TRANSACTION ADVISORS

Trade, Tariffs, and Deals: Keeping up with the Speed of M&A

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Introduction

Rising trade tensions between the U.S. and China and shifts in global trading regulations multiply the risks of fines and sanctions. This means that during M&A transactions, buyers and sellers should be hyper-vigilant in vetting targets for undisclosed—and sometimes unknown—liabilities.

In one case, a European company was set to acquire a U.S.-based manufacturer whose products were made from imported Chinese components. The target estimated its U.S. tariff liability at approximately 10 percent of the total cost of the finished goods. But during due diligence, it emerged that the company had not recognized the 25 percent tariff on its Chinese components. That translated into a 50 percent reduction in the company's valuation and the seller was forced to cut its price substantially.

The risk of tariff surprises continues to grow as U.S.-China trade disputes drag on, the implementation of the new United States- Mexico-Canada Agreement (USMCA) and Britain uncouples from the European Union. Companies can also get tripped up by accidentally violating the growing list of sanctioned parties. And the post COVID-19 race to find more resilient supply chains exposes U.S. companies to additional risks. "People are discovering that there are these trade exposures and they are not sure everything is in line in terms of compliance with different sets of national regulations," notes Alexander Kazan, a managing director of the Eurasia Group, a geopolitical risk advisory firm.

In this article, we share insights on growing risks of trade violations and how to find and mitigate them. We describe the due diligence practices that can keep buyers from inheriting a costly trade violation. And we show how trade diligence can also uncover value.

How to Identify Import Risk

In the U.S., the most common risk is duty exposure for importers. Duties are determined based on the Harmonized Tariff Scheduled ("HTS") classification of the product. Every import into the U.S. is assigned a 10-digit code and that, in conjunction with the country of origin, determines its duty rate. But getting it right is not as straightforward as one might expect.

The current tariff regimes focus on countries where products originate. If an importer does not correctly identify both the appropriate HTS and the country of origin, inaccurate declarations may be made to Customs and Border Protection (CBP). The import environment is further complicated by the various exclusions and duty-savings programs that are used to mitigate the impact of these duties. However, these programs are also complex and have varying requirements. For example, customs violations have a five-year statute of limitations, so an acquisition can leave a buyer responsible for errors that occurred within this window. In the U.S., punitive tariffs under Section 232 (for national security purposes) and Section 301 (for unfair trade practices) increase costs by 7.5 to 25 percent. That's bad enough for earnings before interest, taxes, depreciation and amortization (EBITDA), but non-compliance can unnecessarily increase costs and disrupt operations.

Classification + Country of Origin = Duty Rate

→ Duty Rate X Value = Duties Owed

Managing Section 301 tariff exclusions properly is tricky. If an exclusion is claimed, in most instances the product must satisfy the classification and the product description. In one M&A transaction, the seller had claimed Section 301 exclusions to mitigate duties on its imported products. But trade advisors on the diligence team discovered that the exclusion did not apply to the company's product. They also noted that the product had been misclassified, raising the duty from 4.6 percent with no punitive tariffs to 6 percent plus 25% punitive tariff, resulting in an actual duty rate of 31%. Not only was the potential annual duty-exposure much greater than the valuation reflected, the importer would also have to repay any owed duties. Fortunately, this error was identified before the deal closed.

One of the most complicated but critical subjects for importers is accurately determining country of origin. Almost all the punitive tariffs (as well as anti-dumping/countervailing duties) contain a country- of-origin component. In response to the punitive tariffs imposed on a range of Chinese goods, some U.S. companies have shifted production to other Asian countries. But declaring that products are "Made in Vietnam," when they consist of subassemblies shipped from China may not comply with U.S. country-of- origin rules, which require that a product undergo "substantial transformation" before a particular country can be declared as the point of origin. CBP has recently increased its scrutiny of country-of- origin declarations, resulting in a spike of formal inquiries and, potentially, audits.

Exporters face their own challenges in dealing with multiple federal agencies and highly complex regulations. When working with exporters, it is imperative to understand their complete supply chain because U.S. export regulations are extraterritorial. In other words, a U.S. company with an overseas presence that exports products, even from another country, without an authorization or license, or transacts with a sanctioned party, may be subject to U.S. fines and penalties. This can easily occur if strong internal controls are not in place. Even companies in seemingly innocuous industries, such as consumer goods, have paid significant fines for dealings with sanctioned parties.

Violations of the Export Administration Regulations ("EAR") can result in administrative penalties exceeding $300,000 per violation or twice the value of the transaction. Penalties can include denial of export privileges, although that is rare. Criminal penalties can exceed $1 million per violation and up to 20 years in prison, or both. Additionally, dealing with a sanctioned party—individuals named by the Department of the Treasury's Office of Foreign Assets Control ("OFAC"), or a party located in a sanctioned geographic area --can result in civil fines and penalties exceeding $300,000 per violation or twice the value of the transaction. This information may not come to light without specific inquiries directed to the appropriate personnel in the seller's procurement division.

Many of these traps are avoidable by involving trade professionals early in the due diligence process. While the impact of tax positions remains a focus of due diligence reviews, a change of mindset is needed to treat trade issues with the same rigor. A "temperature check" or "rapid diagnostic" can be taken of the selling company to assess potential trade and customs risks. This may involve a review of import and/or export data to assess the trade profile, including a review of potential anomalies.

The next step would be using the initial analysis to have a conversation with the seller's stakeholders, including targeted questions to uncover unreported liabilities and hidden costs that might have an impact on deal valuations. This light-touch analysis is often sufficient to identify red flags—but in a few cases, a more in-depth analysis covering global activity is required to determine if there are compliance challenges. Armed with this information, the deal team can move forward in quantifying the impact and draft immediate post-closing remediation into its first 100-day plans. This may include requiring that the seller assume responsibility for any violations that occurred within the statutory timeframe through indemnity agreements, developing specific escrow buckets or possibly, purchase price concessions.

Trade diligence for importers is not just for acquirers. Companies considering selling themselves or carving out a business can improve the buyer's confidence and expedite the closing of a deal by doing their own trade diligence and clearly documenting tariff and trade exposure. Prospective sellers may consider summarizing their import profiles, including annual imported value, the amount they have spent on duties, top HTS classifications, use of free trade agreements and duty savings programs. If Section 301 exclusions were claimed for products with China as the country of origin, the seller should be prepared to explain why the exclusion is applicable and the total duty saved.

On the export side, the seller may consider validating that its products are not controlled for export purposes and that appropriate licenses are in place. Management should also be prepared to provide an overview of its controls to prevent transactions with sanctioned parties. Finally, if disclosures were made for either import or export violations, the selling company should be prepared to provide copies. As part of this process, sellers need to align financial, operating and legal advisers to canvas the risks and develop an integrated position.

The table below summarizes certain risks that are frequently identified during due diligence reviews.

When the Seller's Violations become the Buyer's Problem

As illustrated in the case of the imported Chinese parts, without careful diligence, a buyer can unwittingly take on a liability that erases deal value. Successor liability allows parties injured by a previous owner to seek damages from a subsequent owner that either acquired or merged with the business that caused the injury. Buyers should realize, however, that compliance issues will not disappear following a sale.

Here's how successor liability can work. In 2017, Dentsply Sirona, Inc. agreed to pay $1,220,400 to settle charges that it had made 37 unlicensed shipments of dental equipment to Iran in violation of U.S. sanctions.[1] Although the exports had been made by two Dentsply subsidiaries before it merged with Sirona, OFAC applied successor liability and held DSI liable for the violations.[2]

Importers can also be subject to successor liability. In U.S. v. Adaptive Microsystems, the U.S. Court of International Trade found that a company that acquired the assets of the bankrupt Adaptive Microsystems could be responsible for its $6.8 million in unpaid duties and penalties. The court made this determination even though a state court had explicitly found that the acquiring company would not take on Adaptive Microsystem's liabilities. The determination by the CIT revolved around a highly technical state law issue and the Court did not specifically find that the acquiring company would be responsible for the duties and penalties. But it is reminder that CBP is willing to pursue violations even after an acquisition.[3]

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[1] U.S. Dept of the Treasury, Civil Penalties and Enforcement Information, Enforcement Information for December 6, 2017 available at *https://home.treasury.gov/system/files/126/20171206_dentsply.pdf*

[2] *Do Due Diligence or Penalties May be Due*, Export Law Blog (Dec. 13, 2017), last accessed Sept. 11, 2020.

[3] U.S. v Adaptive Microsystems, LLC, 914 F.Supp.2d 1331 (Ct. Intl. Trade 2013); Victoria E. Murphy and Gregory S. McCue, *The curse of the zombie importer: defunct company's CBP duties and penalties haunt successor* (July 19, 2013) available at https://www.lexology.com/library/detail.aspx?g=85cd6c22-788c-4293-b775-33bbbc7908ff; *Buying Import & Export Violations: Successor Liability Risk & Its Impact on the Bottom-line*, Braumiller Law Group (Jan. 23 ,2014) available at https://www.braumillerlaw.com/buying-import-export-violations-successor-liability- risk-impact-bottom-line/.

Import	Export
Incorrect HTS classification or country of origin	Not classifying or incorrectly classifying exported products
Inaccurate import valuation	Inaccurately managing or decrementing export licenses
Retroactive transfer pricing adjustments that are not reported to local customs	No or limited restricted party screening
Provision of raw materials/equipment to suppliers for free or at a discount	Not managing deemed export risks
Noncompliant free trade agreement claims	
Incorrect application of Section 301 exclusions	

Managing Trade Risk, Post-Close

Of course, the due diligence process is not the last opportunity to spot possible trade risks. Even after a deal closes, experienced trade analysts can identify trade risks and mitigate them. This could involve a thorough assessment of trade practices, including a review of processes and procedures, use of duty savings programs, and valuation and classification errors. If discrepancies are identified before Customs opens an investigation, the agency allows importers to submit a prior disclosure in which any owed duties are remitted without penalties.

Sometimes, a review will turn up hidden value. In one case, it was determined that a small error in an exclusion request resulted in CBP denying an exclusion for a steel product. Correcting that error increased enterprise value by several million dollars.

A deep dive can also benefit sellers who want to maximize value. During a recent diligence review, the diligence team identified potentially incorrect NAFTA claims with unpaid duties estimated to be approximately $12 million. Obviously, this issue had the potential to substantially reduce the deal's valuation or tank it altogether. However, the deal team brought in experienced trade advisors to validate the finding. A deeper investigation found that although there were errors, they totaled only approximately $4 million. As a result, the deal moved forward on the planned timeline.

Looking Ahead

Many of these traps are avoidable by involving trade professionals early in the due diligence process. While the impact of tax positions remains a focus of due diligence reviews, a change of mindset is needed to treat trade issues with the same rigor. A "temperature check" or "rapid diagnostic" can be taken of the selling company to assess potential trade and customs risks. This may involve a review of import and/or export data to assess the trade profile, including a review of potential anomalies.

The next step would be using the initial analysis to have a conversation with the seller's stakeholders with targeted questions to uncover unreported liabilities and hidden costs that that might have an impact on deal valuations. Typically, this is sufficient to identify red flags--but in a few cases, a more in- depth analysis covering global activity is required to determine if there are compliance challenges. Armed with this information, the deal team can move forward in quantifying the impact and draft immediate post-closing remediation into its first 100-day plans. This may include requiring that the seller assume responsibility for any violations that occurred within the statutory timeframe through indemnity agreements, developing specific escrow buckets or, possibly, purchase price concessions.

Additional challenges may be on the horizon with deal valuations, further exacerbated by the post COVID-19 economic conditions. Now more than ever, teams must exercise added vigilance on both sides of any deal.

These risks do not have to delay, prevent, or alter a deal if they are managed correctly, whether by the seller or the buyer. Involving the right trade specialists can help a deal team come to the best conclusion to protect the buyer's interest and reduce the risk of unforeseen penalties. The seller may also consider engaging a third party to review its trade posture prior to beginning negotiations so it can adapt its strategy accordingly and limit surprises. We expect that the global trade environment will become even more complex in the months and years ahead, but pitfalls can be avoided by working with trade specialists at each stage of a successful M&A strategy.

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