

BIS PROPOSES RULE THAT WOULD ADD RED FLAGS, REVISE KNOWLEDGE DEFINITION, AND PROVIDE A SAFE HARBOR FROM LIABILITY

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On Wednesday, October 13, 2004, the U.S. Department of Commerce, Bureau of Information and Security (“BIS”) published a rule in the federal register that would enhance its “red flags” guidance, revise the knowledge definition in the Export Administration Regulations (“EAR”) and provide exporters with a safe harbor from liability in some instances. The public may submit comments [proposed rule can be found at 69 Fed Reg. 60829 (Oct. 13, 2004)] until December 15, 2004.

Enhanced Red Flags Guidance

Supplement No. 3 to part 732 of the EAR (“Know Your Customer Guidance”) contains a list of “red flags” signaling abnormal circumstances that must be considered by U.S. exporters in assessing whether a particular export (whether controlled ECCN or EAR99 item) may be destined for an inappropriate end-use, end-user, or destination. The proposed regulation increases the number of red flags to 23, from the current 12. Included among the new red flags are:

- The customer uses an address that is inconsistent with standard business practices in the area (e.g., presence of a P.O. Box address where street addresses are normally used).
- The customer’s order is for parts known to be inappropriate or for which the customer appears to have no legitimate need (e.g., no indication of prior authorized shipment of the system for which the parts are sought).
- The customer does not have facilities that are appropriate for the items ordered or end-use stated.
- The transaction involves a party on the Unverified List published by BIS in the Federal Register.
- The customer is known or suspected to have dealings with embargoed countries.
- The customer gives different spellings of its name for different shipments, which may indicate a disguising of the customer’s identity and/or the nature and extent of its procurement activities.
- The product or system into which the exported items are to be incorporated bears unique designs or marks that indicate an embargoed destination or one different from what the customer has claimed.
- The customer provides information or documentation related to the transaction that the exporter suspects is false, or requests the U.S. exporter to provide suspect documentation.

- The requested terms of sale, such as product specification and calibration, suggest a destination or end-use other than what is claimed (e.g., equipment that is calibrated for a specific altitude that differs from the altitude of the claimed destination).

It is likely that the new red flags will increase due diligence requirements and costs. Further, as noted by the American Electronics Association in formal comments made to the regulation in proposed form, customers 'known to have dealings with embargoed countries' include many of Europe's leading multinationals. (The red flags also apply to the export of EAR99 items and their reexport from foreign entities). Company export management systems would be well-advised to build in enhanced training and education of foreign personnel (e.g., EAR customer screening requirements) as a key component of their export control compliance program.

Knowledge Definition

BIS has proposed amending the current definition of “knowledge” in Section 772.1 of the EAR. The proposed rule indicates that knowledge will be imputed to a party if that party has: “not only positive knowledge that a fact or circumstance exists or is substantially certain to occur, but also an awareness that the existence or future occurrence of the fact or circumstance in question is more likely than not.”

The proposed “reasonable person” standard represents an effort on the part of BIS to provide broader guidance to U.S. exporters concerning the applicable knowledge standard required for export control violations. We will report on any industry comments taken into account by BIS in the announcement of the final rule.

Safe Harbor

The proposed rule envisions a “safe harbor” from liability arising under the knowledge-based provisions of the EAR. Under the safe harbor provision, parties who take the steps in the proposed new section 764.7 will not have knowledge imputed to them. These steps include:

- Comply with any item and/or destination-based license requirements and other notification and review requirements;
- Determine whether parties in the transaction are subject to a denial order or to certain sanctions: screen customers and end-users against the Entity List or Unverified list (or other BIS orders); and
- Follow the procedures for identifying and resolving red flags referenced in the expanded list. If red flags are found and cannot be resolved, the exporter would be required either to refrain from entering into the transaction, or to contact BIS for guidance.

Eligibility and Future Application

In instances where red flags are discovered but resolved, the exporter, in order to take advantage of the safe harbor provision, would be required to jump through a series of hoops. First and foremost, the exporter would be required to submit a written report to BIS detailing all material information regarding the existence, assessment, and satisfactory resolution of the red flags prior to shipment, *and* must not otherwise have “knowledge” under the proposed new definition. BIS

would then inform the exporter whether BIS agrees with its conclusion within 45 days (subject to possible extension) of receipt of the report. A response from BIS stating that it concurs with the exporter's red flag assessment and/or resolution, or will not be responding to the report, would serve as confirmation that the exporter has satisfactorily resolved the red flags – allowing the export to ship under the safe harbor provision.

It is unlikely that the proposed “safe harbor” will offer significant shelter. The exporter would not be entitled to the protections of the safe harbor in any case where it had actual knowledge or awareness that the fact or circumstance in question was more likely than not, or if the submission misstated or withheld material information. BIS would not be precluded from initiating subsequent enforcement actions in such cases.