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United Technologies Corporation and Subsidiaries Agree to a $75 Million-Plus Settlement of Export Control Violations

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United Technologies Corporation (UTC), its U.S. subsidiary Hamilton Sundstrand Corporation (HSC) and its Canadian subsidiary Pratt & Whitney Canada Corp. (PWC) have agreed to pay more than $75 million as part of a "global settlement" with the U.S. Departments of State and Justice to address illegal arms exports to China (in particular, illegal exports of U.S.-origin software used in the development of China's military attack helicopter, Z-10), false and belated disclosures to the U.S. government about these illegal exports, and other outstanding export violations. Roughly $20.7 million of this sum is to be paid to the Justice Department related to three criminal charges.[1] The remaining $55 million is payable to the State Department as part of a separate consent agreement to address 576 alleged violations of the Arms Export Control Act (AECA) and the International Traffic in Arms Regulations (ITAR).[2] Up to $20 million of this penalty can be suspended if applied by UTC to remedial compliance measures. The UTC settlement underscores the U.S. government's heightened vigilance over illegal exports of sensitive U.S. technology, especially to China.

I. Key Facts

Since 1989, China has effectively been subject to a U.S. arms embargo and, consequently, the State Department has denied any requests to export U.S. defense articles and/or defense services to that country. Beginning in the 1990s, China sought to develop a military attack helicopter under the guise of a civilian helicopter program in order to secure Western assistance. The Z-10, developed with assistance from Western suppliers, is China's first modern military attack helicopter.

During the developmental phases of China's Z-10 program, each Z-10 helicopter was powered by engines supplied by PWC. Between 2001 and 2002, PWC delivered 10 of these developmental engines and related electronic engine controls (EEC) manufactured by HSC to China. Between 2002 and 2003, HSC modified its EEC software to fine tune the engine's performance as per PWC's request. Since the modifications were made for a military application — even though HSC at the time did not know that the modifications were for the development of the Z-10 helicopter — the EEC software became subject to the State Department's licensing jurisdiction. Nevertheless, such software was exported to PWC in Canada, which then re-exported it to China, without the requisite State Department licenses.

According to the three-count criminal information filed by the Justice Department (Criminal Information), PWC knew from the start of the Z-10 project in 2000 that the Chinese were developing a military attack helicopter and that supplying it with U.S.-origin software would violate the AECA and the ITAR. Although HSC had believed that it was providing its EEC

1 The Justice Department filed a three-count criminal information charging UTC, PWC and HSC. Count One charges PWC with violating the Arms Export Control Act in connection with the illegal export of defense articles to China for the Z-10 helicopter. Count Two charges PWC, UTC and HSC with making false statements to the U.S. government in their belated disclosures relating to the illegal exports. Count Three charges PWC and HSC with failure to timely inform the U.S. government of exports of defense articles to China. While PWC has pleaded guilty to Counts One and Two, the Justice Department has recommended that the prosecution of UTC and HSC on Count Two and PWC and HSC on Count Three be deferred for two years, provided the companies abide by the terms of a deferred prosecution agreement.

2 This settlement represents the second-highest civil settlement in the State Department's history after the $79 million settlement with BAE Systems Plc in 2011.

software to PWC for a civilian helicopter in China, according to the Criminal Information, it learned that there might be an export problem by early 2004 and stopped working on the Z-10 project. UTC also began to ask PWC about the exports to China for the Z-10. Regardless, PWC on its own — without HSC's assistance — modified the EEC software and continued to export it to China through June 2005.

According to the Justice Department, PWC's illegal conduct was "driven by profit." PWC anticipated that its work on the Z-10 military attack helicopter in China would open the door to a far more lucrative civilian helicopter market in China, which PWC estimated to be worth as much as $2 billion.

Significantly, UTC, HSC and PWC failed to make any disclosure to the U.S. government regarding the illegal exports to China for several years and only did so after an investor group queried UTC in early 2006 about whether PWC's role in China's Z-10 attack helicopter might violate U.S. laws. In July 2006, the companies made an initial disclosure to the State Department regarding the illegal EEC software exports to China, with follow-up submissions in August and September 2006. The 2006 disclosures, however, contained numerous false statements. According to the Criminal Information, among other things, the companies allegedly falsely asserted that they were unaware until 2003 or 2004 that the Z-10 program involved a military helicopter. According to the Criminal Information, contrary to their statements, by the time of the disclosures, all three companies were aware that PWC officials knew at the project's inception in 2000 that the Z-10 program involved a military attack helicopter.

Since the discovery of the illegal exports of EEC software in support of China's development of the Z-10 helicopter, UTC and several of its subsidiaries, including HSC and PWC, have conducted internal reviews of their compliance with the AECA and the ITAR and have filed numerous voluntary disclosures to the State Department. In many of those disclosures, the companies highlighted for the State Department, as mitigating factors, the corrective actions that they planned to undertake. Nevertheless, according to the consent agreement, each disclosure was followed by further violations and additional subsequent disclosures. According to the deferred prosecution agreement, since 2006, UTC and HSC have filed a combined 222 voluntary disclosures to the State Department. Early remedial compliance measures adopted by these companies were evidently not effective in preventing future violations. In total, 576 alleged violations are identified in the consent agreement, which include the following types of violations:

- unauthorized access by non-U.S. persons (*e.g.*, non-U.S. licensees, non-U.S. subcontractors and unauthorized employees (including information technology employees)), to defense articles and technical data;
- manufacturing and/or exporting of defense articles and defense services under expired or unexecuted agreements (*e.g.,* Manufacturing License Agreements, Technical Assistance Agreements, and Warehouse and Distribution Agreements);
- exports exceeding the authorized dollar values; and
- failure to file timely sales reports.

II. Lessons to Be Learned

The UTC global settlement underscores the importance of a robust compliance program to prevent, detect and remediate any violations of export control laws or regulations. It also highlights the importance of making accurate, complete and timely disclosures to government regulators and investigators as soon as possible upon discovery of such violations. The following are key lessons to be learned:

- ***Serious Financial Consequences***. The amount of the settlement is substantial but could have been even larger. Based on the number of charges cited in the consent agreement, the maximum civil penalty could have been $288 million and could have resulted in an imposi-

tion of administrative debarment and, consequently, resulted in UTC and its affected subsidiaries being prohibited from exporting any U.S. defense articles and/or defense services.

- ***Importance of Voluntary Disclosure and Cooperation.*** The government appears to have reduced the penalties to UTC, PWC and HSC for, among other things, voluntarily disclosing almost all of the violations and for substantial cooperation with the government. Significantly, the State Department stated that it will not impose an administrative debarment of the companies due to their voluntary disclosures, cooperation with the State Department's reviews, and implementation or planned implementation of extensive remedial measures.

- ***Voluntary Disclosures Need to Be Timely.*** The Criminal Information and the consent agreement highlight the fact that there was a two-and-a-half year delay between HSC's discovery in early 2004 of potential violations of the AECA and the ITAR related to the unauthorized export to Canada and re-exports to China of its EEC software and when such potential violations were reported to the State Department in the middle of 2006. After its discovery of the potential violations in 2004, HSC halted its provision of modified EEC software to PWC in Canada for use in the development of China's Z-10 program. However, up until the middle of 2005, PWC continued to modify HSC's EEC software on its own and provided it to China, without the requisite State Department licenses. Although not explicitly stated in the consent agreement, timely disclosure of the violations to the State Department and implementation of remedial measures may have prevented the continued violations of the AECA and the ITAR by PWC.

- ***Turning a Blind Eye Does Not Make the Problems Go Away***. The Criminal Information gives examples of instances where various employees of PWC raised concerns relating to potential violations of U.S. export controls. According to the Criminal Information, rather than seriously tackle these concerns, the employees turned a blind eye and forged ahead with the development of China's Z-10 helicopters. In particular, according to the Criminal Information, when the Chinese claimed that a civil version of the helicopter would be developed in parallel, PWC marketing personnel expressed skepticism internally about the "sudden appearance" of the civil program. PWC nevertheless saw an opening for it "to insist on exclusivity in [the] civil version of this helicopter" and stated that the Chinese would "no longer make reference to the military program." Adequate training regarding the requirements of U.S. export control laws, including the AECA and the ITAR, and the consequences of violating such laws may have put on the necessary brakes to prevent the unauthorized exports of the modified EEC software to China.

- ***End-Use Diligence.*** Once HSC suspected that its modified EEC software was being used for Chinese military applications, it required PWC to provide an end-use statement. As a result, HSC was able to verify that its modified EEC software was being used for Chinese military applications and, thus, could not be exported to China under the AECA and the ITAR. Whether explicitly required by law or not, in order to ensure that their products will not be used for military purposes in contravention of U.S. export control laws, companies should consider requiring end-use statements — even from affiliated companies — as part of its end-use diligence.

- ***Remedial Measures Must Be Accurate and Effective.*** According to the consent agreement, certain UTC subsidiaries, including HSC, conducted numerous compliance reviews and identified hundreds of potential export control violations, which were then disclosed to the State Department. In the disclosure documents, these compa-

nies assured the State Department that remedial measures had been adopted or would be adopted. According to the consent agreement, certain of the remedial measures laid out in the disclosure documents either were not implemented or were inadequate. Consequently, each voluntary disclosure was followed by further violations and additional voluntary disclosures. According to the deferred prosecution agreement, since 2006, UTC and HSC have filed a combined 222 voluntary disclosures to the State Department. Before offering remedial measures to obtain mitigation credit, careful consideration must be undertaken to ensure that such remedial measures (i) will, in fact, achieve the stated goals, (ii) will be supported by adequate plans, resources and accountability for timely execution, and (iii) will be tracked to completion and adequately documented. Ineffective remedial measures will not be given any mitigating credit by the enforcement agencies and will likely result in continued violations.

- ***Institution of a "Cradle-to-Grave" Automated Export Tracking System.*** Numerous unauthorized exports of defense articles were identified by UTC and HSC in their voluntary disclosures to the State Department — a substantial number of which were the result of misclassifications of ITAR-controlled items. The proper classification of products and related technology and components from cradle to grave is essential to building a robust compliance program. To that end, capturing information related to commodity jurisdiction determinations and export classifications in one central repository is critical and highly recommended. Furthermore, export classifications must be systematically monitored and continuously updated to reflect any changes in the applicable laws, technical parameters and/or end-uses.

- ***Need to Vigilantly Monitor Compliance With Agreements and Licenses Approved by the State Department***. According to the consent agreement, UTC's subsidiaries, including HSC, identified hundreds of violations relating to agreements approved by the State Department. UTC acknowledged that these violations were the direct result of the lack of compliance measures to monitor the requirements and parameters set forth in the agreements (*e.g.,* Manufacturing License Agreements, Technical Assistance Agreements, and Warehouse and Distribution Agreements). Once the State Department approves agreements or issues licenses for the export/re-export of defense articles, that does not end the compliance requirements. Vigilant monitoring of agreement and license provisos and parameters should be built into any robust compliance program.

- ***Importance of Regular Compliance Self-Assessments, Reviews and Audits.*** Had PWC conducted adequate and regular export control compliance audits of its Z-10 development program, U.S. export controls issues may have been investigated and elevated to senior management earlier in the process and this may have prevented some of the violations. It is important that a robust compliance not only prescribe detailed standards at the business unit level, but also require periodic self-assessment, annual reviews and independent internal audits of those standards.

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Companies that deal with goods and/or technology that may be used in military applications must ensure that they have the requisite compliance infrastructure to ensure that they do not run afoul of the applicable export control laws and regulations — especially if their products and services are destined for China. The failure to do so can result in violations of U.S. laws and regulations and, consequently, serious penalties and reputational harm.