Mergers, Acquisitions And Due Diligence In International Trade

By Robert A. Shapiro

The purchase of the assets of another corporation may now also include the acquisition of significant international trade related regulatory liabilities even if the acquisition is structured as a purchase of assets only. So states the finding of an administrative law judge who examined the charges of the Bureau of Industry and Security (BIS) against three successor corporations.

Issues of successor liability for international trade matters are not limited to enforcement actions by BIS. International trade laws are also enforced by the Office of Foreign Asset Controls (OFAC) at the Department of Treasury and the Office of Defense Trade Controls (ODTC) at the Department of State. Perhaps emboldened by the successful settlement of charges by BIS, ODTC recently issued a charging letter to The Boeing Company based on transactions by Hughes Space and Communications that occurred prior to the purchase of Hughes by Boeing. Boeing settled these charges for $32 million. Officials from the Bureau of Customs and Border Protection (CBP) have suggested that they are giving serious consideration to the BIS arguments regarding successor liability. Given the significance of the penalties that may be imposed by CBP and the prevalence of international trade in many business operations, companies engaged in merger and acquisition activities are well advised to include a thorough review of the target company's customs activities as a component of its due diligence activities.

Successor Liability

Recently, the Bureau of Industry and Security (BIS) charged three companies for the violation of the Export Administration Regulations. While such a charge is not necessarily news, BIS asserted that these companies were primarily liable as successors in interest for violations that occurred prior to their acquisition of a predecessor Company.

The matter was referred to a U.S. Coast Guard administrative law judge to determine, in part, whether the Export Administration Regulations provided a basis for successor liability. The ALJ initially cited the federal rules of statutory construction which state that when the term company or association are used in reference to a corporation, they are deemed to include successors and assigns. Successor liability ultimately rested, however, on the ALJ's application of the theory of "substantial continuity." In this analysis, the ALJ considered whether the successor (1) retains the same employees, supervisory personnel and the same production facilities; (2) continues to produce the same products; (3) retains the same business name; (4) maintains the same assets and general business operations; and (5) holds itself out to the public as a continuation of the previous corporation. This last factor may be most telling since under the facts considered, the successor continued the practices of the predecessor corporation without interruption. Finally, on a policy basis, the ALJ held that a determination that successor liability was well founded because the predecessor corporation was no longer still viable, and the public interests of protecting the national security would be hampered if a change in corporate form or ownership could be used to avoid liability for past acts.

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Customs Penalties

The penalty decisions of the Bureau of Customs and Border Protection, (CBP), are generally less often publicized than those of the BIS, but officials of CBP have indicated their willingness to follow the lead of BIS when faced with a similar factual situation. Such a result may be anticipated because of the policy relationship stated between successor liability and national security, CBP's new role as a security agency within the Department of Homeland Security, and the fact that the BIS decision was made by an ALJ of the Coast Guard, which is now also within the Department of Homeland Security.

The customs laws of the United States clearly place the burden on the importer to exercise reasonable care in entering merchandise into the commerce of the United States. The fact that customs duties have been reduced, or eliminated, for many imported goods does not alter this requirement, and may have little effect on CBP's ability to issue penalties. In some instances, statutory penalties may range from 20 to 100 percent of the value of the imported merchandise, with CBP capable of assessing penalties against merchandise imported over a five-year period.

Due Diligence In Customs Matters

CBP's audit procedures provide a valuable roadmap to the procedures for undertaking a due diligence examination of a target company with significant international trade activities. Unlike other due diligence operations, such a review does not necessarily require extensive and labor intensive document review, and in many instances an accurate estimate of the potential liability can be extrapolated from very limited information.

A structural analysis of the target company provides an initial indication of potential problems. A lack of involvement of the management of the company in customs compliance should be seen as a red flag; the day-to-day customs compliance activities should be clearly delegated from a senior executive. The customs compliance function is necessarily interdisciplinary, and its position within the organizational structure of the company should provide it with access to the necessary information and sufficient authority to be able to elicit support from such varied functions as accounting, engineering, design, purchasing, shipping and receiving, audit, and often other corporate functions. The presence of documented import/export compliance procedures is essential and records should demonstrate that these procedures are being followed. Finally, governmental and private records should be reviewed to determine whether CBP has issued any rulings to the target company about any of its activities.

Every importation into the United States becomes the subject of a declaration to CBP regarding the nature, value, and origin of the transaction and the imported merchandise. The determination of these factors are detailed and complex, and cannot be done on an *ad hoc* basis. At a minimum, therefore, a due diligence review should include an analysis of a representative sampling of the entry documentation to determine whether it has been properly prepared.

For classification decisions, the documentation must demonstrate that the person responsible for the entry activities had access to, and reviewed, necessary information including the component materials used to produce the imported article, its use, where and how it was manufactured, and what additional manufacturing activities may be performed on the imported article in the United States.

For purposes of valuation, the customs compliance function may need access to information regarding any designs, molds, tools or other materials and information that may have been provided to the manufacturer. Information regarding the details of the purchase agreement may also be needed. Important factors include: whether an agent was involved in the sale or purchase of the merchandise, whether the purchase agreement included any additional proceeds from subsequent sales in the United States, whether any other payments were made that inured, directly or indirectly, to the benefit of the seller, and whether the imported merchandise was subject to any royalty or license fees.

Duty-free importations should not be immune from examination. Some duty-free declarations require the possession of official certifications, the absence of which will result in the imposition of duties. Others require the meeting of certain conditions that can only be reasonably met if the importer has searchingly queried the supplier as to the sources of the constituent materials, the method of manufacture, and the shipping methodology. Any failure to accurately demonstrate that the imported merchandise is eligible for duty-free treatment can result in the assessment of the duties that should have been paid plus a penalty.

NAFTA should be of particular concern. While this agreement has resulted in substantial duty savings in many instances, it is also an extremely complex agreement. For an imported article to qualify for duty-free treatment, one often needs to know the origin, classification and value of the parts or substances used to produce the imported article, as well as the classification and value of the imported article itself. This analysis may be required for goods imported into the United States from the other NAFTA countries as well as for goods manufactured in the United States and exported to another NAFTA country for which the target company issues certificates of origin. Once again, substantial penalties and additional duties may result from a failure to accurately make this determination.

Consequences Of The Review

While successor liability issues focus primarily on the risk associated with the past activities of the target company, the discovery of any potential violations are likely to extend to the post-merger or acquisition activities if the acquiring company plans on substantially continuing the operations of the target company. As discussed above, the continuation of the business practices of the target company, with its potential violations, may be an important factor in support of a finding of successor liability. Just as importantly, however, the continuing operations can create new and independent liability on the part of the successor company. Thus, an international trade due diligence review is essential to protect the value of the merger or acquisition, and also to preserve the revenue flow from continuing activities. Given the magnitude of the potential penalties and the prevalence of international trade in almost every business, due diligence in this area is essential.