US Company Settles Whistleblower Lawsuit, Pays for Importer's Customs Fraud

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Mark Strauss January 15, 2018

Federal prosecutors in New York recently announced the settlement of a remarkable lawsuit relating to a scheme to evade import duties. The case involved an importer's undervaluation of apparel to pay less duties than were really owed.

The settlement that prosecutors reached, however, was not with the importer, but its customer. Notations, Inc., a Pennsylvania womenswear wholesaler, agreed to pay $1 million and consented to a court order requiring it to implement a broad range of compliance measures designed to prevent it from doing business with customs cheats in the future.

Notably, there was no legal question in the case that the filing of accurate customs entry documents and the payment of appropriate duties were obligations of the importer. So how did Notations wind up being dragged into—and paying a substantial price to settle—the case? This is a key question for companies that source goods from abroad, especially under a president who is generally hostile to foreign imports and keen to enforce US tariffs.

Scope of US False Claims Act

Prosecutors didn't bring a lawsuit simply to collect unpaid duties. Instead, they brought a case for fraud under the US False Claims Act. The FCA is a multi-purpose anti-fraud statute that imposes substantial potential liability—three times damages, plus penalties—on parties that knowingly overcharge (or underpay) federal agencies. Congress originally enacted the FCA during the Civil War to counter fraud by suppliers of the Union Army. A primary feature of the statute is its *qui tam* or "whistleblower" provision, under which

parties aware of fraudulent conduct can initiate lawsuits on the government's behalf. The government is entitled to intervene in and assume prosecution of the lawsuit. The whistleblowers—who typically are former or present insiders of the wrongdoing company, but also frequently competitors or industry experts—generally are entitled to receive rewards of 15 percent to 30 percent of any recovery.

As illustrated by the Notations settlement, the scope of the FCA can be quite broad. Parties can be held liable for violations even if they only indirectly participated in, or somehow aided or helped to conceal, a scheme to defraud a federal agency. The statute prohibits not only the making of false claims, but also the making, use, or causing to be made or used of "false records or statements" that are "material to" schemes to defraud an agency. There is no requirement that there be a direct connection between the alleged violator and the agency. Claims under the FCA are therefore unlike and more perilous to a potential defendant than those under, for example, the Tariff Act for unpaid duties.

Liability for turning a blind eye to customs fraud

The Notations case was started by a whistleblower (a relative of a former employee of the importer) who brought FCA claims against the importer and its foreign parent company, which was Notation's supplier of the goods in question. Federal prosecutors added Notations as a defendant only after investigating the whistleblower's claims. Prosecutors found that, prior to doing business with the supplier, Notations generally had served as its own importer for garments that it sourced from overseas. It employed staff whose job it was to ensure customs compliance in such Free on Board or FOB type transactions. Yet, when Notations began doing business with the supplier in 2009, it switched to the use of Delivered Duty Paid or DDP type purchase arrangements. This meant that its suppliers had responsibility for taking care of customs entry and duties payment, while Notations simply paid an all-in purchase price.

Prosecutors alleged that, after switching to DDP arrangements, Notations deliberately turned a blind eye to whether its suppliers were cheating on duties obligations. On one occasion, for example, Notations received an invoice that drastically understated the prices of goods it was buying. According to prosecutors, the document easily was recognizable as a fraud directed at Customs and Border Patrol. Notations nevertheless did nothing to stop —or alert CBP to—this illegal conduct. Notations employees testified that they did not believe it was their job to do so.

Prosecutors also alleged that Notations aided the fraud by helping the importer create a phony audit trail. According to the prosecutors, Notations agreed to provide the importer with irregular purchase orders, to accept irregular invoices, and to furnish "assists" (in the form of fabric) knowing that their cost was not being added to the dutiable value as the law required. Notations also agreed to issue its purchase orders directly to the importer—rather

than to the importer's parent company, *i.e.*, the supplier, which is the company to which Notations made its payment for the goods—to support the importer's false representations to CBP that it was an independent middleman.

Prosecutors additionally found it significant that Notations profited from the fraud and received inducements from the supplier. Notations not only got below-market prices on the garments that it purchased, it also was provided with "an excessive number of chargebacks", *i.e.*, post-delivery price breaks. Prosecutors also discovered $200,000 in "cash payments for the benefit of Notations or its owner" which, suspiciously, were paid by the supplier to an offshore Notations affiliate.

In the settlement, Notations "accepted responsibility" for failing to "take action in response to multiple warning signs" that the fraud was occurring. The compliance measures to which Notations consented were broad. It agreed to educate its staff on customs compliance and fraud detection, and to require certifications of compliance from all its DDP suppliers. It also agreed to monitor marketplace price levels and demand explanations from suppliers offering prices "substantially below" average. Additionally, it agreed to "cease doing business" with suppliers suspected of fraud or non-compliance or that failed to explain their pricing.

Warning to US demand chain and call to whistleblowers

The settlement serves as a warning for US companies that source goods from abroad and think that they can depend on transactional arrangements in which their suppliers serve as the importer of record to duck responsibility for customs compliance. Such parties expose themselves to potential FCA liability even if they themselves don't lie to or underpay CBP. This is particularly so if the company receives substantial price discounts or other financial benefits from—or engages in conduct that can be viewed as aiding or helping to conceal—duties evasion. Acting US Attorney for the Southern District of New York Joon H. Kim stated that the Notations case shows that "companies purchasing imported goods cannot turn a blind eye to fraud committed by their business partners. We will be vigilant in holding accountable all parties who engage in or contribute to fraudulent conduct."

Notably, the targeting of US customers in import-related FCA cases solves a major problem for prosecutors and whistleblowers: the difficulty of collecting judgments against foreign importers that have few if any assets in the US. For this reason, prosecutors and whistleblowers have an incentive to pursue claims against US companies—whose pockets are more accessible—where possible. This puts US counterparties of foreign customs fraudsters such as Notations squarely in the crosshairs for FCA suits.

The settlement also serves as a call to whistleblowers regarding potential FCA claims that they may bring. Whistleblowers should not assume that the importer is the only party that can be sued in an FCA case based on duty evasion. Other parties in the supply or demand

chain that contribute to or help cover up an evasion scheme can be named as conspirators and violators under the statute. Furthermore, it is entirely possible for an individual to be an FCA whistleblower in a duties case without being an employee of, or even having first-hand knowledge about, the activities of an importer. Individuals associated with other parties such as a customer like Notations may have information sufficient to support a potentially lucrative whistleblower claim.

There has been a noticeable trend in recent years of federal prosecutors going after duties evasion schemes as FCA violations rather than mere Tariff Act infractions. This trend should accelerate given that a key theme of the Trump administration's trade agenda has been to prevent foreign manufacturers from gaining an unfair advantage over US producers. Companies that source goods from abroad are thus increasingly vulnerable to FCA trade enforcement, while whistleblowers who uncover duties evasion schemes should benefit from prosecutors increasingly taking their allegations seriously and opting to prosecute their claims.

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