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Analysis

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Lessons Learned From The Northrop Grumman Case: The U.S. State Department's Posture Toward Disclosures And Cooperation

In March, the U.S. State Department's Directorate of Defense Trade Controls (DDTC) and Northrop Grumman Corp. (NGC) entered into a consent agreement to settle 110 violations of the Arms Export Control Act (AECA) and the International Traffic in Arms Regulations. In the consent agreement, NGC agreed to pay \$15 million in fines and remedial compliance measures, and to appoint an internal special compliance official (ISCO). The company's violations of the AECA and ITAR included exports to Russia of unique portions of the source code used on Air Force One (the plane used by the U.S. president), exports of inertial navigation systems (INS) to proscribed countries, provision of defense services, and other unauthorized exports and reexports. All 110 violations involved two INS products made by Litton Industries Inc., and most occurred before NGC's April 2001 acquisition of Litton.

Because a majority of these violations occurred before the acquisition, this case highlights once again the perils of successor liability and the need for export compliance review in the due diligence process of corporate transactions. Although DDTC considers whether such violations occurred under previous ownership, a comparison of the NGC case with preceding DDTC settlements shows above all that the U.S. Government places great importance on voluntary disclosure and investigatory cooperation as mitigating factors to reduce penalties. This article examines the nature of NGC's violations and DDTC's response, differences from earlier DDTC settlements, the continuing need for due diligence and lessons learned.

Northrop Grumman Violations and Penalties—*Violations:* NGC was charged with unauthorized exports of Litton's LTN-72 and LTN-92 INS devices. The LTN-92 INS is an aircraft navigation system that provides information on velocity, altitude, geographic position and orientation. The internal motion sensors and processors of the LTN-92 INS, including three-ring laser gyros, enable the device to maintain the accuracy of speed and location for up to 12.5 hours without radio or GPS updating. LTN-92 Laser Gyro INS brochure, available at www.es.northropgrumman.com/solutions/ltn92/assets/LTN-92_Ring_Laser_Gyro_

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Inertia.pdf. The LTN-72 INS is a similar navigation system that uses mechanical rather than laser gyroscopes. Although unmodified versions of these devices are subject to the Commerce Department's Export Administration Regulations, navigation systems that are modified for military use fall under the ITAR's U.S. Munitions List (USML) and are regulated for export by DDTTC.

The most widely reported NGC violation concerned a specially modified LTN-92 INS used on Air Force One. In late 1998, Litton exported portions of the unique source code for this modified navigation system to a company in Russia. NGC Charging Letter 3. This, DDTTC charged, provided Russia with information on some of Air Force One's vulnerabilities and furthered Russia's ability to develop software that is unique to Air Force One. *Id.* at 3–4.

In addition to exporting this source code, between 1994 and 2003 Litton, and later NGC, modified LTN-72 and LTN-92 INS units for military use, and exported 232 such devices without a State Department license to Austria, Brazil, Brunei, Greece, Israel, Malaysia, Singapore, South Korea, Thailand, the UK and Yemen. *Id.* at 4. They also exported 73 such modified navigation systems to Angola, China, Indonesia and Ukraine, all of which were proscribed countries at the time of export. Litton and NGC did not notify DDTTC of the sales to those proscribed countries, a separate violation under ITAR § 126.1(e). *Id.* Neither did the companies obtain nontransfer and use certificates for the exported systems. *Id.* at 5.

Furthermore, Litton exported copies of the militarily modified LTN-72 and LTN-92 software to its London service center, and it exported software to its Canadian sister company for configuration of the modified LTN-92. Litton Canada then sold five modified navigation units to Romania, South Korea, Indonesia and the UK, again violating the ITAR. *Id.* at 4–5.

Penalties: For the unauthorized exports of the modified LTN-72 and LTN-92 INS devices, software and source code, most of which occurred before it acquired Litton, NGC agreed to pay \$15 million in fines and penalties and take remedial measures. NGC Consent Agreement 3. The consent agreement specified that NGC would pay \$10 million of the \$15 million over three years. A \$5 million penalty would be assessed, but suspended subject to the company's application of those funds to partially offset the cost of remedial compliance measures. *Id.* (One million of the \$5 million was credited against this suspended penalty for remedial measures already implemented since 2004.) *Id.* at 4.

In addition to the monetary penalty, NGC agreed to institute strengthened export compliance procedures. NGC Consent Agreement, Annex of Compliance Measures. As part of this process, the company must appoint an ISCO. NGC Consent Agreement 3. This ISCO has primary responsibility for (1) reviewing and preparing certified reports on the company's spending on compliance improvements to offset the suspended penalty; (2) reviewing the company structure, and reporting relationships and career paths for all employees with ITAR compliance responsibilities; (3) auditing ITAR compliance resources throughout the company; (4) monitoring the company's future ITAR compliance program and policy; and (5) providing DDTTC with semiannual status updates on the ITAR compliance program and NGC's reporting requirements. NGC Consent Agreement, Annex of Compliance Measures 2–6.

Comparison with Past Agreements—DDTTC specifically noted in the NGC proposed charging letter that the “United States Government has never authorized the export of this critical (Air Force One) source code, even to our closest allies.” NGC Charging Letter 3. Given the sensitivity of the code and its export to Russia, it might seem surprising that NGC was assessed only \$15 million in fines and penalties. After all, at the time of the NGC consent agreement, the ink had barely dried on DDTTC's settlement agreement with ITT Corp., in which ITT agreed to pay over \$100 million in criminal and civil penalties and fines, in addition to partial debarment, for the unauthorized export of technical data for night vision goggles (NVGs).

Of course, the assessment of criminal penalties in the ITT case, but not in the NGC case is a major difference. But even without the criminal penalties and the suspended \$50 million “remedial” fines assessed against ITT, the company still agreed to pay nearly twice as much as NGC in civil fines and penalties.

One explanation for the lower NGC penalties is that State was backing off from its earlier aggressiveness, which some considered excessive. However, a closer look at the facts of the ITT case shows that State may have taken different approaches in the two cases because of the nature of the voluntary disclosure and level of investigatory cooperation in each.

ITT Settlement Agreement—Like NGC, ITT was charged with exporting ITAR-controlled information that was essential to U.S. national security, making unauthorized exports to proscribed countries, failing to notify the State Department of those exports and failing to obtain nontransfer assurance. ITT Charging Letter 17–19. As

a consequence, in 2007 the U.S. imposed a penalty of over \$100 million on ITT for, among other things, the export of technical data relating to countermeasures used in NVGs. This included over \$2 million in criminal penalties, a forfeiture of \$28 million in illegal proceeds, and \$28 million in fines and penalties. The remaining penalty of \$50 million was suspended subject to ITT's spending that amount to "accelerate and further the development and fielding of the most advanced night vision technology." Statement of U.S. Attorney John Brownlee (March 27, 2007), at 3–4.

ITT's Night Vision Division (ITT-NV) manufactured night vision equipment for the U.S. military for over 30 years, playing a crucial role in the military's ability to carry out its operations overseas, particularly in nighttime environments. ITT Charging Letter 2; Tom Bowman, "Heat and light are silent allies for U.S. forces; Night-vision goggles, thermal imagery help to hunt down Taliban; Army motto: 'We own the night,'" *Balt. Sun*, Nov. 12, 2001, at 4A. One ITT-NV item that helped the military to "own the night" is the light interference filter (LIF)—a countermeasure installed in NVGs.

The State Department charged ITT-NV with unauthorized exports of the ITAR-controlled technical data used to manufacture the LIFs, including unclassified technical data for the LIF blanks, and "secret," "no foreign" classified technical data for the LIF coatings. In 2001, ITT-NV exported the unclassified technical data for the LIF blanks to Avimo Electro-Optics in Singapore, knowing that Avimo Electro-Optics obtained subcomponents from suppliers in China, a proscribed country. ITT Charging Letter 6. At the same time, ITT-NV exported the "secret," "no foreign" classified technical data for the LIF coatings to Avimo Electro-Optics' sister company in the UK, which was not cleared to receive, store or handle classified data. ITT Charging Letter 7. From the Government viewpoint, ITT evinced an aggressive approach to evading ITAR requirements—NGC did not—and even ITT's voluntary disclosure to DDTC was characterized by some defiance rather than full cooperation. Further distinguishing the two cases, NGC was a successor in interest cleaning up Litton's problems, whereas ITT was addressing its own problems.

A Question of Intent—Contrasting Northrop Grumman and ITT: In addition to the violations described, ITT was charged with conspiring to export sensitive technical data abroad, and with misrepresenting and omitting facts in both its voluntary notification to DDTC of its violations and on its permanent export license applications. *Id.* The State Department's charging letter noted repeatedly

that in willfully violating the ITAR, ITT was focused on economic return. *Id.* "There was a culture at this company where they viewed export laws as an obstacle to making money and they actively and willfully worked to circumvent the U.S. laws to increase profits." Alec Klein, "ITT to Pay \$100 Million Export Fine," *Wash. Post*, March 28, 2007, at D01. State also was upset about false and misleading statements ITT made in its original voluntary disclosure. *Id.* at 3–4. ITT's apparent strategy of non-cooperation with the Government's investigation also likely influenced the terms under which DDTC negotiated a settlement. ("ITT and its outside corporate attorneys fought the government's investigation and attempted to essentially run out the clock on the statute of limitations," and "ITT undertook a number of actions that made it difficult for the government to uncover the full truth" Statement of U.S. Attorney John Brownlee (March 27, 2007), at 6–7.)

Likely, NGC's and ITT's different approaches to voluntary disclosure, their levels of cooperation with the Government and the differences between their "cultures" account for much of the disparity in fines and penalties. Although NGC/Litton did not properly classify their modified navigation systems as USML items, ITT exported technical data while specifically *knowing* that such data was classified and subject to the USML. NGC Charging Letter 3; ITT Charging Letter 6.

Indeed, DDTC noted NGC's cooperative voluntary disclosure as a significant mitigating factor and was aware that most exports occurred before NGC acquired Litton. DDTC also stated that if it had not considered the voluntary disclosure, it "could have charged the Respondent with additional violations, and could have pursued much more significant penalties." In contrast, ITT's voluntary disclosure included false or misleading statements, and it fought the Government during much of the investigation. Only its eventual cooperation "may have saved ITT from permanent ruin." Statement of U.S. Attorney John Brownlee (March 27, 2007), at 7.

The Lessons of Raytheon and Boeing—The Government's focus on intent and corporate compliance culture is consistent with other cases in which large fines and penalties were assessed for ITAR violations. In particular, the \$25 million civil penalty assessed against Raytheon Co., and the \$32 million civil penalty assessed against Boeing Satellite Systems and Hughes Electronics Corp. (HEC) for HEC's violations before Boeing acquired HEC in 2000, further evidence that State will assess larger penalties and fines if it believes violations may have occurred to reap financial gain.

Raytheon: DDTC charged that Raytheon violated the AECA and ITAR with the unauthorized export of troposcatter communications equipment to Pakistan from 1990 to 1997. Charging Letter 1. According to the settlement agreement, Raytheon was engaged in discussions with the Pakistani army to sell military troposcatter communications equipment pursuant to a foreign military sale arrangement when the discussions were disrupted because the U.S. invoked the Pressler Amendment in response to Pakistan's nuclear activities. This resulted in a prohibition against U.S. military sales to Pakistan and a restriction on the issuance of licenses for such exports by private companies. Settlement Agreement 3. Because of the amendment, State rejected Raytheon's request for a technical data license to Pakistan. Settlement Agreement 4. Raytheon then allegedly attempted to "commercialize" the troposcatter system so that it would not fall under State licensing jurisdiction. *Id.* Moreover, Raytheon made alternative arrangements to assemble and sell its troposcatter equipment to Pakistan through its Canadian subsidiary and, in some instances, misstated on the shipping documents that Canada, rather than Pakistan, was the ultimate destination. Settlement Agreement 5, 7.

Considering the recitations in the settlement agreement, it appears that Raytheon attempted to circumvent U.S. export control laws, and that this affected the size of the penalty assessed. After the company was advised that it could not sell the troposcatter systems to Pakistan, it sold a similar product through its Canadian subsidiary without first obtaining guidance from State, even though Raytheon was previously denied an export license for related technical data. Raytheon may not have intentionally violated U.S. export control laws, but it certainly chose to interpret those laws aggressively to reach business objectives.

Boeing: Similarly, the drive for pecuniary gains likely contributed to the \$32 million penalty assessed against Boeing/HEC for the unauthorized export to China of sensitive satellite and rocket technology such as guidance systems, aerodynamics, rocket failures and telemetry technology. Charging Letter 8 and Generally.

Hughes Space and Communications (HSC), a division of HEC, had a license to export satellites to China. Charging Letter 5. However, the export of "technical data or assistance related to the design, development, operation, maintenance, modification or repair of the Chinese launch vehicle" was specifically not authorized under the license. Charging Letter 10. Despite these prohibitions, HSC allegedly provided China's space

program with technical information to help it determine why its launch vehicles failed, and with expert guidance on corrective actions needed to ensure successful launches in the future. Charging Letter 7, 8, 13, 19, 20 and 21.

According to the charging letter, HSC was aware that it might be violating U.S. export control laws by providing unauthorized technical data or assistance to China, but the theme that emerged from the State Department documents is that the company appeared more concerned about its monetary interests than its export compliance responsibilities. Charging Letter 9. The settlement agreement ultimately imposed a \$32 million penalty. As in the ITT case, it is possible that DDTC sought a large penalty because of HSC's allegedly willful violation of U.S. export control laws to further its pecuniary interests.

Lessons Relearned: the Importance of Due Diligence and Cooperation—Although NGC was not fined as heavily as ITT, Raytheon and Boeing/HEC, \$15 million is a large penalty. Like Boeing/HEC, the NGC case demonstrated the real potential of successor liability for export violations and the need for due diligence in such circumstances.

Before an acquisition, extensive due diligence investigation into the target company, including a review of that company's export compliance procedures, is essential. As part of that due diligence, the acquiring company should carefully inspect (a) international transactions and international business strategies; (b) export compliance training manuals and internal compliance organizational structure; (c) trade compliance programs, including written procedures to ensure compliance with product and country export restrictions, to screen orders for diversion risk and "red flag" indicators and to prevent unauthorized transfer of controlled data to foreign nationals; (d) status of compliance audit programs; (e) export compliance training programs; (f) incentives and disincentives for employee compliance and non-compliance; (g) technologies subject to license, including technical data; (h) the company's export control classifications of its products and technologies, and the processes used to arrive at those classifications; (i) export and import licenses, authorizations, registrations and exemptions used; (j) immigration status of employees with access to controlled technology and data; and (k) the company's affiliates and customers.

Just as important, the company must be forthcoming with the State Department and adopt a strategy of cooperation if violations are uncovered in the due diligence

process. To get “credit” with DDTC, such violations should be disclosed as soon as the company understands the facts indicating that a violation has occurred. Disclosure must be complete, not selective, and all material facts need to be included. Finally, after a disclosure is made, it is imperative that the company cooperate with DDTC’s review and investigation.



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Developments

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Bipartisan Wartime-Fraud Enforcement Legislation Included In Supplemental Funding Bill

Sens. Patrick Leahy (D-Vt.) and Charles Grassley (R-Iowa) introduced legislation April 19 to improve the prosecution of fraud associated with wartime procurements in Iraq and Afghanistan. By May 16, this bill had been approved by the Senate Appropriations Committee and included in the Senate’s version of the emergency supplemental funding bill for Iraq, Afghanistan and selected domestic programs.

The Wartime Enforcement of Fraud Act, S. 2892, would amend the Wartime Suspension of Limitations Act of 1942, which allows the Government to investigate and prosecute contracting fraud for up to three years after a war ends, but only applies when the U.S. is in a “declared” war. The new bill expands applicability to include situations for which Congress has specifically authorized military force—a provision that would be necessary to prosecute contractors involved in Iraq and Afghanistan, as military operations there were undertaken without congressional declarations of war. The bill would not apply to international peacekeeping missions under the auspices of the U.N., or to military actions not specifically authorized by Congress.

The bill also extends the statute of limitations to five years after the end of a conflict and mandates that the statute of limitations starts to run only when an official act of the president, or a concurrent resolution of Congress, ends hostilities. “Secret proclamation by the President or a self-serving ‘mission accomplished’ speech will not do the trick,” Leahy said when presenting the bill on the Senate floor.

The rationale for amending the Wartime Suspension of Limitations Act looks to previous wartime precedent. “In time of war, we often do not learn about serious fraud until years after the fact,” Leahy said. “What we do know is that tens of billions of dollars are unaccounted for, and potentially lost to fraud. The problem is not new, and Congress has the opportunity now to address it, starting with the wars in Iraq and Afghanistan.” Leahy referenced previous presidents, such as Franklin Roosevelt and Harry Truman, who both investigated and prosecuted instances of wartime contractor fraud during World War II.

According to Leahy, in the last six years the Government has awarded contracts worth billions of dollars to companies that have delivered defective products, including bulletproof vests and ammunition. Leahy criticized the use of “no-bid” and “cost-plus” contracts with little or no oversight or accountability, and the method of distributing money to the regions in question. “Billions in cash—physical, paper money—have been flown to Iraq and handed out in paper bags, often without records of who received what, and when,” he said.

Leahy said that his background of chairing hearings for the Senate Appropriations and Judiciary Committees convinced him of the need for legislation to address wartime contracting fraud. “The testimony at those hearings has exposed the Bush administration’s failure to take aggressive action to enforce and punish wartime fraud,” he said. “It has also shown how difficult it can be for investigators to uncover and prosecute fraud amidst the chaotic environment of war.”

President Bush has threatened to veto any version of the supplemental funding bill which contains provisions for non-war spending. In addition to the fraud bill, the supplemental funding bill includes other extraneous measures, including some requiring domestic spending, such as providing \$5.8 billion to strengthen levees in New Orleans, a measure that the Bush administration itself requested. The supplemental funding bill, H.R. 2642, which incorporates the provisions of S. 2892, passed the Senate on May 22.

¶ 38

Fraud And Corruption Rampant In Iraq, Former Contractor Employees And State Officials Say

The Senate Democratic Policy Committee held hearings April 28 and May 12 on contractor abuse and governmental corruption in Iraq. These were the committee's 13th and 14th hearings in a series on contracting in Iraq. The committee heard testimony about individual experiences in Iraq from three former contractor employees and from former officials from the State Department's now-defunct Office of Accountability and Transparency (OAT).

Chair Byron Dorgan (D-N.D.) opened the April hearing by calling for a special select committee with subpoena power, similar to the 1940s Truman committee, which investigated contract fraud and abuse. Sens. Amy Klobuchar (D-Minn.) and Sheldon Whitehouse (D-R.I.) reemphasized the wartime contracting commission, which was authorized by the National Defense Authorization Act for Fiscal Year 2008, has been stalled as the result of a presidential signing statement. See 49 GC ¶ 476; 50 GC ¶ 40. Whitehouse said the signing statement exemplified the administration's avoidance of accountability for "this carnival of waste and fraud."

The three former contractor employees alleged rampant waste, fraud and abuse by contractors. "The troops suffered and were put at greater risk because of the shoddy work by KBR employees," a former KBR employee said. "There appeared to be widespread corruption with no system of checks and balances," another former KBR employee added. Speaking of a KBR morale, welfare and recreation program for military personnel, she said "we were instructed by our supervisors to do a deliberately misleading count of the number of people who use the facilities." KBR allegedly counted each person who entered, but recounted persons entering specific rooms such as a cinema or game room, and again recounted all persons present each hour. "I refused to falsify those numbers, and when I entered the correct totals, the next morning those figures would be changed." Both witnesses testified that KBR supervisors retaliated against them after they exposed wasteful or fraudulent practices. The second witness explained why she felt that few whistleblowers spoke out: "they didn't threaten to take away your uplift [pay increase] for working in a war zone; they threatened to put you out on the streets of Baghdad."

The third witness described the common practice of overcharging: "no matter how ludicrous the billing was,

no one questioned the cost." While managing installation of equipment in camps for World Wide Network Services on a DynCorp subcontract, he said one of his technicians reported that "the only marker they could find signaling a camp was a stick in the ground." When he reported the absence of actual camps to management, he was told he was "not looking hard enough." After this incident, he said, "I knew that ... I should not push further on why the camps didn't exist." The witness also told the committee of retaliatory measures while he was working for CAPE Environmental Management, stating that he was beaten and received death threats. Contractors generally had an unspoken mutual policy of silence, he testified. "We were notified not to speak to any journalist or media. We were coached ... when the Justice Department officials came, as to what we would speak to them about." All three witnesses testified to having seen minimal or no oversight by military officials.

"The purpose of this [series of hearings] is not to chronicle failure; it's to try to figure out what on Earth is happening, what's wrong, and how do we make it right?" Dorgan said. Sens. John Kerry (D-Mass.) and Barack Obama (D-Ill.) submitted statements for the record calling for passage of S. 2775, the Fair Share Act of 2008, to close a tax loophole "exploited by [KBR] ... to set up shell companies in the Cayman Islands in order to avoid paying [Social Security and Medicare] payroll taxes." See 50 GC ¶ 156(b).

The May hearing focused on the effectiveness of anti-corruption measures and mechanisms in Iraq. "When we appropriate additional money, to what purpose? Where will the money end up?" Dorgan asked in his opening statement. The committee heard testimony from Judge Arthur Brennan, who served briefly as OAT director in Baghdad before resigning for personal reasons. During its operation, OAT was "little more than window dressing," he said, adding that State glosses over corruption in Iraq to avoid "embarrass[ing] not only the U.S. Government, but the current Iraqi government as well." "State has negligently, recklessly and sometimes intentionally misled the U.S. Congress, the American people and the people of Iraq," he told the committee. Brennan also lamented State's treatment of Judge Radhi Hamza al-Radhi, former commissioner of the Iraqi Commission on Public Integrity (CPI), who estimated that corruption at Iraqi ministries amounts to \$18 billion. See 50 GC ¶ 95. State has stymied al-Radhi's application for asylum in the U.S., Brennan said, "and what clearer message could the State Department be sending to any honest Iraqi official about the lack

of credibility, the disloyalty and the unreliability of the U.S. Government?”

During his 11-month tenure, “OAT was understaffed for its mission and had no operating budget—that’s zero,” James Mattil, former chief of staff for OAT at the U.S. embassy in Baghdad, said. U.S. leaders’ silence tacitly approves of corruption in the Iraqi government, Mattil added. CPI, the main Iraqi oversight body, was also poorly equipped and empowered. “Neither CPI nor U.S. Government agencies have legitimate access to track money,” he said.

Dorgan closed the hearing by announcing that he would introduce an amendment to close the Cayman Islands payroll tax loophole, and called contractors that exploit it dishonorable and unpatriotic. “If contractors aren’t willing to pay their U.S. taxes they shouldn’t be allowed to continue working on U.S. government contracts, it’s that simple,” Dorgan said in a May 15 press release announcing the Senate Appropriations Committee’s approval of the amendment.

¶ 39

European Commission Takes Action Against Germany, Italy

The European Commission recently took action against Germany and Italy for alleged infringements of European Union procurement law.

Germany—Pursuant to Article 226 of the EC Treaty, the Commission served Germany with a reasoned opinion related to the award of discount contracts by 240 German statutory sickness insurance funds that use different procedures for awarding contracts, ranging from direct awards to competitive procedures without the use of a EU-wide tender. The Commission noted that most of these procedures did not comply with the standards required by the EU, public procurement directives, disadvantaged small and medium pharmaceutical suppliers and put them at risk of being permanently forced out of the market.

Italy—The Commission sent a reasoned opinion to Italy and requested that it comply with a European Court of Justice judgment in another case.

The first case concerns the direct award of waste management and pharmacies management services by a municipality to a publicly owned company of which the municipality owns .038 percent of the capital. Italy

argued that the award of these contracts is exempt from EU public procurement rules because the company is an “in-house” structure. The Commission concluded that the first condition required for the application of the “in-house” exception is not met in this case because the municipality’s holding in the company is so small and the company is open in part to private capital.

In the next case, pursuant to Article 228 of the EC Treaty, the Commission sent a letter of formal notice to Italy, requesting that it comply immediately with a 2007 ECJ judgment, concerning the award of concessions for horse-racing betting services, without tender procedure. The ECJ found that Italy had infringed the general principle of transparency and the obligation to ensure a sufficient degree of advertising. Although new legislation has been passed to open up sports-betting services, concessions have not been reattributed through a competitive procedure. The Commission warned that if Italian authorities did not comply, it would send a reasoned opinion, and ultimately ask the ECJ to impose a daily fine.

Italy and Germany—The Commission sent reasoned opinions to Italy and Germany relating to the procurement of wastewater and water management services and waste disposal services. Both nations claimed that contracts awarded were subject to an “in-house” exception and, therefore, not subject to the application of EU public procurement rules.

In Italy’s case, a public entity was directly awarding services contracts to a public owned company limited by shares. A municipality owns minority shares of the company. The Commission noted that the powers entrusted to a municipality as a minority owner of a public company do not confer on them a power of control similar to one exercised over their own departments. In its capacity as a shareholder, the municipality did not exercise the amount of control over the company that would be required to invoke “in-house” protection.

In the German case, two municipalities and an administrative district were cooperating in waste disposal removals in an arrangement that had lasted since 1986 and had not resulted in competitive procedures. Instead, each cooperating partner was responsible for a certain type of waste. All contracts were awarded directly. The Commission found that the public authorities were acting as contracting authorities and could not rely on the “in-house” exception because the cooperation structure implied that the municipal companies involved carried out a significant part of their activities for authorities which were not their shareholders.

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CSIS Event Highlights Challenges Facing Export Controls

The changing nature of defense manufacturing and trade requires new approaches to regulating the flow of ideas and technology, John Negroponte, deputy secretary of state, said during a recent Center for Strategic and International Studies (CSIS) symposium on globalization and the U.S. export control system. "The export control system as a whole is under increasing strain due to the nature of the changing environment," added Pierre Chao, senior CSIS associate. The fundamental issue is how to keep the export control system evolving to relieve or reduce the frictions between national security and economic concerns that are "unintentionally impacting [the] broader national security goal" of maintaining the U.S.' technological edge.

The U.S. currently relies on four approaches to control critical exports and technology, Deputy Secretary of Defense Gordon England said, outlining and pointing out the strengths and shortcomings of each approach. These approaches include the Arms Export Control Act of 1976, managed by the State Department, the Export Administration Act of 1979 dealing with dual-use technology, overseen by the Commerce Department, and the Defense Department's procedures on the ability to release classified defense technology and dual-use technology that together act as a dam. "We have built a dam" to prevent classified goods and services from going outside the country without "a strict review and approval process," England said. According to England, the fourth approach, augmenting the others, is the interagency Committee on Foreign Investment in the United States. "This attacks a problem in a different way," England said, by controlling the acquisition of technology critical to national security by "requiring affirmative decisions regarding foreign investment in or purchase of U.S. companies" that produce critical hardware and software.

England also said that statutory export controls date from "the Cold War era," and questioned whether the underlying policies still apply in today's global environment within the context of three national objectives of protecting U.S. security, while "simultaneously encouraging investment in the United States" and not impeding U.S. industry's "ability to compete in the global economy." England said that the interrelation of the four processes can appear confusing from the outside, and questioned the effectiveness of the current export controls in a global

economy that was not envisioned when the regulations were implemented.

England said that in today's global world, "there are hundreds, perhaps thousands, of rivers of technology that flow across this globe," dealing with every kind of technology, and each flow is characterized by a different business arrangement, including outright ownership of technology by companies, people investing in companies, joint ventures, and strictly financial partnerships. "Much of it is outside the visibility and some of it ... outside the control of the U.S. Government today," England noted. He cited as an example the challenges of regulating a foreign-based research and development facility owned by an American company, and whether the Government should regulate the products of such a facility. Adding another layer to challenges facing regulators, England noted, is the fact that consumer and commercial products like Google Earth and global positioning systems can be as important as military technologies. "A lot of the controls we exercise in Washington, frankly, to me, [are] tantamount to damming up the Potomac while all the other rivers flow freely."

"Companies today are building ITAR-free weapons and satellites as a way to circumvent these very complex policies," England noted, pointing out the need to decide if policies controlling the global technology flow are beneficial or restrictive and hurtful, which is "an extraordinarily difficult process" in light of all the technological development and business arrangements across the globe. Security systems like export controls are "really just delay tactics" that can protect vital technologies only for a time, according to England, but the only way to protect security over a longer period is to continually invest in R&D to stay ahead of other nations. According to England, this requires the U.S. to view policy concerns about the U.S. industrial base as national security issues. He cited the limits on the number of critical H1B visas for valuable scientists and engineers, many of whom were educated in American universities but are unable to contribute here. "We are exporting the source of a lot of the needed goods and services," England added, "while we restrict the goods and services."

Sounding a similar note, Negroponte said that large scale weapons development is no longer a one-country effort and can involve hundreds of companies across many borders. While the U.S. would ignore persistent state-sponsored industrial espionage at its own peril, Negroponte said the greatest new threats are transnational, including "terrorist groups and drug traffickers, criminal gangs and weapons proliferators," as well as weak, fail-

ing states. "It is no longer a question of controlling the countries to which we export, but also specific individuals, entities and groups within the countries to which we export," Negroponte said.

Commerce Under Secretary Mario Mancuso added that the "very alchemy" of the U.S. military's technological superiority has changed from having two-thirds of its technology developed by defense research and development and the rest derived from adapting commercial technology to having the opposite proportions today. Mancuso pointed out that a third of the world's R&D staff is now located in India and China and that under current trends, more than 90 percent of all scientists and engineers would be in Asia by 2010. "In this strategic environment," Mancuso said, "we can no longer rely exclusively on export controls to maintain our strategic technology leadership."

Noting that there have been more studies on export controls than any subject except acquisition reform, England said that while current policies are no longer applicable, "there is probably not a silver bullet answer." Some answers are better than others, England said, but no matter what the U.S. does, there will be a downside to it.

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House Oversight Committee Inquires Into DOD DBA Insurance

The House Oversight and Government Reform Committee heard testimony May 15 on the requirement under the Defense Base Act of 1941 (DBA) that overseas contractors obtain workers' compensation insurance, a once-obscure provision that has dramatically increased in significance since 2003. The committee expressed frustration with apparent waste and mismanagement, and questioned panelists from the departments of Defense, Labor and State, the Army Corps of Engineers, the Army Audit Agency (AAA), and the Government Accountability Office. In particular, the committee took DOD to task for delay in collecting data and reforming its DBA insurance programs after a 2005 GAO report. See 47 GC ¶ 220.

The hearing focused on DBA programs at State, the Corps of Engineers and the U.S. Agency for International Development, which contrasted with DOD's program. The former three conducted competitions to select a single insurer, but DOD opted to require its contractors to negotiate their own insurance contracts, a practice which "has been exceptionally lucrative for the private insurers

and the contractors," Chair Henry Waxman (D-Calif.) said. He highlighted the Army's Logistics Civil Augmentation Program (LOGCAP) as an example of DOD's mismanagement of DBA insurance in Afghanistan and Iraq. KBR paid \$284 million to an insurance company, AIG, for workers' compensation insurance, added an \$8 million markup and billed taxpayers \$292 million under the cost-plus contract, although only \$73 million in actual benefits was paid to injured contractor employees, Waxman said. "Congress passed [§ 1041 of the National Defense Authorization Act for Fiscal Year 2006] in 2006 requiring the Defense Department to rethink its approach, [but] the Department reported that it would be too expensive to collect the necessary data and, quote, 'There are no compelling procurement reasons for DOD to initiate any efforts,' end quote," Waxman added. Not only is there evidence that premiums were exaggerated up front, "but, in addition, there was denial of claims ... on the other end, to help maximize the profits," added Rep. John Sarbanes (D-Md.).

The State, USAID and Corps programs were based on a single-insurer model, but "efficiencies and cost controls possible at lesser levels of operations may be overwhelmed by the vastly increased scale of the Pentagon's DBA responsibilities, which dwarf those of State and the Corps, both in size and in diversity of requirements," Ranking Member Tom Davis (R-Va.) noted. A shift to single-source DBA insurance, he cautioned, could actually raise rates and costs by driving carriers out of the federal market.

In 2003, contractors operating in Iraq complained to DOD about sharp increases in DBA insurance premiums and the inability to secure insurance at all, Richard Ginman, DOD deputy director of defense procurement, acquisition policy and strategic sourcing, told the committee. Thus, DOD sponsored the Corps' current pilot program. Despite competition on a best-value basis, only one carrier, CNA Insurance, submitted an offer, James Dalton, the Corps' chief of engineering and construction, said. Its offer, \$5 and \$8.50 per \$100 of salary costs for services and construction, respectively, was below the DOD averages in Iraq cited by GAO in 2005, \$10 and \$21 per \$100. After the one-year pilot phase, a second pilot contract was awarded to CNA as sole offeror on a lowest-price, technically acceptable basis, Dalton said, noting that the second phase rates were lower than the first, yielding significant DBA insurance savings.

The pilot program's risk-pooling also allowed some contractors to obtain insurance in areas they previously could not, Ginman said, but the single DBA rates were

higher than earlier rates in certain non-war zones, and the pilot program “hit small business particularly hard.” Committee members expressed frustration that the pilot program was recently extended for six months beyond its scheduled March completion. Dalton explained that the Corps “needed to have time to actually get a new contract in place, because [the second phase] contract simply would expire, and we would be left with no DBA central insurer.” The Corps is working with DOD to review the data, he added.

Although the Corps’ pilot program reduced DBA costs, no similar department-wide efforts are being made, and DOD continues to lack reliable aggregate data on DBA costs, John Needham, GAO’s director of acquisition and sourcing management issues, said. DOD should weigh all options, including a single pool, various regional pools and the Government as self-insurer, but “this kind of trade-off analysis—they haven’t done this yet,” Needham said. The overriding concern is that DOD “needs to manage the suppliers of insurance, and not have the suppliers managing DOD.” Ginman stressed, however, that the Corps pilot program was collecting data to facilitate a “reasonable business case analysis” of DOD-wide or Army-wide approaches, and the pilot program was not yet completed.

DOL’s role comprises oversight and dispute resolution between insurers and employees, but it cannot regulate premiums under the DBA, Shelby Hallmark, DOL’s director of workers’ compensation programs, said. DOL has sponsored educational seminars for involved officials and contractors, and two of the three major insurers have opened claims processing offices in the Middle East and translated forms into Arabic, he added. “Iraq-Afghanistan claimants are somewhat less successful in obtaining benefits than domestic claimants in the Longshore [and Harbor Workers Compensation Act] program,” he admitted, although the discrepancy is likely due to difficulties in finding and communicating with injured workers in a war zone. DBA premiums may be higher for DOD in Afghanistan and Iraq because local nationals do not waive insurance as often as State’s contractors’ employees in countries with existing effective workers’ compensation programs, William Moser, deputy assistant secretary of State’s bureau for administration logistics management, told the committee. Dalton echoed this sentiment: “[the Corps] concentrate[s] heavily in more hostile areas than, perhaps, the State Department.”

Joseph Mizzoni, AAA’s deputy auditor general for acquisition and logistics, described audits of LOGCAP operations. DBA insurance premiums rose “from about

\$5 million in fiscal year 2003 to about \$165 million in fiscal year 2005.” Excessive premiums may stem from a discrepancy between calculation of premiums based on total payroll costs and the payment of DBA benefits only up to the statutory cap, although many contractors pay employees “danger pay” for working in areas such as Iraq, Mizzoni explained. AAA made recommendations to the Army assistant secretary for acquisition, logistics and technology, who disagreed in part, but has proposed actions meeting the recommendations’ intent.

Reps. Darrell Issa (R-Calif.) and Jim Cooper (D-Tenn.) encouraged consideration of the Government as self-insurer, with an administrative services-only contract. Through self-insurance, “we don’t have to pay the premium, the overhead, the stuff like that ... because we, the United States Government, are the best risk-bearing entity,” Cooper said. Needham suggested that self-insurance may have been neglected because DBA premiums have only relatively recently risen to current levels. Committee Democrats expressed disappointment at the waste and the delay in meeting the repeated demands for reform, and announced they would submit a bill requiring a single, DOD-wide DBA pool.

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Councils Propose Closing Loophole Exempting Overseas Contracts From Ethics Program

The Civilian Agency Acquisition Council and the Defense Acquisition Regulations Council issued a second proposed rule on contractor compliance and integrity programs after the Department of Justice, Congress and public interest groups criticized a provision in the rule that exempted overseas contracts from the program. See 73 Fed. Reg. 28407 (May 16, 2008) and Yukins, Feature Comment, “U.S. Contractor Compliance Rules Are Likely To Expand,” 50 GC ¶ 147.

The initial proposed rule was published Nov. 14, 2007, at 72 Fed. Reg. 64019. See 49 GC ¶ 460(d). The proposed rule was a follow-on case to Federal Acquisition Regulation Case 2006-007, published as a final rule at 72 Fed. Reg. 65873 (Nov. 23, 2007). According to the councils, the private sector raised concerns about (a) the proposed exemption for contracts to be performed entirely outside the U.S. and (b) the proposed exemption for commercial-item contracts. The councils do not contemplate publishing a final or interim rule until

public comments on the proposed changes are received and considered.

The councils published FAR Case 2007-006 at the request of the Department of Justice to require contractors to (1) have a code of ethics and business conduct, (2) establish and maintain specific internal controls to detect and prevent improper conduct in connection with the award or performance of Government contracts or subcontracts, and (3) notify contracting officers without delay whenever they become aware of violations of federal criminal law with regard to such contracts or subcontracts.

The councils ask for comments and recommendations on a revision to the proposed rule that would require inclusion of FAR 52.203-13 in contracts and subcontracts that will be performed outside the U.S. See FAR 3.1004 and 52.203-13(d) in the initial proposed rule. This change would make contracts performed outside the U.S. subject to the clause requirements for a contractor code of business ethics and conduct, business ethics awareness and compliance program, and internal control system. The exemption from the requirement to include clause 52.203-13 in contracts and subcontracts to be performed entirely outside the U.S. carried over from the proposed and final rules under FAR Case 2006-007, which addressed contractor codes of business ethics and conduct, and the use of fraud hotline posters. After publication of the proposed rule, DOJ and other respondents expressed concern about the overseas exemption. See 50 GC ¶ 149.

The councils also seek comments on a change that would require inclusion of FAR 52.203-13 in all commercial-item contracts and subcontracts. The councils note that as is the case for small business contracting, a formal business ethics awareness and compliance program and internal control system currently are not required in commercial-item contracts and subcontracts. This change would have the effect of applying to commercial-item contracts the requirements for (a) a written code of business ethics, (b) preventing and detecting criminal conduct, and (c) notifying the Government if the contractor has reasonable grounds to believe that violations of the civil False Claims Act or federal criminal law have occurred in connection with the award or performance of their contract or any subcontract.

The councils state that this is in some ways more fair to contractors providing commercial items because even though the clause was not included in commercial-item contracts, contractors were still subject under the initial proposed rule to debarment or suspension for

knowing failure to notify the Government of violations of federal criminal law in connection with the award or performance of the contract or subcontract. Now the requirement to report violations is explicitly stated in the contract.

The proposed changes also add a new cause for suspension or debarment to the current lists at FAR 9.407-2 and 9.406-2. For suspension, the new cause is adequate evidence of a knowing failure to timely disclose an FCA violation in connection with the award or performance of any Government contract or subcontract. For debarment, the new cause would be a preponderance of the evidence of a knowing failure to timely disclose an FCA violation in connection with the award or performance of any Government contract or subcontract. The councils state that this would be added as a required disclosure in the contract clause.

In addition, DOJ proposes adding a provision to FAR subpt. 9.4 requiring contractors to report FCA violations. DOJ also wants language stating that failure to timely report such violations is an additional cause for debarment or suspension.

Regulations

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BIS Takes Next Steps Toward Improved Deemed Export Rules

The Commerce Department Bureau of Industry and Security (BIS) has requested public comments on advisory committee recommendations for improving U.S. licensing policy for deemed exports—releases of controlled technology or source code to foreign nationals within the U.S. See Export Administration Regulations (EAR) § 734.2(b)(2)(ii). The Deemed Export Advisory Committee (DEAC) recommended a narrower scope of technologies subject to deemed export licensing requirements and a more comprehensive set of criteria to assess country affiliation for foreign nationals. See 73 Fed. Reg. 28795 (May 19, 2008).

Under the EAR, if technology or source code is released to a foreign national, it is deemed to be an export to the foreign national's home country. For purposes of the EAR's deemed export rule, foreign nationals do not include U.S. citizens, U.S. permanent residents, and protected individu-

als under the Immigration and Naturalization Act, 8 USCA § 1324b(a)(3).

To determine a foreign national's home country for purposes of deemed export licensing, BIS uses a foreign national's most recently established legal permanent residency or most recently established citizenship. For example, an Iranian foreign national who establishes legal permanent residency in Canada and subsequently immigrates to the U.S. would be treated as a Canadian for deemed export licensing purposes. Similarly, an Iranian foreign national who establishes citizenship in the UK and later immigrates to the U.S. would be treated as a UK citizen. BIS relies on exporters to self-determine a foreign national's home country according to guidance provided on the BIS Web site at www.bis.doc.gov.

BIS acknowledged that exporters sometimes have difficulty "determining where a foreign national's ties lie." As examples, BIS cited prior or current employment at a prohibited end-user, expiration of the foreign national's permanent residency status while that foreign national continues to receive technology or source code subject to deemed export licensing requirements, and the possibility of a foreign national's inability to comply with a country's permanent residency requirements. In these instances, exporters should submit a license application or seek guidance from BIS before releasing controlled technology or source code subject to the EAR to the foreign national, BIS said.

The issue of home country determinations was highlighted in a March 2004 report by the Commerce Department inspector general. The report concluded that BIS policies could allow foreign nationals from countries and entities of concern to gain access to controlled technology and source code without a license. The IG recommended that the foreign national's country of birth should be used to determine deemed export license requirements rather than the foreign national's most recent citizenship or legal permanent residency.

In response, BIS published an advance notice of proposed rulemaking in March 2005, seeking comments on how the IG's recommendations would affect industry, the academic community and Government agencies involved in research. BIS received over 300 comments from the public, led by academia, which viewed the IG's proposed change to the deemed export rules as having a chilling effect on university research. See 3 IGC ¶ 55; 3 IGC ¶ 100; 4 IGC ¶ 1.

After reviewing comments, BIS withdrew the proposed rule change. See 71 Fed. Reg. 30840 (May 31, 2006). In the withdrawal notice, BIS stated that it would maintain the current policy of using a foreign national's most recent

country of citizenship or legal permanent residency when determining licensing requirements. BIS reasoned that a declarative assertion of affiliation was more significant than the geographical circumstances of birth when determining the home country of the foreign national.

In May 2006, BIS established the DEAC, to provide recommendations on deemed export policy. After six public meetings DEAC issued a Dec. 20, 2007 final report, "The Deemed Export Rule in the Era of Globalization," recommending improvements to the deemed export rules.

Among its recommendations, DEAC urged BIS to narrow the scope of technologies on the Commerce Control List (CCL) and have outside experts conduct an annual review of which technologies should be subject to deemed export licensing requirements. DEAC stated that BIS should concentrate on those technologies having the greatest national security concerns. DEAC said that building higher walls around fewer technologies, would more effectively protect U.S. national security interests while maintaining U.S. innovation.

DEAC also recommended that BIS use a more comprehensive assessment of a foreign national's country of affiliation for deemed export licensing purposes. Specifically, DEAC recommended expanding the determination of national affiliation to include country of birth, prior countries of residence, current citizenship, and character of an individual's prior and present activities to increase confidence that technology subject to deemed export licensing requirements would not be diverted to unauthorized end-users or activities.

DEAC reasoned that using the most recent citizenship or legal permanent residency may not account for the risk that a foreign national may divert export-controlled technology. DEAC noted that most criminal cases of export control violations of which it had been made aware involve U.S. citizens and U.S. legal permanent residents, who are not subject to deemed export licensing requirements under current BIS policy. DEAC also stated that BIS does not adequately distinguish foreign nationals residing in a specific country for most of their lives. For example, the risk of diversion posed by an individual born and raised in Iran and who only recently attained UK citizenship may differ from that of a native Iranian who became a UK citizen shortly after birth. Comments on DEAC recommendations should be received by August 18.

Several business groups, led by the National Foreign Trade Council (NFTC), have already written to Commerce to criticize the DEAC report. In a February 15 letter, NFTC agreed with DEAC findings on limiting the scope of deemed exports and "the difficulty of controlling

the global flow of technological knowledge, particularly through the use of unilateral U.S. export control regulations,” but warned of “significant negative impact on U.S. technological leadership” if all the recommendations are adopted. NFTC criticized DEAC for not providing guidance to limit the scope of regulations, adding that without such guidance, “the interagency process is unlikely to make any significant reduction in the scope of technologies covered.”

NFTC also compared proposed deemed export controls to top secret security clearances for U.S. citizens. According to the group, if the regulations increase the number of foreign nationals subject to deemed export licensing, but maintain “the current scope of controlled technologies,” they will create a logjam in license processing that, combined with increased denials of licenses for nationals of a larger number of countries, would “accelerate the shift overseas of industrial technology research and development.” NFTC recommends that Commerce work with industry to achieve “a more balanced result.” See 5 IGC ¶ 22; 5 IGC ¶ 27.

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Regulations In Brief ...

(a) Defense Federal Acquisition Regulation Supplement—Defense Acquisition Regulations System—Information Collection Requirement—Taxes—Notice

The Department of Defense announced the proposed extension of a public information collection requirement and seeks public comment on the provisions. The Office of Management and Budget has approved this information collection requirement for use through August 31. DOD proposes that OMB extend its approval for three years. The clause at DFARS 252.229-7010, Relief from Customs Duty on Fuel (United Kingdom), is prescribed at DFARS 220.402-70(j) for use in solicitations issued and contracts awarded in the UK that require the use of fuel (gasoline or diesel) and lubricants in taxis or vehicles other than passenger vehicles. The clause requires a contractor to provide the contracting officer with evidence that the contractor has initiated an attempt to obtain relief from customs duty on fuels and lubricants, as permitted by an agreement

between the U.S. and UK. Comments are due July 7. 73 Fed. Reg. 24576 (May 5, 2008).

(b) Department of Commerce—Bureau of Industry and Security (BIS)—Establishment of the Emerging Technology and Research Advisory Committee

BIS is recruiting individuals for membership on a recently created technical advisory committee that will advise the Department of Commerce on emerging technology and research issues. The Emerging Technology and Research Advisory Committee will (1) identify emerging technologies and research and development activities relevant to dual-use issues, (2) prioritize new and existing controls to identify those of greatest consequence to national security from a deemed export perspective, and (3) address the effect of dual-use export control requirements on research activities. Individuals should respond to the recruitment notice by June 24. 73 Fed. Reg. 30048 (May 23, 2008).

(c) BIS—Regulations and Procedures Technical Advisory Committee—Notice of Partially Closed Meeting

The Regulations and Procedures Technical Advisory Committee will meet at 9 a.m., on June 10 in room 4830 of the Herbert C. Hoover Building, 14th Street between Constitution and Pennsylvania Avenues, N.W., Washington, D.C. The committee advises the Office of the Assistant Secretary for Export Administration on implementing and updating the Export Administration Regulations. The public agenda includes (1) chairman’s opening remarks, (2) presentation of public papers or comments, (3) opening remarks by BIS, (4) regulations update, (5) export enforcement update, (6) working group reports, and (7) automated export system update. There will also be a closed session to discuss matters that are exempt from the provisions relating to public meetings found in 5 USCA app. 2 §§ 10(a)(1) and 10(a)(3). 73 Fed. Reg. 30049 (May 23, 2008).

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