

## China—Law Firms

# Exporting Commercial Goods And Technology To China Under The New Military End-Use Restrictions

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This summer, the Department of Commerce Bureau of Industry and Security (BIS) implemented controversial regulations expanding the types of commercial products requiring a license for export to China.<sup>1</sup> Under the regulations, exports of certain controlled U.S. goods and technology that previously could be shipped to China without a license now require an export license if the goods or technology will have a “military end-use” in China. To offset the controversial restrictions, the regulations also allow certain otherwise licensable exports to be made to “Validated End-Users” in China and India approved by BIS.

When originally proposed, the China Rule was hotly contested by many in the U.S. business community because of the ambiguity and effect on U.S. business for items uncontrolled by most other countries. Although BIS made some concessions by limiting the scope of the rule, it believes that the rule targets a carefully considered list of military useful items not widely available on the world markets.<sup>2</sup> Such proposition is in line with the Bush Administration’s broader strategy to deny or delay technological development and enhancement of the Chinese military. Almost a year after BIS initially published its proposal for rule making, and after receiving over 1,000 pages of comments from the industry, final regulations were issued this summer.

### When Do The Additional Restrictions Of The China Rule Apply?

The additional licensing restrictions apply if: (1) a product, software, or technology is identified in the expanded list of controlled items; and (2) the U.S. exporter knows or has reason to know that the item is going to a military end-use.

### What Additional Items Are Controlled?

Expanded List of Controlled Items. All products, software, and technology controlled under the China Rule are items already designated as controlled items on the Commerce Control List (CCL); however, prior to issuance of this regulation, they could generally be exported without a license to any country, entity, or individual, except for embargoed countries and certain prohibited end-users or end-uses. These items include certain products, software, and associated technology in twenty categories, including:

- depleted uranium
- carbon fiber and prepreps for use in composite structures
- hydraulic fluids
- bearings and bearing systems
- computer and non-computer controlled machine tools used for generating optical quality surfaces
- dimensional inspection or measuring equipment

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- oscilloscopes
- flash X-ray machines and pulsed power systems
- high performance computers (exceeding 0.5 Weighted TeraFLOPS) (this would not include most available desktops or laptops, but may include certain servers)
- radio equipment that meets MILSPEC requirements or uses QAM
- phased array antennas
- lasers
- optical sensing fibers
- airborne communication and inertial navigation systems
- underwater systems
- aircraft
- aero gas-turbine engines
- microprocessors with certain performance criteria (these were already controlled for military end-use to a number of countries, including China, under existing regulations)

Unlisted Items Are Generally Not Subject to the Rule. These regulations do not directly place any additional restrictions on commercial items that are not identified above, or that are not specifically listed on the CCL. However, even these items may be restricted if, for example, the U.S. exporter knows or has reason to know the item will be used:

- in certain nuclear activities
- in a missile, space launch, or unmanned aerial vehicle program
- in chemical or biological weapon production
- by an entity identified on one of the many U.S. barred entity lists

Furthermore, BIS indicated that it may notify individual companies or publish lists of items subject to additional restrictions. The implications of this are unclear, but it may mean BIS will indirectly require additional due diligence or license requirements for certain items that it believes are likely to be used by the Chinese military. In addition, BIS recently expanded the criteria for designating companies on the “entity list,” which bars virtually all exports to that entity.

Knowledge of a Military End-Use. An exporter will be deemed to have knowledge of a military end-use if:

- the company has actual knowledge of a military end-use
- the company “should have known” of such military end-use
- if the product is specifically identified by BIS as being intended entirely or in part for military end-use in China
- if a particular transaction or entity in China is identified by BIS as being at risk for diversion to a military end-user.

### What Constitutes A Military End-Use?

An item is exported for a military end-use if:

- the item will be incorporated into a piece of military equipment, software, or technology
- the item will be for the “use,” “development,” or “production” of military items,

as these terms are defined by BIS

- the item is exported for the “deployment” of civil or demilitarized aircraft and aero gas-turbine engines, if such items will be assigned to Chinese military units.

### Will Licenses Be Granted?

If the product is on the China Rule list and will be exported for a military end-use, a company can apply for a license, but grants of such licenses are likely to be few and far between, and likely subject to a lengthy interagency review process.

No License Exceptions. Generally, no license exceptions will be applicable where there is a military end-use.

Presumption of Denial. BIS has adopted a formal “presumption of denial” for any license applications for the export of all items controlled for national security, chemical, biological proliferation reasons, or where the item would make a direct and significant contribution to the Chinese government’s military capabilities, including major weapon systems which contain night vision equipment, and the broad category of Command Control Communications Computer Intelligence Surveillance and Reconnaissance (C4ISR).

Required End-User Statement. An “end-user statement” will be required for any licensable export to China if it exceeds \$50,000 in total value, except for certain controlled cameras and computers where the limit is \$5,000. This end-use certificate is issued by MOFCOM, the Chinese Ministry of Commerce. Since this requirement was not coordinated with MOFCOM, it is unclear how easy it will be to obtain such certificates.

### What Is The Validated End-User (VEU) Program?

The one “carrot” in these regulations is a new provision that allows a Chinese (and now Indian) company to receive advance screening as a “validated end-user.” A VEU company can receive items that would otherwise require a license to export to China or India. In theory, this could apply to any item, provided the Chinese company intends to use the item for a bona fide civil purpose at its facility, consume it during use, or transfer it subject to a BIS license. However, as a practical matter, very sensitive technologies are unlikely to fall under the VEU program.

Reduction in Licensing. Since certain industries represent a significant portion of the technologies currently licensed, BIS expects that the VEU program may reduce the number of licenses by as much as 30 percent based on the dollar value of the licensable exports.

Initial VEU’s Approved. In October 2007, BIS published the names of the first five companies who have received VEU status.<sup>3</sup> By BIS own account, these five companies represent 20 percent of all export licenses issued for China in the last few years. Four of the five approved entities are in the semiconductor industry, and one is a subsidiary of a U.S. aerospace company that manufactures composite aircraft materials and related tooling. Another five applications for the VEU status are currently pending.

MOFCOM Reaction. Immediately after BIS released the names of the approved companies, the Chinese Government issued a directive stating that the United States should not visit for VEU screening any companies registered in China without prior permission from MOFCOM. U.S. officials

have downplayed the Chinese move pointing that the directive simply requires approval rather than formulating a denial policy.

### Tips For Complying With The New China Rule

Any U.S. company exporting to China needs to review its existing products and customers to determine whether it is affected by the new regulations. The hardest part of compliance will be assessing what steps need to be taken to be reasonably assured the item is not going to a military end-use. Some measures to consider are the following:

Contractual Requirements / Customer Certification. A U.S. company should consider including end-use restrictions as a standard contractual provision, or as part of a separate customer certification form.

Additional Due Diligence on New Customers. When supplying controlled products, companies should consider conducting some level of due diligence, particularly given the wide definition of military end-use. For example:

- for certain controlled manufacturing or test equipment it may be possible to ascertain whether the Chinese customer manufactures goods for the Chinese military
- while sales to companies owned or linked to the Chinese military are not prohibited, this should be a red flag triggering additional due diligence.

Documenting Bona Fide Commercial Use on License Applications. It is not unlikely that the “presumption of denial” of licenses will, as a matter of practice, “bleed over” to applications for commercial uses in China, requiring exporters to go to great lengths to demonstrate the bona fide commercial use of its Chinese customers.

### Conclusion

Because the products, software, and technology on the expanded list of controlled items are not generally subject to export restrictions to most countries, these new regulations create an additional administrative burden on companies exporting to China. In addition, underlying this new regulation is a policy goal of trying to prevent U.S. products and technology from being used to enhance the Chinese military. In this light, virtually any sale to the Chinese military or its wide-flung commercial enterprises is potentially a suspect. It may be that BIS’ recent expansion of the criteria for designating entities on the entity list is a precursor to allow BIS to add to the list certain Chinese entities closely associated with the Chinese military.

While U.S. industry and Chinese news sources remain highly critical of these new restrictions, to its credit, BIS made significant efforts to engage U.S. exporters in formulating the regulation. As ambiguities are raised by those in the affected industries, BIS is likely to provide additional interpretive guidance.

<sup>1</sup> Revisions and Clarification of Export and Reexport Controls for the People’s Republic of China; New Authorization Validated End-User ; Revision of Import Certificate and PRC End-User Statement Requirements, 72 Fed. Reg. 33646 (June 19, 2007).

<sup>2</sup> See “Commerce Department Announces Updated Export Controls for China,” BIS Press Release (June 15, 2007).

<sup>3</sup> Approved End-Users and Respective Eligible Items for the People’s Republic of China Under Authorization Validated End-User, 72 Fed. Reg. 59164 (Oct. 19, 2007), as amended in 72 Fed. Reg. 61512 (Oct. 31, 2007).