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Extra-territorial Application to U.S. Export Control Laws on Foreign Subsidiaries of U.S. Corporations: An American Lawyer's View from Europe

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1. Introduction

The subject of extra-territorial application of national laws (especially U.S. laws) has received considerable attention in the press and in legal publications in recent years, particularly since the recent enactment of so-called "blocking legislation" in a number of countries.[1] The main focus of attention has been the transborder application of U.S. antitrust laws, with respect to both government and private actions. Other U.S. laws in areas such as export controls, foreign boycotts, and securities regulations have also been the target of criticism by other nations because of their extraterritorial reach. The pros and cons of the U.S. position have been extensively debated on both sides of the Atlantic over the past years. The debate has at least served to improve the understanding of a rather esoteric subject, and may have contributed to a more moderate approach in recent U.S. legislative and regulatory actions. However, as will be demonstrated later, such moderation is sometimes more apparent than real. The purpose of this article is not to present yet another general overview of this subject. Rather, it is to focus on the effects which the extra-territorial of U.S. export-related laws may have on foreign subsidiaries of U.S. multinational corporations, and to suggest that the attempts by the U.S. government to impose its laws on economic activities outside of its borders are of dubious value to the implementation of domestic and foreign policy goals, are clearly harmful to the interests of the U.S. corporations involved, and are often, in practical

The opinions expressed herein are solely those of the author, and are not intended to reflect the views of anyone else. This article was written prior to the recent imposition of sanctions by the U.S. Government against Dresser Industries' French subsidiary in connection with the European gas pipeline project, a dramatic example of some of the issues discussed herein.

[1] *E.g.*, Protection of Trading Interests Act, 1980 (United Kingdom).

effect, against the U.S. national interest. It is admittedly difficult to quantify the negative effects, but obviously in these troubled times we should avoid any actions which even marginally reduce the competitiveness of U.S. corporations in the world market, particularly if they also harm the foreign relations of the United States, without at the same time producing compensating material benefits.

2. Applicability of U.S. Export Controls to Foreign Subsidiaries

One of the principal aspects of the extra-territoriality issue is the applicability of certain U.S. laws and regulations to foreign subsidiaries of U.S. companies. This is commonly done in the export control area by defining the covered U.S. persons as including controlled foreign subsidiaries. Under regulations of the U.S. Department of the Treasury, the foreign subsidiary may be affected even if there is no U.S. connection other than the subsidiary's direct or indirect ownership by a U.S. person or legal entity.[2] Often, however, the application of the U.S. law is also based on some involvement with the foreign commerce of the United States, as in the case of the anti-boycott provisions of the Export Administration Act.[3] But in contrast, under the anti-boycott provisions of the Tax Reform Act of 1976[4] (whose intended effect is extra-territorial in the sense that the U.S. parent will be expected to put pressure on the foreign subsidiary in order to avoid adverse U.S. tax consequences), a 10 percent share ownership in a foreign company may be sufficient for that law to apply.

The complex reexport sections of the Export Administration Regulations are of particular significance to foreign subsidiaries of U.S. companies, as they purport to control rigorously the destiny of U.S. origin end products and components once they have been exported from U.S. territory[5] and also to regulate the export or reexport of certain *foreign produced* direct products of U.S. technical data, and even commodities which are produced abroad by a "plant or major component thereof which is a direct product of U.S. technical data."[6] These rules are worth examining, since they are a striking example of the U.S. government's attempt to control the activities of foreign persons outside the United States.

Section 374.1 of the Export Administration Regulations, entitled "Prohibited Exports and Reexports," includes the following language:

> Unless the reexport of a commodity previously exported from the United States has been specifically authorized in writing by the Office of Export Administration prior to its reexport, or is authorized under the permissive reexport provisions of Section 374.2, or is otherwise authorized under any other provision of the Export

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[2]Foreign Assets Control Regulations, 31 C.F.R. Part 500; Transaction Control Regulations, 31 C.F.R. Part 505; Cuban Assets Control Regulations, 31 C.F.R. Part 515.

[3]50 U.S.C. app. § 2408 (supp. III 1979).

[4]I.R.C. § 999.

[5]*E.g.*, 15 C.F.R. § 374.1 and 15 C.F.R. § 376.12 (1981).

[6]15 C.F.R. § 379.8(a)(3) (1981).

Administration Regulations, *no person in a foreign country (including Canada)*, or in the United States may:

a) Reexport such commodity directly or indirectly, in whole or in part, from the authorized country(ies) of ultimate destination; . . .

(Emphasis added)

This prohibition applies to all "persons"—not just to U.S. citizens or U.S.-controlled foreign entities. Once a commodity is sold to a foreign person in a foreign country, one would normally assume that whatever happens to that commodity thereafter lies solely within the jurisdiction of the foreign country. It has simply become an asset of that foreign country. To attempt to control the reexportation of the commodity on grounds of U.S. national security stretches the "effects" doctrine (the only conceivable justification under international law for such control) to an absurd length: what would then prevent a nation from seeking to control any activity in a foreign country on the grounds that its security is affected?

Nobody would question the right of the U.S. government to control the destination and use of strategic commodities *at the time of exportation from the United States*, but once the commodities have been exported, any further attempt at such control should be handled on a government-to-government basis (through COCOM, for example), and not through a highly questionable application of U.S. law. Moreover, the reexport provisions of the Export Administration Regulations must as a practical matter be virtually unenforceable, and are probably largely ignored outside the United States—except of course when the reexporting company is a subsidiary of a U.S. company.

The reaction of European governments towards the extra-territorial reach of U.S. laws is on the whole negative, but the individual characteristics of foreign subsidiaries may influence a host country's attitude towards particular applications of U.S. laws. For example:

i) A U.S. company operates a sales subsidiary in a European country, with no manufacturing activity and usually with few employees. The subsidiary may have a local board of directors, but it is clear that the company is merely a sales arm of the parent. The economic and social interest in such a subsidiary from the host country point of view will usually be minor, and its subjection to U.S. antitrust laws and export controls should not raise serious problems.

ii) A U.S. company establishes a 100 percent-owned manufacturing subsidiary in Europe, to produce its U.S.-designed products. The host country interest will obviously be greater, but again, the application of U.S. laws such as export controls to what is in effect a foreign manufacturing arm of the U.S. parent could be viewed with some tolerance by the host country. However, this tolerance may be slight or nonexistent when a substantial number of jobs is at stake, and when the subsidiary

is a significant factor in the local economy.[7]

iii) A U.S. company acquires the shares of a foreign company, whose products and technology are basically of non-U.S. origin. Large numbers of such companies in Europe have come under U.S. control mainly since World War II, and they raise the most difficult problems in the extra-territorial application of U.S. laws. Very often their management is entirely European, and sometimes they are important suppliers to their governments in defense and other areas. For the U.S. government to seek to apply its policies and laws to such "national" economic entities is particularly difficult to justify.

The above analysis would seem to cast doubt on the too simplistic proposition that mere U.S. ownership of a foreign company makes it essentially "American" and properly subject to U.S. laws and policies.

3. The Consequences

Some of the reactions which the U.S. policy on extra-territoriality has generated from certain foreign governments are well-known, particularly the enactment of blocking legislation, designed specifically to prevent local subsidiaries of U.S. companies from complying with U.S. directives in certain cases. There are other less visible consequences of the U.S. approach which should not be ignored.

One such consequence, which is surely not in the interest of the United States, is to make it more difficult for U.S. companies to acquire foreign companies. It is not unreasonable to assume that the long arm of U.S. export controls may have contributed to the French government's restrictive policy towards take-overs of French companies by U.S. corporations. An interesting recent case in the U.K. involved the negative recommendation by the Monopolies and Mergers Commission on Enserch Corporation's bid to acquire Davy Corporation Ltd.[8] One of the grounds for the Commission's conclusion was the possible detrimental effects of the Foreign Corrupt Practices Act on Davy's business in certain countries. The Commission also examined the potential effects of the Export Administration Act, but concluded that in this case the effects would be limited. The report of the Commission contains the following significant statement as to the British government's attitude:

> The Department [of Trade] also explained that the United Kingdom Government does not accept the view that the nationality of the shareholders in a body corporate founds a claim to jurisdiction over the body corporate itself. Difficulties have arisen for United Kingdom companies from the view of the United States authorities that for the purposes of certain United States laws the United States of

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[7] *E.g.*, the *Fruehauf* case, Judgment of May 22, 1965, Cour d'Appel, Paris [1968] Dalloz-Sirey, Jurisprudence 147.

[8] The Monopolies and Mergers Commission, Report on the Proposed Merger of Enserch Corporation and Davy Corporation Limited (September 1981—H.M. Stationery Office).

> America has jurisdiction over companies incorporated in the United Kingdom and doing business there simply by reason of the United States nationality of shareholders in those companies. These have given rise to discussions with the United States authorities since the United Kingdom Government does not accept the application of United States laws to United Kingdom companies by virtue of such claims of extra-territorial jurisdiction. Powers to protect United Kingdom companies in these circumstances are among those contained in the Protection of Trading Interests Act 1980 and, in support of diplomatic pressure, the powers would be available in appropriate cases (for example where, as in the anti-boycott laws, the application of United States law depends on a requirement for companies to report particular activities). Some difficulties have been overcome after representations to the United States of America and over the years the number of major problems coming to the Department's attention has been small, although there are many companies in the United Kingdom with United States shareholdings. United Kingdom companies may, however, feel inhibited in aspects of trading by reason the United States shareholdings in them in ways which have not come to the Department's attention and the United States authorities are clearly in a position to exert influence through United States parents on their wholly-owned or controlled United Kingdom subsidiaries.[9]

The reference in the last sentence of the statement to "influence through U.S. parents" highlights one noteworthy aspect of this subject, which can be described as "indirect extra-territoriality." It is perhaps even more objectionable than the outright assertion of jurisdiction over foreign subsidiaries, since the U.S. government attempts to achieve the same result indirectly while at the same time professing its desire to avoid conflicts with friendly governments through the exclusion of foreign subsidiaries from the coverage of certain laws and regulations.

An example of "indirect extra-territoriality" is the pressuring of the U.S. parent by the U.S. government (the pressure sometimes involves the threat of unfavorable publicity through leaks to the press) to compel its foreign subsidiaries to follow "voluntarily" the U.S. rules. The application of such pressure may be facilitated by reporting requirements which are imposed on the U.S. parent regarding transactions by its foreign subsidiaries which are prohibited for U.S. companies but permitted for such subsidiaries.[10] Another "indirect" aspect is the applicability of the U.S. laws to officers and directors of foreign subsidiaries who are U.S. citizens. This presents the parent company with unpalatable alternatives: either to avoid having any Americans on the boards of its subsidiaries, or expose them to possible prosecution if the subsidiary does not follow the U.S. rules. The result may be that the U.S. parent will seek to compel the subsidiary to apply the U.S. rules, even though the particular law may exlcude foreign subsidiaries as such.

Following are other possible consequences of U.S. extra-territoriality on the policies of foreign governments regarding U.S.-controlled companies:

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[9] *Id.*, ¶ 8.12.

[10] Iranian Assets Control Regulations, 31 C.F.R. § 535.207(b) (1980).

a) Foreign governments inclined to nationalize private industry, either through government ownership or by forcing a U.S. parent to sell its foreign subsidiary to local shareholders, may find the extra-territoriality issue to be an additional justification for this policy.

b) Foreign governments may be less inclined to support the export activities of U.S.-owned subsidiaries, if they feel that their efforts in this respect may be frustrated by the application of U.S. export control laws.

c) Foreign governments, which often have a tendency to favor nationally-owned companies in their procurement policies, may find it easier to justify such discrimination towards foreign-owned entities if they can point to the influence of foreign legislation on the activities of these subsidiaries, which in every other respect may have strictly "local" characteristics.

The extra-territoriality problem can also affect in a negative, if intangible, way the relations between the managements of the foreign subsidiaries and their U.S. parents. Many European subsidiaries are, as previously noted, essentially "local" in character. Often there are no Americans in the management, and to the local public, the subsidiaries are considered national companies, as the foreign ownership is seldom emphasized or well-known. The maintenance of this local identity is frequently dictated by business necessity, and works to the advantage of both the subsidiary and its American parent. The managers of the local company personify this legal entity, while at the same time functioning as loyal members of the corporate family. Consequently, the directives of the parent company requiring that certain U.S. laws affecting the subsidiary's business be observed are adhered to, but they can generate considerable resentment and frustration on the part of the foreign managers, particularly when there is a negative economic effect on the company. The application of certain laws, such as the Foreign Corrupt Practices Act and the anti-boycott provisions, is particularly difficult for the European managers to swallow, since they are viewed as purely U.S. domestic political measures, the rationale for which is often not accepted in the foreign country. Moreover, the European managers will feel that they are acting at a disadvantage vis-a-vis their home country competitors, which may affect their morale and motivation. The foregoing factors are obviously difficult to evaluate, but they undoubtedly can adversely influence the functioning of an international management team.

Another factor to be considered is that the extra-territorial application of U.S. laws can place the officers and directors of the foreign subsidiaries in a difficult position in respect of the laws of their own country. Under most European company laws, the directors are accountable to the shareholders, but their affirmative duty is to carry out their functions in the best interests of their company. Any actions which they may take at the direction of the

controlling shareholders contrary to the interests of the subsidiary could subject them to civil actions by creditors, employees or minority shareholders, and possibly even to criminal proceedings.

Fortunately, there appear to have been few problems of this kind so far, even though local managements tend to comply with parent company directives despite the potential damage to the subsidiary. On occasion, however, directors of U.S.-controlled subsidiaries have been known to refuse to comply with demands from their parent to provide information regarding their companies' activities for submission to U.S. government agencies, on the grounds that such disclosure could cause serious harm to their company. It is clear that from a legal point of view, the directors' refusals were entirely proper. But such incidents are unpleasant and can place the U.S. parent company management in a difficult situation under U.S. law. They can only have a harmful effect on the proper functioning of a multinational corporation. Problems in this area will no doubt arise more frequently in the future, as the European company law continues to tend towards emphasizing the social responsibility of management—namely, to the employees, the unions, the consumers and the national economy as a whole. It seems inherently improper to force the subsidiary's management to abandon a particular sale because, for example, the transaction would violate the U.S. export regulations due to the inclusion of one U.S. component representing an insignificant part of the sale. In a period of increasing unemployment, the foreign subsidiary's management could be placed in an untenable position if it refuses job-creating business for such reasons. The problem is of course aggravated whenever local minority shareholders exist.

4. Conclusion

The well being and development of U.S. foreign investments and commerce should be an important goal of national policy. The extra-territorial application of U.S. laws to foreign subsidiaries clearly does not help to achieve this goal—quite the contrary. Such application can be defended on the grounds that it is required to foster certain other national policies, such as national security, and also to avoid the circumvention of U.S. laws through off-shore activities. The latter defense seems weak—it should be possible to sanction such circumventions through the U.S. parent. One can also reasonably question whether U.S. export controls in their present form really contribute to any significant extent to national security. The U.S. approach to export controls is considered unnecessarily broad by the western Europeans. Indeed, as a recent study by the Rand Corporation reportedly asserts,[11] export controls, other than those relating to strictly military applications, may be counter-productive, in that they may force the Soviet Union to find its own solutions to technological problems, rather than

[11]International Herald Tribune, August 19, 1981.