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MEMORANDUM

PRIOR DISCLOSURES UNDER U.S. CUSTOMS LAWS AND REGULATIONS

Errors made while entering goods into the United States may give rise to substantial monetary penalties under Customs laws. Such penalty liability may be avoided in many instances by filing a "prior disclosure" (self-disclosure) of the errors with Customs and paying any duties that may be due. However, filing a prior disclosure may not always be the best course of action in every instance. This memorandum lays out the various factors that must be considered before a decision to make a prior disclosure is made.

Customs penalties most often are assessed under Section 592 of the Tariff Act of 1930, which authorizes Customs to assess monetary penalties against parties who make material false statements, acts or omissions in connection with their importations. Such material false statements, acts, or omissions must result from the parties' negligence, gross negligence, or fraudulent conduct. Common examples of such violations include misclassification of merchandise, undervaluation, failure to deposit antidumping or countervailing duties, improper claims for duty preference under free trade agreements, and improper country of origin declarations or markings.

Customs penalties are assessed based on the degree of fault (negligence, gross negligence, or fraud) which Customs believes the importer has exhibited, and penalties generally are computed by using a multiple of the loss of revenue resulting from the violation. For simple *negligence,* the maximum penalty is two times the loss of revenue. For *gross negligence,* the maximum penalty is four times the loss of revenue. For *fraud,* the maximum penalty is the resale value of the goods in the United States.

In addition to the hefty penalties noted above, importers are *also* required to pay Customs the loss of revenue which has resulted from the violation. In other words, importers who have committed the requisite violations are liable both for unpaid duties *plus* substantial monetary penalties.

Importers may avoid the substantial monetary penalties outlined above for violations resulting from *negligence* or *gross negligence,* however, by making a prior disclosure of the violation or violations to Customs. So long as Customs accepts the prior disclosure, the importer will be required to repay the loss of revenue, and the maximum penalty that will be assessed is the interest on that loss of revenue.

Where violations result from *fraud,* importers may still make a prior disclosure; however, unlike prior disclosures for violations resulting from negligence or gross negligence, the maximum penalty that may be assessed may be higher (the importer may be required to pay the loss of revenue plus an amount equal to the loss of revenue). By way of background, the term "fraud" means a knowing, intentional, voluntary violation of the law. It is important to understand that a prior disclosure involving fraud on the part of the importer does not preclude

the Government from criminally prosecuting an offender. However, unless the offender's conduct has been especially egregious, the Government generally takes its goal of encouraging the use of prior disclosures into account when it decides whether to prosecute disclosed criminal conduct.

It is important to understand that a prior disclosure *cannot* be made once an importer becomes aware (has knowledge) that Customs has opened a formal penalty investigation into the violations at issue. Typically, when Customs opens a formal investigation, it notifies the importer so that there is no question that the importer has knowledge of the investigation and cannot make a prior disclosure.

The possibility that Customs will open a formal investigation of a violation, and that the importers' right to make a prior disclosure of that violation will be cut off, is one of the largest drivers of whether a prior disclosure should be made, and of the timing for such a disclosure. To be valid, Customs' regulations require that a prior disclosure fully disclose the circumstances of the violation, including the class or kind of merchandise, the transactions involved, the material false statement, omission, or act(s) (including an explanation as to how and when they occurred), and, to the best of the disclosing party's knowledge, the true and accurate information that should have been provided.

It is often the case that an importer will discover that a violation has occurred but does not know all of the facts and circumstances of the violation at that time, including which individual entries are involved and the total additional revenue which might be due. In such circumstances, the importer will often choose to disclose the violation to Customs, while requesting additional time to more fully ascertain the facts and circumstances of the violation. Making such an initial disclosure forestalls the possibility that the importer's right to make the prior disclosure will be cut off by the initiation of a formal Customs investigation. Customs gives the importer 30 days to complete the process of "perfecting" the initial prior disclosure, and will grant additional extensions of time for good cause. Where a large number of entries is involved or where the prior disclosure is complex, Customs almost always will grant the importer additional time to complete the process.

It is essential to note that not every disagreement with Customs amounts to a violation which would subject an importer to penalty action. For example, the tariff classification of many articles can be very complicated, and reasonable people can differ as to the proper tariff classification of particular products. Customs valuation similarly can be very complicated. Mere disagreement with a tariff classification or valuation used by the importer does not automatically mean that Customs is entitled to take penalty action. The key question is whether the importer used "reasonable care" in making the declaration in question. If the importer exercised reasonable care, then the culpability required to support penalty action (negligence, gross negligence, fraud) is not present. Whether an importer exercised reasonable care is fact specific and should be carefully explored before a prior disclosure is considered. Where Customs recognizes that an importer exercised reasonable care, it will not initiate a penalty action, and it is limited to recovering any loss of revenue from unliquidated entries, not against entries made during the longer statute of limitations period (discussed below).

The statute of limitations for negligent and grossly negligent violations is 5 years from the date of violation, while the statute of limitations for fraud is 5 years from the date that Customs discovers the violation. In the great majority of cases, the violations that precipitate a prior disclosure result from negligence or gross negligence. Therefore, in most prior disclosures, the importer will compute and tender any loss of revenue related to the disclosed violation which has occurred during the past 5 years. In many instances, Customs may accept loss of revenue calculations based on statistical sampling, which can substantially lessen the amount of time that would otherwise be spent in reviewing each individual entry made during the disclosure period. It is important that the calculation of the lost revenue be carefully performed as, absent a prior agreement with Customs, importers cannot recover a tender of lost revenue made in connection with a prior disclosure which it later discovers to have been made in error.

Where an importer has made errors which have resulted in both overpayments and underpayments, Customs regulations allow the importer to *offset* the overpayments against the underpayments when calculating the amount of lost revenue ultimately due. However, the ability to offset does not mean that Customs will refund any net excess in duty payments; it only means that duty overpayments may be used to reduce the amount of back duties which must be tendered in connection with the prior disclosure. Importers may only obtain refunds of excess duty payments for any entries covered by the prior disclosure by filing protests on these entries, and such protests must be filed within 180 days from the date of liquidation. Moreover, offsets are not allowed for entries whose liquidation has not yet become final, nor are offsets allowed where the violations have resulted from fraudulent conduct.

The statute and regulations provide that Customs will compute the loss of revenue associated with a prior disclosure and advise the importer of the amount due. However, we strongly recommend that the importer undertake this task, because it will enable the importer to verify the actual amount due. In addition, it is in the importers' interest to make the calculations and supply any required documentation, because it substantially reduces the amount of work that Customs must perform and evidences the importer's good faith. In our experience, the less time Customs spends on a file, the less likely it is that Customs will conduct an investigation of the importer (as discussed below).

When making a prior disclosure, importers are advised to carefully review their Customs transactions and to disclose all violations. Such a review is prudent because a prior disclosure of a violation insulates the importer from penalties that arise only in connection with disclosed violations. If, during its review of an importer's transactions, Customs discovers *additional* violations that have not been disclosed, the prior disclosure does not protect the importer from penalty liability for these additional, undisclosed violations. Where Customs discovers additional, undisclosed violations, it generally proceeds as outlined above and issues penalty demands based on the loss of revenue and degree of culpable conduct. We can assist you in this review process as there are about 15 areas that, in our experience, most commonly give rise to Customs penalty actions.

It is also important for the importer to satisfy Customs that it has taken remedial action to ensure that similar violations will not recur. This may involve instituting procedures to capture assists, preparing tariff classification databases to ensure that the company's merchandise is

properly classified, etc. It is also important that Customs understands that the importer has reviewed its transactions with competent, experienced Customs law professionals to ensure that additional, unrelated violations are not present. If Customs is confident that the importer has correctly calculated the lost revenue due, reviewed its current transactions, and taken active measures to ensure that future violations do not occur, it is likely that the prior disclosure will be accepted without further action from Customs.

One final consideration when making a prior disclosure is an importer's potential liability under the federal False Claims Act, which permits private citizens to sue and recover damages on the Government's behalf against those who knowingly submit a false claim for payment to the Government, or who knowingly act to avoid paying the correct amount of money owed to the Government. While Customs has traditionally relied on Section 592 penalties to address import errors, there has been a rapid increase in False Claims Act recoveries by the Government for import violations in recent years, including False Claims Act recoveries for misclassification, misdeclaration of country of origin in connection with antidumping duties, and undervaluation. However, the False Claims Act bars actions which are "based upon allegations or transactions which are the subject of a civil suit or an administrative money penalty proceeding in which the government is already a party." While the courts have not yet ruled on whether filing a prior disclosure precludes actions under the False Claims Act, we believe that the better view is that they do bar such recoveries.

In sum, the prior disclosure process can afford significant benefits. However, it is a fact specific process which can involve potentially competing legal and business considerations, and should only be undertaken under the advice of experienced counsel.