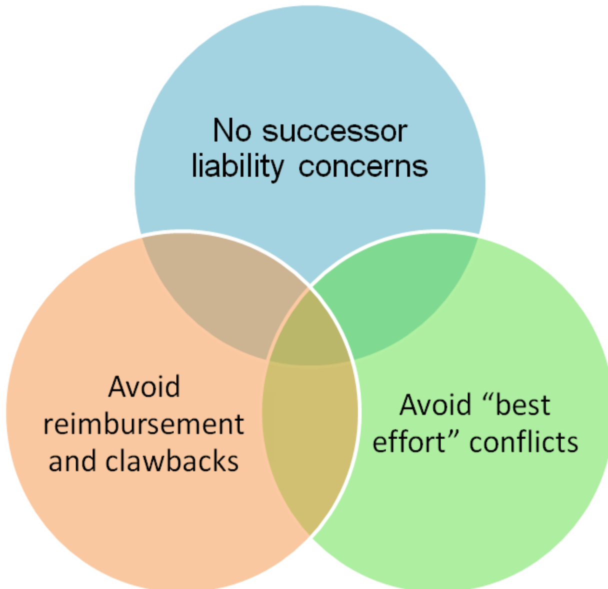
Risk Mitigation in International Trade

In the wake of our previous articles two things are clear. First, middle market companies are a significant proportion of companies that import and export. Second, there can be significant, unexpected liabilities from international trade. In this article we discuss identifying and mitigating these liabilities.

Anyone concerned with due diligence already agrees it is better to that identify potential risks and liabilities before an acquisition than after. However, the value in identifying import and export compliance issues is greater than most for at least three reasons. First, import and export issues can remain latent for years and, therefore, can lead to unexpectedly large liabilities. Second, it is typically easier to resolve issues before money changes hands. And, third, the sellers are generally in the best position to defend or justify their past acts. Taken together these reasons make clear the benefits of including import/export issues in the due diligence process. We discussed latent liabilities in some detail here. As discussed in that article, both import and export transactions generally are subject to a five year statute of limitations. As such, it is common for a company to face one time liabilities that represent five years of repetitive errors. The long periods of liability make individually trivial errors potentially significant when faced by a new owner that did not reap the benefit of the earlier imports or exports.

In connection with imports, the context of payments to the government bears review. Import duties are similar to other tax payments, except they are settled as each transaction occurs. It's as if a complete tax return were filed every time a person was paid. However, importers use a number of tax avoidance strategies to avoid paying duties. Legal tax avoidance strategies include the use of free trade agreements (e.g., the NAFTA), unilateral duty preferences, or drawback (i.e., the claim for a refund of duties paid on merchandise subsequently exported). However, duty avoidance can also be a decision to report imported goods to Customs in a way that might not be legally supported including undervaluing merchandise, improperly claiming a duty preference, or misdescribing the goods. Both Customs and experienced counsel can often spot unusual activity, as well as the weak internal controls that create the risk of violations.

Second, it is typically preferable to resolve issues before money changes hands. This is true for a number of reasons. First, it keeps the acquiring company from having to establish whether it has successor liability for the target's past acts. Second, it is generally easier for sellers to adjust a sales price or establish a set aside if needed, as opposed to indemnifying for losses post-acquisition. And third, resolving the issues allows the seller the opportunity to deal with the issues and be assured that best efforts were expended to get the best possible outcome. The diagram below reflects the overlapping benefits of resolving international trade issues earlier rather than later.



Finally, the seller knows what their business did and why. This puts the seller in a much better position to address concerns or irregularities in their international supply chain. This is especially important in international trade transactions because access to and familiarity with the documents in the transactions is key to any effort to mitigate risk in international trade transactions. Mitigation could include seeking rulings or licenses, disclosing violations of the law to the government, or other actions. Each of these efforts at mitigation is assisted tremendously by the involvement of people familiar with the transactions and documents. Furthermore, these efforts at mitigation all make it easier to quantify potential risk and address them in the financial terms of the deal.

Ultimately several things are clear. Middle market companies are significant international traders. That creates many opportunities. But, they can also incur very significant liabilities (latent and otherwise) that may not be obvious to due diligence professionals unfamiliar with the international trade laws. However, where international trade compliance issues are discovered they can often be quantified and mitigated relatively quickly. Experienced international trade counsel can be a significant benefit in uncovering these issues.

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