

Morgan Lewis

# Import Due Diligence in M&A Transactions

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# Housekeeping

- This presentation is merely guidance, not legal advice
- This presentation will be emailed to all attendees
- The presentation will also be uploaded to Morgan Lewis's website
- Questions can be submitted via “Q&A” and “Chat” functions
- **CLE is pending**

# OUTLINE

- **SUCCESSOR LIABILITY**
  - **OVERVIEW**
  - **COMMON LAW ELEMENTS**
  - **DIRECT AND VICARIOUS LIABILITY**
- **IMPORT DUE DILIGENCE IN MERGER & ACQUISITIONS**
  - **OBLIGATIONS**
  - **RISKS**
  - **BENEFITS**
  - **ACTIONS IN LIGHT OF SUCCESSOR LIABILITY AND BUSINESS BENEFITS**



# SUCCESSOR LIABILITY

## OVERVIEW

# What is “Successor Liability?”

- ***Question presented: When can a deal result in liability for a party’s pre-deal lapses or liabilities?***
- Form of the deal not determinative
  - Mergers
  - Acquisitions
  - Consolidations
- Fact intensive – “5 Ws”
- ***Due diligence cannot avoid liability where it exists but can mitigate the effects***



# SUCCESSOR LIABILITY

## COMMON LAW ELEMENTS

# Common Law Elements/Factors

- Traditional rule against liability, unless one of four factors commonly cited is present:
  - Express or implied agreement to assume past debts
  - *\*Merger/de facto merger*
  - A mere continuation of the predecessor entity
  - Intent to defraud creditors
- Conflicts of law/choice of law issues
  - *Funai v. Daewoo*
  - *Federal question: choice-of-law rules of forum state apply*

# Common Law Elements/Factors (cont'd)

- Merger focus
  - Continuity of management
  - Continuity of shareholders
  - Immediate dissolution of the seller corporation
  - Assumption of liabilities “ordinarily necessary for the continuance of business operations.”
- Policy considerations
  - Protect shareholders/stakeholders
  - Deterrent/disincentive to risky or unlawful conduct
  - Ensures person (entity) in best position to absorb risk is held responsible





# SUCCESSOR LIABILITY

## **DIRECT AND VICARIOUS LIABILITY**

# Direct Liability

- Common Law Liability in M & A
  - Target and acquiring companies' existing claims/liabilities
  - Potential claims/liabilities (prior acts and omissions)
    - *Stock ownership alone?*
    - *Stucki v. Worthington*
  - Conduct occurring mid-deal
- Statutory authority
  - Principal's conduct
  - Aiding and abetting- ***distinguishable*** from vicarious liability
    - *United States v. Trek Leather*
    - 19 U.S.C. §1526(f)

# Vicarious Liability

- Agency Liability
  - Respondeat superior
  - Rogue actors/ultra vires conduct
  - Independent contractors
- Parent/subsidiary issues
  - Observing corporate formalities
  - Operating autonomously
  - Manipulation to unjust detriment of creditors
  - Corporate veil/alter ego

# Ataka: Example of Successor Liability in Import Actions

- Successor liability is not codified in customs and export laws.
- Most of the authority has been extrapolated from federal court law, also known as common law, and from rules of constitutional construction.
- Federal Court case that tacitly allows CBP to pursue successor liability for unpaid import duties under the Tariff Act of 1930
- US v. Ataka America, Inc., 826 F. Supp. 495 (Ct. Int'l Trade 1993).

# ATAKA AMERICA

- Defendant acquired the business assets of an importer that had underpaid antidumping duties for shipments of wire rope
- CBP seeking to recover penalties for the import violations of Ataka America (original parent company) from the successor of the subsidiary
- CIT stated, “[o]ne cannot assume that a subsidiary is liable for the debts of its parent.”
- The CIT also recognized that liability could attach only under the doctrine of a de facto merger or a continuation of the business

# ATAKA AMERICA CONT.

- Court stated that there was enough similarity in business activities of the two companies and enough uncertainty on the facts of the business transactions, that discovery was warranted to further investigate whether the doctrines of de facto merger or substantial continuation would apply
- After the CIT allowed time for discovery, Defendant decided to settle with CBP
- Case is still be considered as precedent for CBP in investigating customs violations and assigning liability through successorship

# SUCCESSOR LIABILITY CBP STANDARDS

- Factors that could make CBP less or more amenable to pursuing charges against a successor company include:
  - The amount of the lost revenue to CBP (such as unpaid duties)
  - Public policy considerations including the type of harm caused by the violation
  - The possibility of the violation recurring under the successor
  - Successor liability situations are analyzed on a case-by-case basis



# IMPORT ISSUES IN MERGER & ACQUISITIONS

## **OBLIGATIONS**



# REASONABLE CARE

- Importer obligations are set forth in the [Customs Modernization Act](#) (Pub. L. 103-182, 107 Stat. 2057, December 8, 1993), Title VI of the North American Free Trade Implementation Act.
- Introduced the concepts of:
  - “informed compliance”
  - “shared responsibility.”
- Statutory duty to exercise “reasonable care”
- Penalties imposed for failing to exercise reasonable care.

# IMPORT ENFORCEMENT ACTIVITY

- Initiated and concluded under strict confidentiality
- Few cases are litigated or settled publicly
- What you don't know can cost you!
  - Estimated \$61 million collected in fines and penalties (2010)
  - Estimated \$346 million collected in AD Duties (2012)
  - Estimated \$30 million collected in CVD Duties (2012)
  - Estimated \$168 million in additional duties (2012)
- Omnipresent financial risk for importers and their acquiring companies

# PREPARING THE REVIEW

- Assemble a team consisting of buyer's and seller's export, import and leadership personnel
- Dedicate sufficient resources and time
- Consider using export/import outside legal counsel



# IMPORT ISSUES IN MERGERS & ACQUISITIONS

## **RISKS**

# WHAT TO REVIEW

- Due diligence should include a review of the target's:
  - Import activity for the past 5 years
  - Analysis of internal controls
  - Customs compliance manual and procedures followed
  - Recordkeeping practices
  - Reports of penalties, enforcement proceedings and rulings
  - Supply chain security filings
  - Audit reports

# ASSEMBLING DOCUMENTS FOR REVIEW

- Any product listing or product matrix with product classification
- Policies relevant to international transactions or trade compliance manuals
- Supply chain security documentation, including any C-TPAT agreements and submissions to CBP
- All documents relating to previous, pending, threatened or suspected government audits, investigations or enforcement actions related to import operations.
- Pending import license applications
- DDTC registration
- Prior and pending annual disclosure reports

# DOCUMENTS FOR REVIEW CONT.

- List of U.S. Customs brokers and associated powers of attorney
- Importer ID numbers
- Current U.S. Customs bonds.
- Samples of import filings made with CBP
- Samples of NAFTA or FTA certificates of origin.
- List of products for which claims duty preference have been made
- Samples of import documents
- Current and expired licenses
- A USML list of all products manufactured or sold

# COMMON IMPORT VIOLATIONS

- *Successor Liability can be imposed:*
  - ✓ Undervaluing imported merchandise
  - ✓ Erroneous HTSUS classification
  - ✓ Improper claim for duty free treatment
  - ✓ Recordkeeping violations
  - ✓ Failure to obtain import licenses
  - ✓ Dealing with sanctioned entities/persons
  - ✓ Failure to deposit Antidumping/Countervailing duties
  - ✓ Sourcing conflict minerals



# VALUATION

Select Appraisement Method (in hierarchical order)

- **\*Transaction Value of *actual* goods**
  - *Price paid or payable when sold for exportation*
- **Transaction value of *identical/similar* goods**
  - *Same production, commercial level and quantity*
- **Deductive value**
  - *Resale price in the United States after importation*
- **Computed value**
  - *Sum of production costs + profits + packing costs*
- **Derived value/ “fallback” value**

# SAMPLE VALUE QUESTIONS

- How is Customs valuation of imported products determined, particularly products obtained
- Are any of the products imported from related foreign companies
- What are the terms of the purchase agreement
- Are there separate licensing agreements
- Is it a multi-tiered transaction
  - First sale

# CLASSIFICATION

**Assigning standardized product identification numbers for import / export purposes.**

- Eliminates need to translate product names**
- Identification number is referred to as a classification number.**

# SAMPLE CLASSIFICATION QUESTIONS

- Does the Target Company have an import and/or export "product listing" or "product matrix"
  - If so, does it cover all products imported and exported by the Target Company?
  - If not, how were products not included on the list classified for import or export purposes?
- Who determines the import and export classifications
- Have U.S. Customs Rulings been requested for any of the imported items

# ORIGIN MARKING REQUIREMENTS

All goods imported into U.S. **must be marked** with the country of origin in a manner that is:

legible,  
indelible,  
permanent &  
conspicuous.

# SAMPLE ORIGIN QUESTIONS

- Does the company claim duty preference on products it imports (*e.g.*, *NAFTA* or *FTA*, HTSUS Chapter 98)?
  - Who determines whether the imported merchandise is eligible for preferential treatment?
  - Who executes certificates or declarations required by the applicable programs?
  - Who maintains certificates or declarations obtained from other parties pursuant to the applicable programs?

# RECORDKEEPING

## – Retain Import Records For Five Years from Date of Import

- Make Available for CBP Inspection as Required

## – Records To Be Retained

- Entry summary, invoices, bill of lading etc

# SAMPLE RECORDKEEPING QUESTIONS

- Is a centralized database of import and export transactions maintained from retrieve all documents relating to a particular transaction for a period of five years can be retrieved
- What documents are maintained in the database?
- Are paper copies maintained as well
- How has custody and control of the database



# Import License Requirements

## U.S. Department of State - Directorate of Defense Trade Controls

- International Traffic in Arms Regulations (ITAR) (22 C.F.R. Parts 120-130)
- DDTC controls exports and temporary imports\* for purposes of:
  - U.S. national security and defense trade objectives
  - Arms embargoes/sanctions
- U.S. Munitions List – the USML
  - Defense Articles
    - *Defense Items*
    - *Technical Data related to defense items*
    - *Defense Services*

# Import License Requirements

**U.S. Department of Treasury – Bureau of Alcohol, Tobacco, Firearms and Explosives (BATFE)**

**TITLE 27—Alcohol, Tobacco and Firearms**

**CHAPTER II—BUREAU OF ALCOHOL, TOBACCO, FIREARMS, AND EXPLOSIVES, DEPARTMENT OF JUSTICE**

**SUBCHAPTER B—FIREARMS AND AMMUNITION**

**PART 447—IMPORTATION OF ARMS, AMMUNITION AND IMPLEMENTS OF WAR**

- **ATF regulates, via permit, the permanent import of Defense Articles that are listed on the United State Munitions Import List (USMIL) - 27 C.F.R. Part 447, Subpart C**
- **Anyone engaged in the business of importing articles on the U.S. Munitions Import List for commercial purposes must register with ATF as an importer**

# SAMPLE IMPORT LICENSE QUESTIONS

- Do any of the products constitute "defense articles" – e.g., *goods, services* or technology that is modified for military application or is otherwise on the USML
  - If so, has the Target Company registered with DDTC?
  - Have appropriate licenses been obtained for such imports when required
  - Have all license conditions, including record-keeping requirements been complied with

# OFAC Sanction Regimes

## **Comprehensive sanctions on** **5 countries**

<b>Cuba</b>	<b>Iran</b>	<b>North Korea</b>
<b>Sudan</b>	<b>Syria</b>	

# SAMPLE SANCTIONS QUESTIONS

- Have there been ever directly or indirectly through third parties:
  - Any dealings with U.S. sanctioned governments, entities or persons
  - Received goods or services from any U.S. sanctioned governments, entities or persons
- Is there a "whistleblower" procedure, compliance hotline or other internal procedure for reporting possible violations

# ANTIDUMPING/COUNTERVAILING DUTIES

- U.S. industries may petition the USITC and Commerce for relief from imports that are sold in the United States at less than fair value ("dumped") or that benefit from countervailable subsidies provided through foreign government programs ("subsidized")
- CBP enforces AD/CVD orders and collects the AD/CVD due on imported goods
- AD/CVD paid at the time of entry is a cash deposit of estimated AD/CVD duties
- Final duties owed aren't not determined until Commerce conducts an administrative review to establish the final AD/CVD rates on past entries

# SAMPLE AD/CVD QUESTIONS

- Are the goods subject to AD, CVD or safeguard duties, quotas or orders
- Have any goods been subject to any AD, CVD or safeguard proceedings in the last ten years?
- Is there substantial reliance on foreign inputs that are or could be (or have in the last ten years been) subject to AD, CVD or safeguard duties, quotas or orders

# CONFLICT MINERALS

- Products imported into the U.S. cannot contain conflict minerals from D.R. Congo or “adjoining countries”
- Conflict minerals include the following:
  - Gold
  - Tantalum
  - Tin
  - Tungsten
- Conflict minerals are found in:
  - Circuit boards (tin)
  - Electronic devices like mobile phones, laptop computers (tantalum)
  - Light bulbs, televisions (tungsten)



# SAMPLE CONFLICT MINERAL QUESTIONS

- Reporting company under the Exchange Act?
- Manufacture or contract to manufacture products for sale to third parties?
- Are any of tantalum, tin, tungsten or gold (“conflict minerals”) contained in the final products?
  - Are any of those conflict minerals necessary to the functionality or necessary to the production of those products?
- List each product and which conflict mineral(s) it contains.

# CONFLICT MINERALS QUESTIONS CONT.

- Which of the necessary conflict minerals for such products were from recycled or scrap sources?
- Are any of the smelters or refiners of such conflict minerals certified as “conflict free”?
- What are the countries of origin of the necessary conflict minerals for such products?
  - What efforts did you undertake to determine the countries of origin?
  - Do any of the countries of origin include the Democratic Republic of the Congo, Zambia, Angola, Republic of the Congo, Central African Republic, South Sudan, Uganda, Rwanda, Burundi, and Tanzania (the “Covered Countries”)?



# IMPORT ISSUES IN MERGERS & ACQUISITIONS

## **BENEFITS**

# OPPORTUNITIES FOR SAVINGS

- **Uncovered opportunities for savings**
  - ✓ **Overvaluing imported merchandise**
  - ✓ **Correcting misclassified merchandise**
  - ✓ **Duty deferral programs (FTZ's and bonded warehouses)**
  - ✓ **Duty-Free programs (FTAs, Drawback, TIB, Chapter 99, 9801/9802)**

# DUTY DEFERRAL PROGRAMS

- **FTZ:** Articles admitted into the FTZ for processing or storage do not pay duties until they are withdrawn for entry
- **Bonded Warehouse:** Goods imported for the storage of merchandise in a bonded warehouse may delay payment of duty until the merchandise is withdrawn from the warehouse

# DUTY FREE PROGRAMS

- **FTA:** Provides duty free or reduced duty treatment for goods originating in a specified country
- **Drawback:** Duties are refunded on the imported portion of goods manufactured or produced in the US subsequently exported
- **TIB:** Articles imported for repair, samples for testing, or other temporary importation may be entered duty free provided they will be exported within 1 year (extensions can be up to 3 years)

# DUTY FREE PROGRAMS CONT.

- Chapter 99: Pertains to the importation of specific products that are subject to special or temporary alteration in duty or other customs treatment pursuant to legislative, executive and administrative actions
- 9801/9802: US Goods being returned (9801), articles assembled abroad with US components, articles exported for repair or alteration, articles of metal exported for processing abroad and returned to the US for further processing/machining (9802) receive duty free or reduced duty treatment



# IMPORT ISSUES IN MERGERS & ACQUISITIONS

## ACTIONS



# THE PATH FORWARD

- Dealing with violations discovered in connection with due diligence
  - Valuation reduction
  - Escrow – sum of money withheld from sales price to offset costs associated with potential penalties for violations
  - Require target to file voluntary disclosure with relevant U.S. Government agency prior to closing
  - Buyer can make closing terms contingent upon outcome of action on voluntary disclosure

# THE PATH FORWARD CONT.

- Indemnification (possibly in conjunction with a post-closing voluntary prior disclosure)
- Require post-closing cooperation in connection with future audits etc.
- Earn-out where the parameters are defined by losses resulting from penalties and audits
- Stripping “offending” assets out of the transaction or isolating them in a separate acquisition vehicle or cancellation of transaction altogether

# THE PATH FORWARD CONT.

- Bonds, brokers, powers of attorney and letters of authority...oh my!
  - Consider whether the bond must be cancelled where there is a merger
  - Consider if a bond rider is needed to add the new business unit and 2 digit suffix
  - Consider if the amount of the bond is sufficient
  - Does a prior POA need to be revoked or a new POA granted

# THE PATH FORWARD

- Issue new documentation and shipping instructions to foreign suppliers and affiliates with instructions on the new name
- Consider issuing a right to make entry document before the acquisition
- Issue new letters of authority for carriers, freight forwarders and breakbulk agents how to handle imports

# QUESTIONS



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# Questions?

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