Caught in the Crossfire

International Trade

Despite a limited agreement reached in January, it's increasingly clear that the trade conflict between the U.S. and China is unlikely to be resolved in 2020, if ever. It's a troubling development, especially for multinational companies that have spent two decades establishing complex supply chains with China at the manufacturing center.

"Companies are looking at what to preserve in China and what to move elsewhere in Southeast Asia—particularly Vietnam—or to Mexico and other locations," says Ambassador Robert Holleyman, a partner at Crowell & Moring, president of Crowell & Moring International, and a former deputy U.S. trade representative. "It's a problem they have to face. But it's also an opportunity to review with fresh eyes their supply chains and structure them for future business, not just past business."

Hanging Tough in China

The trade conflict has undoubtedly made life harder for foreign businesses in China, says Evan Chuck, who leads the Asia practice as a partner at Crowell & Moring. Chinese authorities have many ways of expressing displeasure at U.S. companies, including delaying routine permitting requests and initiating cumbersome tax audits. Non-Chinese companies are also struggling with new laws, such as a vaguely drafted Chinese cybersecurity law that appears to require data localization in many cases.

Separately, a "blocking statute" for international criminal justice assistance appears to require that companies conducting in-house investigations notify Chinese authorities of potential wrongdoing before they notify the U.S. government in broadly defined circumstances. These measures are in addition to the tariffs China has implemented on many U.S. goods imported into China in response to the wide-ranging U.S. Section 301 tariffs.

Dealing with China Customs can be particularly vexing, because unlike in the U.S., importers into China do not have access to an established appeals process if they believe customs officials have abused their discretion. Those officials have a lot of leeway in determining the tariff codes in which U.S. imports are classified, thereby determining the applicable rates of duty. They're also empowered to determine whether an importer is lowballing its estimate of a product's value in an attempt to reduce the duty. Customs officials appear to be targeting products with significant intellectual property or those subject to royalty and licensing fees, Chuck says.

Under Chinese law, the criminal prosecution threshold for corporate customs violations is roughly $30,000 (RMB 200,000). "How you negotiate with Chinese customs to avoid criminal liability is where the professionals come in," says Chuck, who notes that one of his colleagues is a former Chinese customs official. "You don't want your folks working in China—as well as control persons outside of China—to be subject to criminal prosecution."

But companies are still succeeding in avoiding or mitigating special duties by using a range of legal strategies. They are redesigning products to ensure classification in a tariff code with a lower duty rate. They are also advocating that an imported good should be excluded from the applicable Section 301 or Chinese tariffs.

And even as Chinese officials make life difficult for some foreign companies, they are taking other measures to lure foreign investment. In the past, new foreign businesses had to request a plethora of permits for specific activities; now only a broad "notice filing" is required. "This is a sea change in the way businesses are set up in China," Chuck says.

A Whole New Supply Chain

Even companies without a substantial presence in China should be rethinking their supply chains, says Holleyman,

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because “there are more free trade agreements being negotiated by more countries than at any other time in history.”

The most sophisticated companies have developed “war rooms,” where they map their supply chains—product by product—against a matrix of trade agreements in place or pending around the world, Holleyman says. Tariff preferences and assessment of non-tariff barriers will help determine where to locate manufacturing, assembly, and consumer markets.

For example, one option for companies producing goods in China for consumption in the U.S. is to move final production to a third country. If U.S. customs agents rule that the product has been “substantially transformed” in this third country, China may no longer be the product’s “country of origin” and special tariffs would no longer apply. (This strategy, however, requires a product-by-product review to ensure that the strict U.S. legal guidelines for substantial transformation have been satisfied in the third country.)

But that’s only one scenario. Consider a product manufactured in China, assembled in the U.S., and shipped to consumers in Japan. A company might have the product assembled in Vietnam to avoid the new special duties. By virtue of the trade conflict with China and by opting out of trade agreements, the U.S. has been effectively squeezing itself out of some supply chains, Holleyman says. And new hotspots are emerging, such as Vietnam, Mexico, and Singapore, a corporate and services hub committed to free trade.

But tariffs are only one of the considerations when mapping out supply chains. Companies must assess a country’s political stability, its legal system, its tax and bilateral investment treaties, and much more. For example, while Vietnam has generally lower tariffs with the U.S. than with China, it poses a greater risk of currency manipulation, Chuck notes. A manufacturer in a country designated as a currency manipulator could be hit by antidumping or countervailing duties that could be significantly greater than the Section 301 tariffs it was trying to avoid.

For many companies, China is very hard to leave behind. That’s why it’s important to understand China’s dynamic regulatory and political landscape—and the landscape of all of its alternatives—before making big decisions to reorder your supply chain.

Which Side Are You On?

The increasingly divergent sanctions policies between the U.S. and the rest of the world have multinational companies struggling to chart a path forward. “Non-U.S. companies are increasingly finding themselves in the crosshairs of U.S. ‘secondary’ sanctions if they do business with Iran and some actors in Russia and Venezuela,” says Michelle Linderman, a partner in Crowell & Moring’s London office. Potential new U.S. sanctions against Turkey could cause further problems. The biggest divergence is in the case of Iran, and the European Union has pushed back by updating the 1996 “EU Blocking Statute” to prohibit compliance with certain extraterritorial U.S. sanctions against Iran. “As a result,” Linderman says, “companies in Europe are caught between two conflicting jurisdictions.” Many companies have therefore chosen to cease all business with Iran out of an abundance of caution rather than struggle to comply with competing requirements.

With the increase in the number and complexity of sanctions, the number of enforcement actions will likely grow. Beyond establishing compliance programs, companies need to train employees to spot potential sanctions issues and to seek external guidance when necessary, Linderman says. They should also ensure that contracts contain appropriate clauses to deal with the possibility of the business being impacted by new developments.

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