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Trek Leather Opens Pandora's Box On US Customs Penalties

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On Sept. 16, 2014, the U.S. Court of Appeals for the Federal Circuit dropped a unanimous en banc bombshell into the bitter no man's land of the customs penalty field, reshaping the hard-fought ground over the scope of liability for unintentional customs violations.

United States v. Trek Leather held that an individual by the name of Harish Shadadpuri — who did not act as the importer of record but who participated in activities giving rise to customs violations — could be held directly liable for grossly negligent conduct under the customs penalty statute, 19 U.S.C. § 1592 (Section 592).[1]

Trek Leather breathed vibrant new life into Section 592, and laid to rest a widely held interpretation of the statute — the assumption that absent good cause to disregard the corporate form, only the importer could be directly liable for customs violations. Under that now discredited view, a company or individual that was not the importer could only be indirectly liable under Section 592 if its actions served to "aid or abet" the importer's culpable conduct.

The decision in Trek Leather was earth-shattering along many fronts. First, on procedural grounds. Historically the Federal Circuit has granted no more than 3 percent of requests for en banc review, and not since its inception in 1982 had it granted rehearing en banc in a case where the central issues involved customs laws. And whereas en banc review usually does not lead to a different outcome on the merits, here it resulted in a unanimous decision diametrically opposed to the initial panel decision.[2] From this highly unusual about-face it is clear the court considered the outcome of Trek Leather to be of existential importance to the customs penalty statute.

The Trek Leather decision was equally thunderous in substance. To fully appreciate its roar, one needs to contemplate the core elements of Section 592 and the awkward trail the statute has carved through the courts.

Section 592 sets forth three levels of culpability for customs violations: negligence, gross negligence and fraud. The statute makes it unlawful for any "person" to "enter, introduce, or attempt to enter or introduce" imported merchandise by means of an omission or false statement that is "material." The

statute also creates liability for any person who "may aid or abet any other person to violate" those provisions.

Two customs disclosure and declaration statutes are centrally related to Section 592. The first is 19 U.S.C. § 1484, which requires the importer to use "reasonable care" to accurately declare the value, classification, and applicable rate of duty when merchandise is entered.

Second, 19 U.S.C. § 1485 requires the importer to file an oath declaring (1) that the prices shown in the entry documents are "true and correct"; and (2) that if it discovers in the future any documents or information showing that the price declared upon entry was not true and correct it will produce that evidence to the government "at once." With this background in place, we are ready to examine the considerable turmoil surrounding the interpretation of Section 592, and appreciate just how groundbreaking the Trek Leather decision truly is.

The battle lines for Trek Leather were drawn up 15 years ago in United States v. Hitachi. The defendants were Hitachi America and Hitachi Japan, who had won the bid to supply subway trains to the city of Atlanta. As the U.S. Court of International Trade explained, the affiliates worked closely together on the project, with Hitachi Japan acting as the seller of the subway cars, and Hitachi America acting as the buyer and importer of record.[3] Certain post-importation side payments made by Hitachi America to Hitachi Japan were never reported to U.S. Customs, and duties owed on those payments were thereby avoided. Evidence showed that Hitachi Japan actively controlled the project including the customs aspects.

After a six-week trial, the CIT ruled that Hitachi America committed a negligent violation of Section 592 by failing to report the side payments to U.S. Customs "at once" as required by 19 U.S.C § 1485. With respect to Hitachi Japan, the CIT ruled that it could not be directly liable for violating 19 U.S.C § 1485, because that statute only creates duties for importers. Nevertheless, the CIT found Hitachi Japan liable for aiding or abetting Hitachi America's negligence.

On appeal, the Federal Circuit agreed that Hitachi America committed a negligent violation of Section 592, but did not agree that Hitachi Japan could be held liable for aiding or abetting.[4] The court ruled that aiding or abetting liability requires knowledge of an underlying violation, i.e., proof of an intent to violate the law, which is inconsistent with liability arising from unintentional torts. Rather than ruling Congress lacked constitutional power to promulgate liability for aiding or abetting an unintentional act, the Hitachi court reasoned that construing the statute in such broad fashion would create a statutory scheme "inconsistent with fundamental legal logic."

Thus, with the stroke of a pen, the Federal Circuit removed some powerful arrows the government thought were harbored in its Section 592 quiver. Liability for aiding or abetting was now a rump provision inoperative outside the fraud context, and the government had suffered a devastating loss.

Now the government had to get creative. Although customs penalty actions are commonplace, it is difficult to prove civil fraud in any context. In the customs field, the government has historically relied on smoking-gun evidence like dual invoices to prove fraud, which is hard to come by. Otherwise, it only succeeds in proving unintentional violations. After Hitachi, how was the government going to be able to catch bad guys running amok in negligent or grossly negligent customs mischief if they themselves did not act as the importer of record?

The government's first bright idea was to attempt a piercing of the corporate veil. Here the government

tries to prove that the corporate form was not respected — for example, if director and shareholder meetings did not take place, corporate minutes were not kept, personal and business accounts were commingled, etc. If the corporate veil is pierced, an officer, director or shareholder of the company can be held directly liable for negligence or gross negligence.

Another creative approach is the "alter ego" argument, related to veil piercing but with a Freudian twist. Here, the government tries to show that the importer is an inanimate corporate doppelganger under the spell of another person who manipulates it to the extent that the importer is merely the "agency or instrumentality" of the other person. The government prevailed on this voodoo theory in Inn Foods, where the CIT found joint and several liability for fraudulent dual invoicing.[5]

Still, the government faces daunting burdens of proof to demonstrate an alter ego or that a corporate veil should be pierced. It is difficult to prevail under either one of these theories, and companies and individuals can do much to insulate themselves from these tactics simply by following corporate formalities.

Fortunately for the government, Trek Leather came along to eliminate some of these pesky complications. As we shall see, with its back to the wall and Shadadpuri pushing Hitachi to its logical extreme, the government capitalized on the bad facts presented and outflanked the defendant, forever hoisting nonimporters directly onto the Section 592 hook.

The relevant bad facts of Trek Leather are straightforward. Shadadpuri was in the business of producing and importing garments, including men's suits. He provided dutiable "assists" in the form of fabric to the foreign factories, but the value of those assists was not always added into the price declared to U.S. Customs. In 2002, a U.S. Customs import specialist informed Shadadpuri personally that such assists were dutiable. One of Shadadpuri's companies that had been importing the finished suits then disgorged $46,156 in unpaid duties. Mercifully, the government did not pursue penalties in that instance.

However, two years later the very same Customs import specialist discovered that Trek Leather, of which Shadadpuri was the president and sole shareholder, was not paying duties on fabric assists. The government wasted no time commencing a penalty action against both Trek Leather and Shadadpuri, alleging fraud, gross negligence and negligence.

On cross motions for summary judgment before the CIT, Shadadpuri expressly conceded that "prior to importing the men's suits at issue in this case, [he] knew that fabric assists must be included on the import documentation." It might have seemed like a simple recipe for fraud, but Shadadpuri claimed the omission was an oversight; therefore, the CIT could not decide the contested factual issue of fraudulent intent on summary judgment.[6]

Nonetheless, the CIT had no problem concluding that gross negligence was afoot, and ruled that since Shadadpuri was a "person" under the plain meaning of Section 592, he would be held jointly and severally liable along with Trek Leather for $45,245 in unpaid duties and $534,420 in penalties.

After the loss at the CIT, counsel for Trek Leather and Shadadpuri pursued what appeared to be a brilliant strategy at the time, but would later present the private bar with its very own Waterloo: Trek Leather would not appeal its liability for gross negligence, but Shadadpuri would appeal his own. If the government took the bait and agreed to drop the fraud counts in exchange for a sure victory on Trek Leather's gross negligence, that would only leave an unintentional violation in the arena, forcing

dismissal of the case against Shadadpuri because he was not the importer of record.

The government accepted the gambit and abandoned the fraud counts against both defendants. With fraud and the corporate importer out of the case, now the long-simmering battle over whether an individual could be found liable for an unintentional violation even though he was not the importer of record would take front and center stage at a showdown before the Federal Circuit.

The initial indication was that the defendants' legal gambit was a brilliant success. In July 2013, a divided 2-1 panel held that Shadadpuri could not be held liable for a grossly negligent violation because 19 U.S.C. §§ 1484 and 1485 only create duties for importers of record.

In so holding, the majority opinion relied extensively on the court's prior decision in Hitachi. No doubt sensitive to the bad facts, the majority repeatedly stressed that the government had foregone readily available alternatives to pursue Shadadpuri in his personal capacity. In particular, the majority noted that the government could have sought to pierce Trek Leather's corporate veil and hold Shadadpuri directly liable for gross negligence, or it could have sought to prove that Trek Leather committed fraud, and Shadadpuri aided or abetted that fraud.

During oral argument before the three-judge panel, the government explained that Section 592 was a free-standing "prohibition" proscribing material false statements and omissions, and did not require subsidiary statutory violations such as an importer's noncompliance with the disclosure and declaration provisions of 19 U.S.C. §§ 1484 and 1485.

The government also argued that Shadadpuri could be held directly liable under Section 592 because even if importers of record are the only ones who can "enter" merchandise, the statute also expressly covers persons who "introduce" merchandise. To substantiate this claim, the government discussed the expansive interpretation of the term "introduce" by the U.S. Supreme Court in a 1913 case called Panama Hats.[7] There, the Supreme Court held that "introduce" covered the actions of a foreign person who prepared fraudulent invoices for the importer to use in making entry. Unpersuaded, the majority rejected all the government's arguments and dismissed the gross negligence claim against Shadadpuri. The private bar feasted on another glorious victory.

Having suffered a corroborative but still crushing blow to its Section 592 arsenal, the government's last gasp was to request a rehearing en banc. To the astonishment of many, the Federal Circuit granted the government's request, vacated the panel's decision, and agreed to convene en banc to hear a customs law case for the first time in its 32-year history.

The en banc Trek Leather decision embraced the government's previously rejected arguments lock, stock and barrel. The decision relies centrally on Panama Hats for an expansive interpretation of what it means to "introduce" merchandise, holding that the term is "not restricted to the 'technical' process of 'entering' goods." Instead, it covers "actions completed before any formal entry filings" such as choosing which company will act as importer of record, or "sen[ding] manufacturers' invoices to the customs broker."

An interesting colloquy regarding the government's theory had occurred during oral argument before the three-judge panel. One of the judges asked whether under the government's theory a "CFO of General Motors" could be held directly liable for negligence under Section 592. The government responded in the affirmative, so long as that person "signs the documents" or otherwise "owes a duty." However, the government stated its prerogative to "exercise prosecutorial discretion." Corporate

America will take cold comfort.

Furthermore, it is important to note that the court's en banc analysis did not rely or depend on Shadadpuri's status as an officer and sole shareholder of the importer. Rather, it was simply his conduct that mattered. Whereas veil piercing and alter egos involve officers, directors, and shareholders, the class of persons who can "introduce" merchandise is not so circumscribed.

With the government's theories now adopted by the Federal Circuit, it is possible that any company or individual who, for example, helps prepare or send invoices for presentation to U.S. Customs — including corporate affiliates, in-house customs compliance personnel, customs brokers, perhaps even customs attorneys — could theoretically "introduce" merchandise, and potentially be directly liable for both the lost duties and penalties arising from unintentional customs violations.

Another terrifying aspect of the decision is that Section 592 is no longer moored to the specific customs law obligations set forth in 19 U.S.C. §§ 1484 and 1485. Accordingly, trademark, copyright and patent violations, noncompliance with any federal or state laws, and even private contractual breaches associated with imported merchandise could theoretically give rise to a sea of "material" false statements or omissions that can be made upon entry. And where false statements or omissions do not impact the amount of duties owed, penalties are based on the dutiable value of the merchandise (up to 20 percent of the dutiable value for negligence and 40 percent for gross negligence).

The government may now perhaps monitor the U.S. International Trade Commission docket for highly lucrative sources of penalty actions arising from intellectual property disputes and go directly after anyone in the world who had a role in importing infringing merchandise. The possibilities seem endless.

While Trek Leather leaves the Section 592 landscape foggier than ever, one thing is entirely clear: The government has a fresh new army at its disposal. Either Congress steps in to limit and clarify Section 592's rules of engagement, or new surprises and a long and bloody war of expanding frontiers lie directly ahead.

—By Michael T. Cone, Fisher Broyles LLP

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[1] United States v. Trek Leather Inc., 2014 U.S. App. LEXIS 17746 (Fed. Cir. 2014).

[2] The Federal Circuit's initial decision in the Trek Leather litigation resulted in a divided 2-1 result where the majority opinion embraced the now discredited theory, ruling that Shadadpuri could not be held directly liable for an unintentional Section 592 violation unless the corporate veil was pierced. See United States v. Trek Leather Inc., 724 F.3d 1330 (Fed. Cir. 2013). The court vacated that decision, and then sitting en banc unanimously agreed with the conclusions reached by the dissent.

[3] United States v. Hitachi Am. Ltd., 964 F. Supp. 344 (Ct. Int'l Trade 1997).

[4] United States v. Hitachi Am. Ltd., 172 F.3d 1319 (Fed. Cir. 1999).

[5] United States v. Inn Foods, 515 F. Supp. 2d 1347 (Ct. Int'l Tr. 1997), aff'd on other grounds, 560 F.3d 1338 (Fed. Cir. 2009).

[6] United States v. Trek Leather Inc., 781 F. Supp. 2d 1306 (Ct. Int'l Tr. 2011).

[7] United States v. Twenty-Five Packages of Panama Hats, 231 U.S. 358 (1913).