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Client Alert

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How Can PE and VC Investors Mitigate Risk in an Unpredictable Trade Environment?

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What You Need To Know:

- **Companies engaged in international business present increased risks for private equity (PE) and venture capital (VC) investors as U.S. trade regulations are continuously revised to complement the government's diplomatic efforts abroad. Consistent monitoring and an in-depth understanding of sanctions, tariffs, and investment restrictions are needed to effectively mitigate such risks.**
- **Investors should periodically conduct rigorous due diligence on portfolio companies' businesses practices, partners, and compliance procedures so as not to acquire material liabilities.**
- **Investors can demand increased transparency and documentation of compliance from portfolio companies, in addition to conducting their own independent audits.**

Volatility defines the current trade policy environment. For investors in PE and VC, every day brings another trade-related issue that could significantly affect their portfolios.

Prudent investors need to be prepared with thorough knowledge of the latest changes in trade regulations and investment restrictions in order to adopt ways to accurately identify and assess risks and establish appropriate compliance and mitigation plans.

Here is an overview of some of the most recent changes in U.S. trade law and policy, with initial suggestions for PE and VC investors seeking to minimize duties, ensure (and document) continued compliance, and avoid falling victim to costly violations.

Economic Sanctions

Changes to U.S. sanctions regulations have caused confusion and instability for many businesses. These changes affect companies doing business, directly or indirectly, with the following countries:

- Iran: U.S. entities acquiring new holdings must ensure that all parties, foreign and domestic, are compliant with U.S.-Iran sanctions, which have returned to pre-2015 levels.
- Russia: The pervasiveness of relations between U.S. entities and sanctioned Russian entities initially required the Office of Foreign Assets Control (OFAC) to issue multiple general licenses (exceptions) so that U.S. businesses could transition to supply chains involving non-sanctioned business partners. As a result, investors must now do their due diligence to ensure their portfolio companies are functioning under an existing general license if they are doing business with any entities or individuals associated with sanctioned Russian oligarchs.
- Cuba: Obama-era policies on Cuba have been rolled back, and there are now restrictions on transactions related to the Cuban military and its intelligence services. Check the State Department's Cuba

Restricted List for entities with which U.S. persons and entities are prohibited from transacting.

- North Korea: U.S.-North Korea sanctions now include secondary sanctions, enforceable against foreign financial institutions and other non-U.S. parties. As a result, entities involved in trade and shipping with North Korea, including some Chinese businesses, have been added to the Specially Designated Nationals list, which cuts them off from U.S. markets and financing.

Additional Tariffs

- Steel and aluminum tariffs: With a 25 percent duty on steel products and a 10 percent duty on aluminum products imported from most countries (plus a 50 percent duty rate on steel from Turkey), companies must consider how to handle these additional costs – charge customers more, or share them with the other members of their supply chain? Only an extremely limited number of exclusions have been granted, so sharing costs may be the only option for companies trading in steel products.

- China tariffs: Due to U.S. claims of unfair trade practices, 10 to 25 percent tariffs are now levied on most Chinese imports. Three separate lists were released that identify affected products by import classification numbers.

- Antidumping/Countervailing Duties (AC/CVD) laws: Imposed on items imported into the U.S. at artificially low prices, these high tariffs cannot be paid for or reimbursed by any third party or the importer will be charged double duties. Make sure that import classifications are correct and the products you are importing are outside the scope of the particular AD/CVD order.

- Washing machines and solar products: Applicable to goods from most countries unless an exemption applies, these tariffs start at 30 percent for solar products, de-escalating 5 percent annually until 2022. Washing machines are charged a similar three-year de-escalating tariff based on the number of units imported.

- Note: New duties are proposed against the European Union to target everything from airplanes to cheeses olive oils, and wine.

Investment Restrictions

- Committee on Foreign Investment in the United States (CFIUS) filings: The Foreign Investment Risk Review Modernization Act (FIRRMA) is intended to reform the rules governing review of international investment in the U.S.; CFIUS is the interagency committee that reviews transactions that could impact national security. FIRRMA has expanded the list of transactions and investments subject to potential review, creating filing requirements for real estate transactions; transactions involving critical technology, infrastructure, and sensitive personal data; and activities involving certain changes in a foreign person's or foreign company's rights. The current pilot program requires filings when a foreign person has control of critical technology or access to material nonpublic technical information in certain targeted industries. Key provisions will not be finalized until 2020, so dealmakers need to monitor the developing landscape and carefully review all CFIUS filing requirements as they evolve. Note: There is no de minimis exception for low-value deals, nor are there any country exceptions.

Forced Labor Prohibitions

- Goods may not be imported if they have been produced abroad using forced labor, including convict, child, or indentured labor. Penalties include the exclusion or seizure of goods and possible criminal investigation. Before investing, review supply chains and perform a comprehensive risk assessment of the company in question.

In light of all these evolving rules, here are some strategies for PE and VC investors navigating this landscape.

- **Do your due diligence:** It's not enough to know your portfolio companies' businesses; you need to understand their supply chains and sourcing as well. Stay current on trade policies and the rules prohibiting transactions with restricted parties. Firms investing in or acquiring foreign entities involved in cross-border transactions must conduct rigorous research on a target's activities, ownership, and supply chains so that they do not acquire material liabilities for OFAC sanctions and export violations.

- **Conduct a compliance audit:** Don't rely on companies' own compliance reporting – do your own audit. Interview parties and partners, and scrutinize documents and practices for warning signs like shell companies engaged in prohibited behavior.
- **Seek specialized legal advice:** As an investor, you can recommend that your portfolio companies obtain the specific legal help they need with issues like country-of-origin and classification analyses. They should not rely solely upon a customs broker, who may be helpful as an agent or logistics supplier but bears no liability if classifications are incorrect. Global trade attorneys can provide guidance on determining correct import classifications, whether duties have been properly assessed, and whether a competitor is failing to comply with country-of-origin rules.
- **Plan for adversity:** Incorporate uncertainty into your investment strategies by planning for challenging events while leaving room for positive change.
- **Develop creative solutions:** If you want to avoid burdensome tariffs, you need to come up with innovative solutions. Review the supply chain for alternative suppliers, locations, and processes. Find ways to cut costs to balance the impact of duties.

Contacts

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