Sovereignty and the Regulation of International Business in the Export Control Area

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A disclaimer that I have to make at the beginning is that I am one quarter Canadian; moreover, on this issue, as you will probably find out, I am about 99% Canadian. So I am not sure how much disagreement we are going to be able to stir up, at least on the issue of the U.S. embargo of Cuba, which I think both of us are going to say something about.

Back in February of 1992, Bill Clinton was making a campaign appearance in Miami. At that time, Florida was regarded as a key swing state in the election; it was not clear which way it would go. It was one of four or five major swing states and it was very important to carry Florida.

Either President Clinton or one of his advisors decided that now was the time for Bill Clinton to endorse something called the Cuban Democracy Act (CDA), which was the principal legislative goal of a group called the Cuban American National Foundation. That Foundation is a potent force in Florida politics. It speaks, or purports to speak, for a substantial Cuban refugee community in south Florida and it also donates very generously to certain key Congressmen in a number of other states, including Representative Robert Toricelli of New Jersey, a member of the House Foreign Affairs Committee.

One of the key features of the Cuban Democracy Act was a provision to make the U.S. embargo of Cuba effectively extraterritorial in the sense that it would command subsidiaries of U.S. companies outside the U.S. to observe the embargo. That particular provision, which was known as the Mack Amendment, for Senator Connie Mack of Florida, had been pending in Congress for about two years before the CDA came around. It was bitterly opposed by Canada, by the United Kingdom, by the European Community and various other foreign countries. President Bush had said that he would veto the Mack Amendment, if it was put into any legislation that came to his desk. In fact, he did veto the Export Administration Act of 1991, partly on that ground. To make a long story short, Mr. Clinton endorsed the Cuban Democracy Act. At that point President Bush had a change of heart, and he endorsed the Cuban Democracy Act. All the opposition was swept away and it became law in October of 1992.

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Before turning to some of the practical aspects of that development, let me just talk a little bit about the background of the extraterritorial features of U.S. trade controls, of which this is a classic example. What is it that makes U.S. export and transaction controls so unpopular outside the United States? In a word, it is extraterritoriality, a wonderful big word, which means in this context, that these laws purport to apply to actions that take place outside the United States and that do not involve nationals of the United States.

Well, what connection does the United States have with these actions? The answer is one of two things: First, either the products or the technology that is involved in the transactions has some kind of connection to the United States; either the source was in the U.S., or the products or technology contained something from the United States. Or, second, one of the parties involved in the transaction, although foreign, is owned or controlled by U.S. interests.

When has the United States resorted to this kind of control? In very general terms, the extraterritorial "product source controls," have been broadly applied, and have not really occasioned a lot of controversy outside the United States. The other type, what I will call the "entity controls," have been applied more spasmodically, but with a great deal more controversy. I will say just a little bit more about the "source" type controls, so that we are all sure we understand the breadth of these.

The most typical case is that of so-called "reexports." In the context of Canada, this is a shipment out of Canada of goods that came to Canada from the United States. The U.S. calls this a reexport and asserts authority over it. It is not quite as bad as it might seem, because there are a lot of transactions involving those goods that the U.S. considers permissive. In other words, you do not have to go in and ask somebody in the U.S. government if you can do it if you are a Canadian company. For example, reexports out of Canada to all of Western Europe, Japan, Australia, New Zealand and certain other countries, are permissive for virtually everything.

The controls become more troublesome when they reach beyond what I call reexports to foreign, in this case Canadian, products that have U.S. content in them — either materials or components. The U.S. will apply its export controls to those transactions, in certain circumstances. For products generally, the U.S. will apply its controls if the U.S. content is over a certain threshold percentage level. For most exports from Canada, that level is 25%. And it is measured by the cost to the Canadian producer of the U.S. content against the Canadian export selling price. If you have mark ups and labor and so forth, the U.S. content may be, in fact, as high as 50% on a materials test, but be below 25% on a cost basis. That is significant because, as I understand it, the Canadian government has had a general policy, although I do
not think it is written down, of deferring to U.S. export controls for Canadian products that have more than 50% U.S. content. But, Canada compares the U.S. content with the Canadian content. It is a different kind of a test, so although the percentage numbers are different, in practice the tests may often be very much the same.

The U.S. has further controls reaching even beyond product content to so-called “direct products” of U.S. technology. There may be no U.S. content in the product, but some U.S.-source technology was used to make the product. That control has been exerted only in the area of national security, and only to target exports to certain “controlled countries”; this is something left over from the Cold War, basically dealing with exports to Russia, China, and Eastern Europe.

When the Coordinating Committee on Multilateral Export Controls (COCOM) still existed, the Canadians had a very parallel set of controls, which I think remain in effect. So that the U.S. “direct product” controls really did not do any more than the Canadian controls did, and that there was in fact a general exemption in the U.S. controls for shipments out of Canada or other countries that participated in the COCOM regime.

So, the U.S. extraterritorial “product source controls,” I think, have less of a problem in our relations with Canada and other countries. The “entity controls,” as I mentioned, have been much more of a problem. I will run through these quickly, with a little history by country, rather than cite a lot of regulations to you.

The first set of these controls effectively came in the wake of the Korean War, and affected trade with North Korea and China. Vietnam was added later, in the course of the U.S. involvement in that civil war. These transaction controls applied to so-called “persons subject to the jurisdiction of the United States,” a terrible term, because it includes persons who are not in fact subject to the jurisdiction of the United States. The term “a person subject” is defined to include Canadian companies and companies in other countries, in which U.S. interests have a controlling ownership, or managerial control position. And so, the United States told these “persons subject” that they could not trade with these embargoed countries, even if the products were 100% non-U.S.

The controls did lead to some problems. There were conflicts with Canada over the China controls that appeared episodically. A more serious episode arose with France that led a French court to place a U.S. subsidiary in that country under a court receivership in order to prevent it from breaching a contract to supply truck bodies for delivery to China. After President Nixon’s trip to China, the U.S. removed China from this embargo program and that potential conflict went away.

North Korea does not have significant international trade. It is basically a very isolated country. So, to my knowledge, we have not had
similar conflicts, at least serious ones, with Canada or other countries concerning transactions of U.S. subsidiaries with North Korea. Vietnam started to open up to international trade and investment in the late 1980s, and there was a potential for significant conflict problems, but the U.S. eased and finally dropped the Vietnam embargo early this year.

Cuba was put under a regime very much like China and Vietnam, but with a major difference in the original Cuba program, which dates from when Castro turned communist shortly after the 1959 revolution. Basically, in the early 1960s, there was an exception. “Persons subject” was in the law, but there was an exception for trade transactions with Cuba by “persons subject” outside the United States. The exception applied if there was no participation by anybody in the U.S., and no U.S. goods. This means the trade transaction had to be totally foreign.

Despite the exception, the U.S. did have some serious conflicts with Canada and with certain of the Latin American companies that began to build up in the 1970s. Then the decision was made to drop the exception and set up a licensing regime under which even goods with some U.S. content could be exported to Cuba. As it turned out, the Treasury Department licensed just about everything. So potential conflicts with Canada and other countries seemed to go away, until the Cuban Democracy Act. I will come back to that.

I will note here in passing that in the newer types of U.S. embargoes, beginning in about 1980, and starting with Iran and then proceeding on to Libya, Yugoslavia, Iraq, Haiti, Panama, and Nicaragua, we have steered away from the “persons subject” concept and started regulating “U.S. persons,” a term defined to exclude U.S.-owned companies in foreign countries. So we stepped back from the extraterritorial approach that had stirred up these conflicts, except that some of the regulators in Washington came up, over the years, with some pretty extreme constructions of when U.S. companies were involved in subsidiary transactions. For example, if the parent company says to its subsidiary, it is okay to go ahead, the parent company, a U.S. person, has violated the law. So the U.S. company has to be very careful not to do that.

I might mention briefly that in the U.S. antiboycott program, we do not call the regulated parties “persons subject.” We call them “U.S. persons,” but we define that term to include foreign companies that are controlled by U.S. firms. Having done that, however, we regulate conduct of U.S. persons only if such activities are in “U.S. foreign commerce.” This is sort of a compromise. So far as I know the U.S. antiboycott program, although controversial in Canada, has not stirred up too many real conflicts.

The last regulatory action I will mention in this general sector is the 1982 U.S. pipeline controls, when the U.S. invoked the “persons
subject” authority to stop the building of the Soviet natural gas pipeline into Western Europe. We did it at a time when all the governments of Western Europe were committed to providing equipment and support for this pipeline, which they regarded as important economically for them.

When the U.S. tried to stop the building of the pipeline, after European equipment contracts had been signed, it kicked up a huge fuss and almost destroyed the Atlantic Alliance. Fortunately, George Schultz came in as Secretary of State. He could see what was happening. He advised President Reagan to drop the controls. The President took this advice, thereby depriving all of us lawyers of the opportunity to argue this important case in the Supreme Court.

Now, let me go back and say a few things about the Cuban Democracy Act, and how a U.S. company with a subsidiary in Canada copes with it. The reason this has become difficult is not only that the U.S. has gone backward and said: “No more licensing for U.S.-owned Canadian companies, which are deemed ‘persons subject’ and bound by this control,” but Canada has put in a blocking order, basically saying: “If you, a Canadian company, go along with the U.S. embargo, you are violating Canadian law.” So, we have a direct conflict between these two regimes.

One thing that ought to be kept in mind, when you consider this conflict, is a legal doctrine that is recognized in the United States (I honestly do not know whether it is recognized in Canada or not. In this case, I think it is more important that the doctrine is recognized in the United States). It is the legal defense known as “foreign state compulsion.” Essentially that defense means that a U.S.-owned Canadian company operating in Canada that is under threat of Canadian prosecution if it does not proceed with a trade transaction with Cuba, may have a legal defense in the U.S. courts to a charge that it has committed a violation of U.S. law by going forward with the Cuban transaction. The U.S. parent company does not have that defense, however. If the U.S. company does anything to facilitate or authorize the Cuban transaction, it is subject to prosecution. But the Canadian company, exposed to Canadian law and subject to Canadian prosecution, may have the foreign state compulsion defense. This defense has not been recognized by the U.S. Supreme Court, but it is found in lower court decisions. It is also in the Restatement of the Foreign Relations Law and I think most of us feel that it probably is going to be upheld in U.S. courts.

Let me add some practical comments about the legal exposure that the U.S. parent company has and the legal exposure that the Canadian company has. First, the Treasury Department in the United States, which enforces the embargo, is very likely to pick on the U.S. company, rather than the Canadian subsidiary. It has personal jurisdic-
tion over the U.S. company, and it is certainly going to find it to be the most attractive enforcement target. Thus, from the standpoint of preventative U.S. law treatment, the most important patient is the U.S. parent company.

Second, there are persuasive reasons why the Treasury would feel it had to take enforcement action if a Canadian subsidiary were to go ahead with a trade transaction with Cuba. The Cuban embargo has a very strong political constituency. I have recited a little history earlier to give you that flavor. It would be politically hazardous for any administrative agency to disregard the embargo proscriptions. So the Treasury Department is going to be strongly motivated to take some action. Otherwise it is going to have Congress on its back and the Cuban refugee community on its back and so forth.

There are a number of legal theories that might be resorted to, in order to pin the U.S. parent company, if a Canadian subsidiary goes ahead with a Cuba transaction. Obviously, if there is any kind of transactional support, or any kind of approval, even perhaps a good-faith failure to attempt to stop the transaction, the Treasury will use this to implicate the U.S. parent. It is conceivable the Treasury will try theories of imputed liability, piercing the corporate veil, and will try to hold the parent company liable per se, for what its Canadian subsidiary has done. I think that would be moving beyond where the law is, particularly recognizing that this is a program for which there are criminal sanctions.

Despite the fact that the embargo is very tight from the U.S. standpoint, there are some exceptions in it which offer a potential way out. The most significant that I can think of is an exception for pre-existing contracts, which is being interpreted by the Treasury quite generously to avoid conflicts with foreign blocking measures and trade policies. So, if there is any factual basis on which you can argue a pre-existing commitment, perhaps not even a formal contract, but an understanding or something like that, you may be able to avoid the problem by getting a license from the U.S. Treasury, to permit the Canadian subsidiary to fulfill its Cuban commitment.

There are also exceptions in the Cuban Democracy Act that permit Treasury licensing for exports of medicines, food, and certain telecommunication services. Again, depending on the particular situation, it may be possible to persuade the Treasury Department to license something by a Canadian company under one of these exceptions. So, do not give up hope, just because you have an apparent legal conflict between two nations; there may be an easy way out.

Now let us look at the Canadian side. I have no expertise in Canadian law, so everything I say can be contradicted and you should rely on my co-speaker and not what I am saying. But, as I understand it, if a Canadian subsidiary of a U.S. company disregards the Canadian
blocking order and rejects a Cuban order, it is potentially subject to criminal prosecution in Canada. And there are some reasons why you could expect that would occur. The Canadians made quite a public display of invoking this blocking order. The *Cuban Democracy Act* is viewed in Canada, I believe accurately, as a U.S. infringement on Canadian sovereignty and if an important Cuban transaction came along that presented the issue clearly, it would seem to me that the Canadian government would be bound to use legal process to compel the Canadian subsidiary to go ahead.

In addition, there are notification obligations in the Canadian blocking order that require Canadian companies, if they are given directives or orders, or perhaps even suggestions, to go along with the U.S. embargo, to report it to the Canadian Attorney General. So the government is going to know about such situations. Still, there are circumstances in which the Canadian government might exercise discretion, in a particular situation, to avoid a confrontation. There might be, for example, situations in which it could be established that the proposed transaction was for some reason commercially not feasible or financially or otherwise attractive to the Canadian company: The price could be wrong; the products may not fit; the customer's credit terms may not be acceptable, etc. I do not know what the Canadian government would do if, for example, there were an alternative source of supply in Canada for an equivalent product. I do not know whether the government would use its influence to arrange that the order be diverted to the other supplier.

There is a basis, I mentioned, in pre-1992 Canadian policy for deferring to U.S. trade controls in situations where the product is of U.S. origin, or has more than 50% U.S. content. Now, I do not know for a fact whether the Canadian government would accept that as a situation where it would defer to the U.S. embargo, notwithstanding the blocking order.

Another possible situation would be a Canadian subsidiary that is subject to a parental territorial constraint that is totally independent of the Cuba embargo, but excludes Cuba from the Canadian subsidiary's sales territory. In many multi-national corporations, sales territories are assigned to various units, and a Canadian company might be serving, for example, Canada only, and so would not have any export sales. Or it might be the practice of the American parent company that all Latin American sales would be handled out of Mexico, for example, or perhaps out of the United States. Query whether the Canadian government would feel comfortable advising a Canadian subsidiary under such conditions, if it got an order from Cuba, "You do not have to deviate from your standard company policy to fill such an order." But again, I caution, I am not a Canadian lawyer, none of what I said is advice to be followed in any way. Ask your Canadian law/policy ques-
tions to my fellow speaker.

Well, suppose there is no easy way out. You are advising an American company with a Canadian subsidiary. The subsidiary has been getting orders from Cuba in the past. What do you do to prepare for the next such order? It seems to me it is very important for the U.S. parent company, under such conditions, to give a very clear instruction to the Canadian subsidiary that any trade with Cuba would violate U.S. law, in the absence of a license from the Treasury Department. Yes, that instruction will have to be notified to the Canadian Attorney General, but my view is that that instruction should be given to protect the parent company from any possible implication that it tolerated or went along with Cuban trade.

Certainly, if any such trade is imminent, the U.S. parent company should not do anything to help the Canadian company perform any Cuban transaction. It should not provide any parts, components or materials that might help the Canadian subsidiary to go forward. If the U.S. company knows something with Cuba is going to happen, and it does happen, the U.S. company must not be a part of it. That means, of course, if you have a situation where there is a very close working relationship between the management of the U.S. parent company and the Canadian subsidiary, the U.S. company is likely to be in for trouble. That is not a very good situation to be in from the standpoint of this legal conflict. Finally, both companies had better get good legal advice, and that may mean that there is a need for some U.S. legal advice in Canada and some need for Canadian legal advice in the United States.

I have worked with several Canadian law firms on this conflicts problem. We have found it very useful to communicate directly between firms, because we can talk informally, without triggering the kind of notification to the Attorney General that might be required if parent companies and subsidiary companies were talking to each other. I have also found that those conversations with Canadian counsel to be very useful to understanding the Canadian perspective.

Now what does a Canadian subsidiary do to cope with the legal conflict? It has to be in a position to minimize its own exposure and hopefully its parent’s exposure as well. I guess the first advice might be to not go looking for trouble, i.e., one should not be beating the bushes for Cuban business at this juncture. You have to talk to your Canadian lawyer about how far you can refrain from normal marketing efforts without transgressing the blocking order. But hopefully you do not have to make trouble for yourself or for your parent company. The second point is to keep a respectful distance in dealing with the U.S. parent. You are going to make your own decisions in this matter; the parent company is not going to be able to make them. It is probably best, if the situation comes up, to let the two outside counsel communicate, and
then let the Canadian counsel advise the Canadian company, and the U.S. counsel advise the U.S. company.

We talked about the need under U.S. law for the U.S. parent to send a written communication to the Canadian company. I would also think it important for the Canadian company to inform the U.S. parent, if a Cuban transaction materializes. I do not think it is a good idea, from a U.S. law perspective, to keep the U.S. parent company in the dark. It is better for the U.S. parent to know if the situation is coming, and to act intelligently. It is certainly not a good idea for the U.S. company to withdraw any constraints, such as territorial limits that already may exist, in terms of export business. As I mentioned before, some companies have such territorial limits. I certainly would not advise the U.S. company to change such limits or ease up on them, because that would be asking for trouble, and maybe those limits would stand up in Canada if a particular situation arose.

Obviously the Canadian company, in the last analysis, is going to have to comply with Canadian law. I just do not think there is any way around that. I do not think any parent company in the U.S. is going to say to its Canadian company, "Okay, you guys all go to jail in Canada, because we have got to protect the home office." That just is not the way it is going to happen. If it really gets that hot, I think the Canadian company is going to make a decision to comply with Canadian law, and if I were a Canadian company, I think that is the decision I would make.

If an order does come in to a Canadian subsidiary, it should inform the U.S. company, and then get immediate legal advice. The first thing to do is look and see if there is an out, either in Canada or in the U.S. Is there something in the transaction that makes it licensable under U.S. law? Perhaps it is a pre-existing contract, perhaps it is medicine, food, or something else that can be licensed in the U.S. Certainly one must take advantage of a license opportunity, if one exists. You are not going to have any defense of foreign state compulsion if you had a license you could have gotten and did not seek it.

Next, look on the Canadian side, with the aid of Canadian counsel, and see if there is some way to avoid the confrontation there. Third, it is important that the Canadian company, if it gets caught in a real bind, and there is not a way out, to be able to demonstrate that it did act under compulsion. There are various ways of doing that. You might even consider going to the Attorney General or going into a Canadian court and asking if the transaction must go forward. At the very least, you would, I think, be well advised to get an opinion of reputable Canadian counsel, that says not only does Canadian law say you must proceed but, if you do not do so, you are likely to be prosecuted in a Canadian court. That is the kind of situation that would lend itself to the defense of foreign state compulsion.
Let me mention a couple of additional aspects. The U.S. embargo is broadly construed. It does not apply only to exports from, say, Canada to Cuba by subsidiaries of U.S. companies in Canada. It can apply to transactions that go through several stages. For example, an order from Cuba comes in to some wholesale distributor in Canada. The Canadian distributor places an order on a Canadian subsidiary of a U.S. company. If that subsidiary goes forward knowing the product is ending up in Cuba, it has a problem under the U.S. embargo. So this embargo catches indirect as well as direct transactions with Cuba.

Second, the U.S. embargo reaches individual U.S. nationals, as well as "persons subject," that we have been talking about that are entities. Individual U.S. citizens who are officers or directors of a Canadian company are subject to the U.S. embargo. That is a very difficult situation, because those individuals, if they are resident in Canada, are really subject to prosecution in both countries. I have found, in some situations, that it was advisable to get separate counsel for such individuals, if there was really likely to be trouble, because the only answer for them might be to resign, and I do not want it said that their resignation was caused by my U.S. client. I want any such decision to be made by the individual himself.

Earlier on, we talked about the other side of U.S. extraterritorial controls, that is the "product source" controls. Suppose a Canadian subsidiary receives an order to sell a product to Cuba that has U.S. content in it, or that is of U.S. origin. Two U.S. control schemes are in play. I do not know if the defense of foreign state compulsion would protect the Canadian subsidiary in the context of the Commerce Department "product source" control scheme. That could be the worst situation you could have — a Canadian subsidiary with a U.S.-content product, gets an order from Cuba — because the Canadian company is potentially violating two laws. One is the Trading with the Enemy Act under which the Cuban embargo exists — the one I have been talking about based on entities. The other is the Export Administration Act, which is the product source control scheme. The problem with the latter is that it has a remedy in it which is deadly, something called the denial list. The Commerce Department can take a foreign company and put it on the denial list. It is then out of business, because nobody can deal with it who deals in U.S. goods, and that is fatal for almost any company with U.S. connections. That is a terrible punishment, and Commerce can impose it even though Commerce has no personal jurisdiction over the Canadian company.

Given the conflict of laws, why has there not been a big case, after more than a year and a half? That is very disappointing for the legal profession, although not for clients. Some of us thought this was going to be another opportunity for a Supreme Court case, like the 1982 pipeline controls. I can only speculate on the absence of litigation. I
would guess the first and foremost reason is that the Cuban economy and foreign exchange position are so weak that there is very little Cubans can buy abroad, including Canada. A second reason why conflicts may not yet have developed is the licensing provisions in U.S. law that I mentioned, the licenses for pre-existing contracts, in particular. Time must be about to run out for that provision, but I know in a couple of situations that I have encountered, that licensing has saved the day, so to speak. I have mentioned the other licensing exceptions for food, medicine, and some telecommunications. Sometimes there are transactions that offend the embargo that do not involve actual exports to Cuba. Those the Treasury can still license, as I see it, and I think the Treasury agrees. There are some possible escape hatches on the Canadian side to which we have referred. That may also have helped prevent conflicts.

I have a sense, although I must say the U.S. government people that I have talked to have been very circumspect, that there has been a serious effort by both countries to avoid provoking the conflict between the U.S. embargo and the blocking order. I did not think that would be the attitude when the conflict emerged in late 1992. I thought both sides were spoiling for a fight. But there not having been such a fight leads me to think that maybe some cooler heads have concluded perhaps that it is not in the overall interest of either country to bring this to a head.

I would like to end by noting that the first conflict case I have had did not arise in Canada. It came up in the United Kingdom. There is a very parallel situation in the United Kingdom. There is a U.K. blocking law that is very similar to the Canadian one, and it has been invoked with an order responsive to the Cuban Democracy Act that is quite similar to the Canadian blocking order. There is very little trade between Great Britain and Cuba, but the British Department of Trade and Industry takes British sovereignty very seriously.

We had a case involving a very small export of pharmaceutical products to Mozambique from England. The English company was a subsidiary of my U.S. client. The sale was to be financed under a letter of credit that had been confirmed for the African customer by Havana Bank International's London office. My client spotted this as a potential problem under the Cuban embargo, because the embargo does not just prohibit dealing with Cuba; it prohibits dealing anywhere with any Cuban party. And this bank was Cuban-owned; it was on the list of "specially designated nationals" of Cuba that the Treasury Department publishes. So the subsidiary could not legally go forward. The British barrister that is with our London office went to see the Department of Trade and Industry, and was asked, "Have you been to see the U.S. Treasury?" And he said no. And they said to him "Well that is good, because then we will talk to you." They explained: "Somebody else
came in here a few weeks ago and they had seen the U.S. Treasury, and we tossed them out.”

So my barrister colleague said “Well, can you do something for us?” They said, “Well we will consider issuing you a consent order.” My colleague thought that should solve the problem; DTI will consent to the nonapplication of the blocking order so that the English company can go ahead and finance the transaction with some other bank. There will not be any trouble under the U.S. embargo. But DTI said, “Oh no, that is not what we mean by a consent order. A consent order allows you to go talk to the U.S. Treasury and get them to back down.”

Well, it took them ten days to issue such a consent order; it had to go up to the Secretary of State of Great Britain, and apparently was the first of its kind. But, of course, it did not solve anything in the United States. Fortunately, because the transaction did not involve an export to Cuba, we were able to get a license, somewhat grudgingly, from the Treasury Department. This experience with the British conflicts situation tells me that there is really very little prospect of accommodation on the part of the British government if a real conflict arises there over the U.S. embargo.