Middle Market International Trade Liability

It is clear that Middle Market companies in the United States are deeply entrenched in international trade. For Middle Market manufacturers it is almost impossible to maintain a range of competitive products without importing at least some element of their production, be it components or certain lines of finished goods. Similarly, hundreds of thousands of Middle Market companies also export their products around the world. The open question is how much financial risk this activity poses.

With respect to import liabilities, there is often an assumption that because import duties average about 3% of imported value, the level of potential liability is low. This assumption is wrong for two reasons. First, it ignores the fact that duties are “bottom line” numbers added to the finished value of a good. As such, a 3% duty difference typically comes directly from profit. Second, the assumption does not account for cumulative effect of import liability.

Import liabilities accumulate because importers are generally liable for errors made over the previous five years. As the chart below shows, the effect of incurring five years of liability at one time is much more dramatic than incurring it incrementally over five years.

	Year 1	Year 2	Year 3	Year 4	Year 5
Import Value	$600,000.00	$600,000.00	$600,000.00	$600,000.00	$600,000.00
Declared Rate	0.0%	0.0%	0.0%	0.0%	0.0%
Correct Rate	3.0%	3.0%	3.0%	3.0%	3.0%
Duties Owed	$0.00	$0.00	$0.00	$0.00	$90,000.00

While the duty rate remained a modest 3% throughout the five year period, the owner in Year 5 effectively incurred a 15% duty rate on $600,000 of imports. Since companies do not generally plan to have 15% swings like this in their costs, the impact is substantially greater than a 3% duty rate would suggest. This is especially true when we consider that the analysis above does not include penalties, interest and other factors that can double (for negligent errors), quadruple (for grossly negligent errors), or more (for fraud) the amount of duties owed. All from a 3% duty error.

A similar, but less common scenario involves importers with antidumping duty liability they have not properly accounted for. These cases are meant to prevent unfair competition in the United States from imports, and often mandate that double-or triple-digit duties be charged to imports. If the 3% duty example above had been small diameter graphite electrodes imported from China, it is likely that the chart would have looked even worse:

	Year 1	Year 2	Year 3	Year 4	Year 5
Import Value	$600,000.00	$600,000.00	$600,000.00	$600,000.00	$600,000.00
Declared AD Rate	0.0%	0.0%	0.0%	0.0%	0.0%
Correct AD Rate	159.64%	159.64%	159.64%	159.64%	159.64%
Duties Owed	$0.00	$0.00	$0.00	$0.00	$4,789,200.00

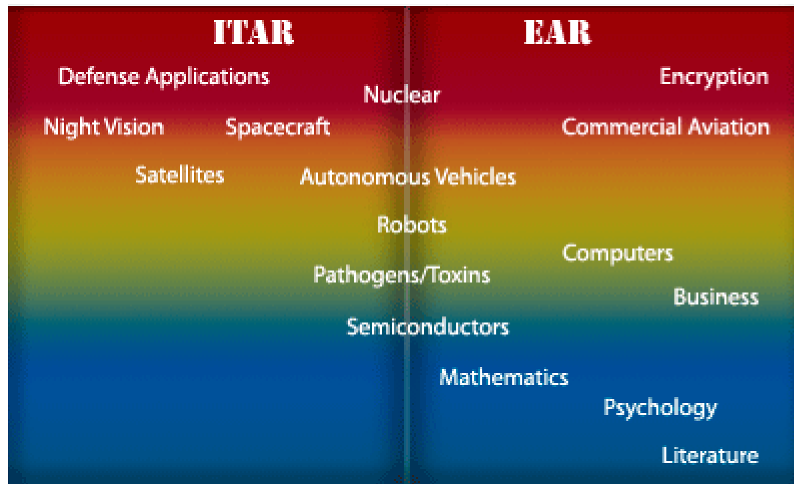
As dramatic as the example above is, simple errors by importers often lead to inadvertent violations where antidumping duties should be deposited. Like other imports, antidumping duty entries have a five-year statute of limitations. As such, owing $4.789 million in duties for $3 million in imports is not an uncommon situation.

The story with regard to export activity is even more dramatic because the penalty regime for export errors is much more severe than for import errors. In most cases the penalties are $250,000 per violation or two times the value of the exported goods, as well as potential ban on the right to export. Where the goods are controlled for military/defense reasons the penalties can also be very high and criminal charges are not uncommon. These cases very often settle for hundreds of thousands of dollars, even when the exporter is not a large company. These penalties can be out of all proportion to the value of the underlying transaction.

In addition to the high penalties, many companies violate the export laws without realizing they have. This happens in a variety of ways, but the easiest is allowing certain foreign nationals (typically employees) to have access to information that is controlled under the export laws. This is a “deemed export” and could violate United States law. This is true even if the company does not export any of its products, and there is no evidence that the foreign national did anything with the knowledge gained.

The complexity of export compliance is compounded by the fact that multiple agencies regulate exports and various articles can be controlled if they are used in controlled articles. A very rough heat map of what is controlled by who was published by the Massachusetts Institute of Technology. As you can see, a huge variety of articles are controlled:

Partial List of Controlled Items



See: http://osp.mit.edu/compliance/export-controls/sensitive-technologies

Finally, private equity groups and other new owners must be aware of the threat of False Claims Act claims in the international trade arena. There is an excellent discussion of FCA law here, but suffice it to say that employees can have tremendous incentives to bring international fraud cases against their employers. A person successfully bringing such a claim can recover a portion of any funds the United States recovers. This can very quickly represent multi-million dollar payouts for mid-level international trade professionals. It is easy to imagine employees concerned for their jobs and frustrated with past company activity in the trade area deciding to gamble on an FCA case with a potentially life-changing payout possible. We'll discuss in our next article how to lessen the risk of an FCA claim, but the short answer is due diligence to uncover potential fraud, and appropriate resources to the trade area after acquisition.

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