Buyer Beware
The Trade Compliance Risk of Mergers and Acquisitions

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Caveat Emptor! Literally translated this Latin phrase means "May it beware, the buyer!" This is sound advice in many areas of business, but especially in the field of mergers and acquisitions and particularly when it comes to the issue of trade compliance. With company supply chains increasingly dependent on international trade, a failure to consider trade compliance early in the M&A process could have serious implications down the road.

Trade compliance is seldom a deal breaker. It certainly, however, could be a deal influencer. If discovered in advance, the parties may be able to take steps to minimize the effects of historical non-compliant practices within the acquired company on the purchasing company. Likewise the acquiring company may be able to identify risks and take measures to avoid trade violations after acquisition. Because of both financial and regulatory risks, trade compliance managers should be included earlier in the M&A process.

The challenge, of course, is that M&A process necessitates confidentiality. The fewer people involved in the process, the easier it is to maintain confidentiality. Therefore the knowledge of a pending merger or acquisition is on a need-to-know basis. M&A professionals tend to focus on broader business issues and avoid getting drawn into the weeds of tactical operational issues. Trade compliance, unfortunately, is often viewed as tactical. It is generally understood that some thorny operational issues will arise after the merger or acquisition is completed, even in the areas of regulatory compliance.

It is common, therefore, for purchasing companies to withhold money in escrow to cover any unforeseen regulatory fines or penalties or to draft contracts containing other clauses that allow the purchaser to claw back funds should any undisclosed issues result in additional expenses. These mechanisms effectively cover some of the financial risks associated with M&A but do they cover all of them? As an example, the final outcome of an antidumping or countervailing duty review could result in duties jumping from a few percentage points of product cost to, in one example, more than four times the original product cost. Without proper planning, the purchasing company may be saddled with additional duty costs that are not covered by monies set aside in escrow.

Some executives seem to be satisfied that setting funds aside to cover fines and penalties is sufficient. They may even accept the financial risk described above. This approach, however, ignores the reality of successor liability. No matter how the commercial contract is structured between seller and buyer, importing and exporting regulatory responsibilities can move forward to the buyer. While the fine may be paid, the purchasing company now has a severe violation on its record and will be subject to the non-monetary penalties and heightened regulatory scrutiny accompanying that violation. The buyer may also inherit conditions of a consent decree requiring it to meet obligations not applicable to the typical exporter or importer.

Consider the following risks that might be discovered by including trade compliance earlier in the M&A discovery process

Core import competency: Does the selling company have control over the core trade disciplines relating to classification, valuation, country of origin, duty payment and record keeping?

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Remember that customs law contains a five-year statute of limitations. A buyer considering acquisition of a company with little or no control over its import operations may wish to consider withholding more in escrow or choose to probe more thoroughly into the transactional import history of the target company to gain a better understanding of the financial and regulatory risks.

Core export competency: Exporters have similar tactical obligations to report classification and valuation and to maintain documentation. They have the added responsibility of complying with export control laws mostly detailed under the Export Administration Regulations (EAR) and the International Traffic in Arms Regulations (ITAR.) If an exporting company does not know what, to whom, where and for what purpose it sold goods globally, the purchasing company may wish to investigate more thoroughly or hold back more money in escrow.

Similar product, differing regulations: The reason for considering a merger or acquisition may be that the target company offers complementary product in the same industry vertical. By acquiring them the purchasing company can expand its product offering to its client base. It might, be however, that the acquired product line is subject to regulatory oversight with which the purchasing company has no expertise. For example, a company used to dealing with goods subject solely to the EAR may acquire a company that has goods subject to the more rigorous ITAR munitions export controls. The purchasing company will need to ensure the acquisition has been in compliance with ITAR regulations. It will also want to ensure it is capable of managing the process post acquisition.

Dedicated staff: A company that does not have dedicated trade compliance staff or formally documented policies and procedures represents a greater risk than one that does not. Trade compliance staff will also possess unique compliance expertise relative to their products. Prior to closing on an acquisition, companies should develop a plan for ensuring a smooth transfer of that knowledge or consider how to retain a particularly talented trade compliance individual.

Merging with a foreign entity: When merging with a foreign entity companies should consider the trade compliance ramifications. It could be the acquisition's goal is to gain access to foreign markets. Consider, however, if U.S. trade law forbids interacting with some of those markets. For example, a U.S. company might explore merging with a Canadian company that has considerable sales with Cuba. After acquisition the U.S. embargo against Cuba would prohibit the merged company from continuing that business. Terminating that business based upon the U.S. embargo would place the Canadian operation in direct conflict with Canada's foreign extraterritorial measures act. Identifying this conflict in advance of a merger would offer the parties more opportunities to avoid the regulatory conflict.

In a similar vein, companies may discover that U.S. export control law requires them to shield portions of their product lines from some of their own foreign employees. This could mean preventing certain foreign operations from gaining access to product specifications or other controlled technological knowhow.

Free Trade Agreement Participation: An exporter or producer that has been using an FTA without proper controls may have grown its business under false pretenses. That business may be at risk when the purchasing company discovers it must withdraw from participation in the FTA. Likewise, an exporter or producer that has not been taking advantage of FTAs may present an opportunity to expand its business in those markets.

Importers that misuse FTAs may be subject to reimbursing the government for duties it improperly avoided. This could extend to the five-year statute of limitations in the U.S. and longer in other

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countries. An importer that has missed the opportunity to take advantage of a duty exemption under an FTA usually has a year to request a refund. Understanding this prior to a merger will allow parties to respond promptly to the opportunity.

AD/CVD: Antidumping and countervailing duties paid upon entry into the U.S. are merely an estimated deposit subject to an annual review process. Upon completion of the review the importer may be assessed additional AD/CVD amounts. In cases where the importer is already paying the higher AD/CVD amount, any additional payments are typically modest adjustments to the existing AD/CVD order. It can occur, however, that the review results in a substantial escalation of duties.

Under recent changes to AD/CVD law, importers are subject to greater scrutiny for AD/CVD evasion. A company considering a merger with or acquisition of an importer is well advised to investigate AD/CVD risk.

Duty drawback: Sometimes there is an upside. Less experienced exporters may not be familiar with duty drawback laws that permit a company to obtain a refund of duties paid on imported goods when those goods are subsequently exported from the United States. This might result in found money for the purchaser of the company. Drawback laws are soon to change and will allow an exporter to review exports of goods imported within the previous five years. The drawback opportunity may be considerable. Of course a purchasing company will want to ensure the documentation is in order to ensure it can substantiate the claim for drawback. Drawback is also generally the privilege of the exporter. Before retiring an EIN, consider if there is an untapped drawback opportunity associated with it.

What should a company considering a merger or acquisition do?

The sooner a trade compliance expert is involved in the process, the better. That individual may be an internal expert or, to retain confidentiality, a third party consultant. At a bare minimum that individual should be asking the following questions.

Questions to ask:

1. Does the selling company have dedicated trade compliance staff?
2. Does the selling company have written trade compliance policies and procedures?
3. Does the company follow these policies and procedures and have effective mastery of importer and export compliance and control disciplines relating to:
    a. Valuation
    b. Classification
    c. Country of origin
    d. Duty
    e. Record keeping
    f. Export restricted party screening
    g. Export restricted product screening and
    h. Export destination controls?
4. Does the selling company have product that is subject to trade compliance regulations or other government oversight that differ from experience and expertise within the buying company?
5. Has the selling company experienced any trade violations in its history? If so, what were the natures of those violations and what is any ongoing risk?

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Get your own house in order.
Of course any company that is considering a merger or acquisition should ensure it has its own trade compliance house in order. Merging two non-compliant organizations merely compounds the problem.

A final consideration
Often the aftermath of a merger or acquisition can be a chaotic affair. One of the benefits of M&A is the opportunity to throw out the old and replace it with a streamlined, updated and eventually more profitable organization. This can take time to refine a process. In the area of trade compliance, building classification databases, ensuring free trade agreement participation and screening goods against export control commodity lists can take months of intensive work that may even require external resources.

U.S. importer and export regulations, however, do not provide companies the luxury of time. They expect the process to be correct on day one of the new organization. If the trade compliance experts are not included early on in the M&A process, there will not be sufficient time to respond appropriately.