications and drawings. In addition, ITT NV never told the government that the U.K. company retained a copy of the classified specification, and the government has been unable to recover it.¹¹

Eventually, ITT changed course and began to cooperate. According to U.S. Attorney John Brownlee, the company's subsequent decision to cooperate with the government "may have saved ITT from permanent ruin."¹² When the Justice Department informed the company in fall 2005 that it was prepared to seek an indictment, ITT's new CEO replaced outside counsel, instructed the company to fully cooperate with the investigation, ordered a complete internal investigation and directed that findings be shared with government investigators.¹³

Deferred Penalty

One of the unique aspects of this case is the \$50 million deferred penalty. The penalty will be forgiven if ITT 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 government will retain the right to share any newly developed technology with other manufacturers.

The \$50 million is far in excess of the \$1 million fine that can be imposed under the Arms Export Control Act. Brownlee has justified this amount as "restitution to the victims of their crimes — the American soldier."¹⁴ Some have argued that this structure will give ITT an advantage when it comes time to compete for a contract to design and produce these items for the Army. What they fail to acknowledge, however, is that the U.S. government will have the right to share any technology that ITT has developed with ITT's competitors. Thus, ITT's rivals may receive the benefit of its new technology for free.

Partial Debarment

As a result of the guilty plea, ITT NV is barred from participating in the export of defense articles for three years. The debarment is subject to certain limitations:

- It is limited to the business unit responsible for the violations, ITT NV;
- The State Department will consider reinstatement requests one year after the date of debarment; and
- The government may grant "transaction exceptions" to the debarment on a case-by-case basis.¹⁵

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."¹⁶

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."¹⁷ Given these exceptions, it is not clear how significant the impact of the debarment will be on ITT's operations.

ITT's recent 10-Q report with the Securities and Exchange Commission is particularly revealing in this regard. The 10-Q says: "[I]t is expected that the net effect of the debarment will restrict less than 5 percent of total night-vision sales for a period of not less than one year. The company can seek restatement of export privileges after one year. The company anticipates negotiating administrative agreements with Departments of State and Defense during the second quarter of 2007. Management believes that this matter will not have a material adverse effect on the company's consolidated financial position, results of operations or cash flows."¹⁸

While the impact of ITT's debarment is relatively mild, this is due to the importance of night-vision devices to the U.S. military. Another exporter that runs afoul of the Arms Export Control Act and International Traffic in Arms Regulations whose technology is not as important to the U.S. military will not likely fare as well.

Settlement Is Generating Additional Lawsuits

ITT's recent 10-Q says the board of directors received a letter April 17 on behalf of a shareholder requesting that the board take appropriate action against the employees responsible for the actions described in the settlement agreement. ITT's 10-Q indicates that the request "is being evaluated."¹⁹

In addition, a shareholder derivative action was filed against the company April 10, alleging that the directors breached their fiduciary duties in connection with ITT's compliance programs at its night-vision business.²⁰ The complaint seeks compensatory and punitive damages for the company from its directors, the removal of the directors and the election of new directors. ITT's 10-Q states that the company intends to file a motion to dismiss the complaint at the appropriate time and that management believes that the suit will not have a material adverse effect on the company's consolidated financial position, results of operations or cash flows.²¹

Lessons to Be Learned From the ITT Case

U.S. Attorney 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 inadequately 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."²²

Conclusion

ITT's \$100 million penalty, combined with its three-year debarment, indicate how serious the government is about enforcing obligations under the Arms Export Control Act and the International Traffic in Arms Regulations and should cause companies to strengthen their compliance systems and ensure that outsourcing arrangements are carefully controlled and comply with U.S. trade laws.

Notes

¹ *United States v. ITT Corp.*, No. 7:07-CR-00022, *guilty plea entered* (W.D. Va. Mar. 28, 2007).

² See Statement of Facts, Appendix A to ITT's Plea Agreement, at 15-23.

³ *Id.* at 11.

⁴ *Id.* at 35.

⁵ *Id.* at 21.

⁶ *Id.* at 28-29.

⁷ *Id.* at 3-10.

⁸ *Id.* at 6.

⁹ *Id.*

¹⁰ *Id.* at 6-10. See also 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 (Mar. 27, 2007), at 6.

¹¹ Statement of Facts at 26.

¹² Brownlee Statement at 7.

¹³ *Id.*

¹⁴ *Id.* at 3.

¹⁵ 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 (Apr. 11, 2007).

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ ITT Corp., Quarterly Report (Form 10-Q) at 20 (May 4, 2007).

¹⁹ *Id.*

²⁰ See *Piven v. Loranger*, No. 7:07-CV-02878 (S.D.N.Y. Apr. 10, 2007).

²¹ *Id.* at 20-21.

²² Brownlee Statement at 5.

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