Trade Tariffs and Disrupting the Supply Chain: The Right to Pass the Tariff Cost to Customers (Legal and Competitive Issues) and Re-evaluating the Customer Risk Profile

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Abstract

Tariffs have emerged as a hot topic for suppliers. For products the supplier imports which are subject to tariffs, the credit team, along with other departments, are being tasked with whether tariff costs may be passed to customers.

If such costs may be passed, the credit team is strategizing about disclosing and implementing the costs to customers. The credit team is also considering the federal antitrust laws for how the costs are rolled out, as well as for customer carve-outs. If tariff costs are not passed, the credit team is considering whether it may qualify for a tariff exclusion. If an exclusion cannot be obtained, suppliers are evaluating whether products may be obtained from countries not subject to tariffs, or otherwise risk shrinking margins as a result of tariffs.

This article considers these topics and presents a best practice for the credit team in dealing with tariffs.

Tariff Rollout

The Trump Administration in March 2018 announced its first round of trade tariffs which imposed a 25% tariff on steel and a 10% tariff on aluminum imports, sparking an all-out tit-for-tat trade war. It wasn't soon after those retaliatory tariffs were enacted that a number of countries threatened their own tariffs. China, leading the war against the US, slapped retaliatory tariffs on $16 billion of US goods. US industries, such as the farm belt and fishing companies, have felt the negative impacts associated with the tariffs.

In August 2018, the Trump Administration finalized a second round of Chinese tariffs that targeted an additional $16 billion on imports. China's retaliatory efforts affected a variety of US supplier chains and company operations.

Tariff Timeline

On September 24, 2018, the Trump Administration's plans for new tariffs went into effect. The new tariff increased 10% (until January 1, 2019) on as much as $200 billion in Chinese goods - on top of the current 25% on $50 billion of imports. China's retaliatory tariffs total $60 billion on US goods. The US has made additional threats to impose new tariffs on an additional $267 billion worth of imports.

Recent reports have stated that the tariff battle is in fact helping China become more competitive. After building its economy on the production of inexpensive exports, China has been on a mission to upgrade its output. The current tariff battle has only accelerated China towards this goal.

Agreements with the EU and the New NAFTA

The Trump Administration began waging tariffs targeting the EU on March 1, 2018, when the introduction of a 25% tax on steel and 10% tariff on aluminum was enacted. The EU's retaliatory measures against the US included Kentucky Bourbon, Levi jeans and Harley-Davidson vehicles. The Administration threatened with higher tariffs that would target European cars. In July 2018, the US and EU agreed to hold off on any further tariffs, providing a relief for many exporters, particularly the German car industry, which would have suffered heavy sanctions by a trade war.

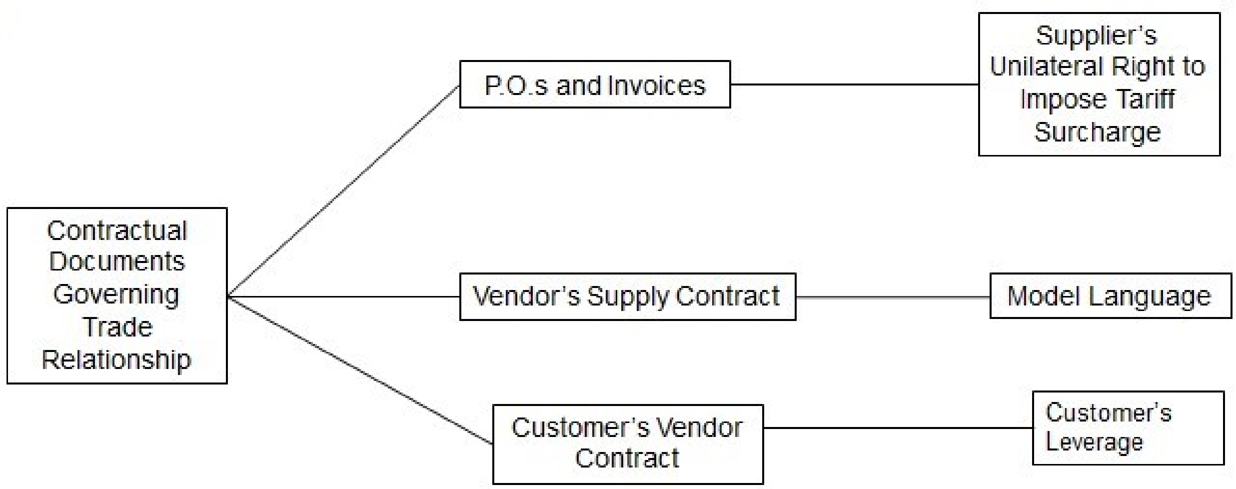
After more than a year of negotiations, on October 1, 2018, the US, Canada and Mexico reached an agreement to significantly revise the North American Free Trade Agreement (NAFTA). NAFTA, a 1994 pact, governs more than $1.2 trillion worth of trade between these three nations. The new deal will not go into effect right away, as many of the key provisions are set in 2020 due to a grueling approval process by all parties.

The title NAFTA is no more as the new deal will be known as the United States-Mexico-Canada Agreement (USMCA) and sets out new rules for cars, labor and IP protections. The goal of the new deal is for North America to produce more parts for cars and trucks. Beginning in 2020, any car or truck must have 75% of its parts manufactured in Canada, Mexico or the US. There's also new rules regarding labor - starting in 2020 cars and trucks should have at least 30% of the labor required on a vehicle to be done by workers earning $16 an hour.

Although these new rules are aimed at helping some North American workers, the possible rise in car prices might force them to be made elsewhere due to rising costs under the new requirement. Along with the new trade deal, the Administration signed side letters giving assurance to both nations that they will not endure auto tariffs. They may continue to send parts across the border free of charge, regardless of whether auto tariffs go into effect later.

Passing Tariff Costs to the Customer: Contract Review

The as-is starting point for whether the tariff cost may be passed to the customer is the contractual documents that govern the trade relationship. As the decision tree highlights, there are three settings: (1) P.O. and invoice-based trade relationship; (2) supply contract; or (3) customer contract.



P.O. and Invoice Based Trade Relationship

If the trade relationship is based on the customer placing a P.O. and the supplier issuing a confirming invoice, then the supplier has the legal right to pass the tariff cost, whether through a price increase or a tariff surcharge.

Vendor-Drafted Supply Contract

If the trade relationship is based on a vendor-drafted supply contract, then the supplier may have the legal right to pass the tariff cost to the customer. A supply contract provides for the supplier to provide its product or service based on time, say a multi-year term, or by quantity. The language of the contract will control the supplier's right to pass the tariff cost. If the contract was negotiated at least a couple of years ago, it's unlikely the supply contract has an express provision dealing with shifting the tariff cost to the customer.

The supply contract, however, may contain a catch-all provision that allows for the supplier to pass costs not expressly identified, but part of the supplier's operating costs. The contract, for example, may provide for annual price increases that are tied to indexes (CPI for example). The catch-all or implied contract provision as a basis for a tariff surcharge may cause customer pushback, contending there is no justification for the tariff surcharge.

Customer-Drafted Supply Contract

If the trade relationship is based on a customer-drafted supply contract, then the supplier's legal right to pass the tariff cost to the customer may be limited. Given the contract is drafted by the customer, supplier-friendly terms may not have been negotiated into the agreement as the customer has leverage in the relationship. This means the supplier may try to negotiate an addendum to the contract to allow for passing the tariff costs, or simply notify the customer in writing of the tariff surcharge.

It is crucial to keep in mind that the overall price to the customer will impact the supplier's ability to maintain a competitive position in the market. Track the costs of the tariffs in separate ledger accounts, so that if the ability to pass the costs to the customer exists, those amounts will be supported. This is much like a separate line item on an invoice, similar to that of freight and tax. Logging information this way will make it easier to delete it if or when a tariff is rescinded.

Passing the Tariff Cost: Price Increase or Tariff Surcharge?

The supplier must weigh how to present the tariff cost to the customer: price increase, where the tariff is not disclosed, or a tariff surcharge, where the tariff is disclosed through a line item on the invoice. How the tariff cost is disclosed to the customer is the supplier's choice. Given the credit team is the relationship builder, the best practice of disclosing passing the tariff cost may be through a tariff surcharge set out in a line item on the invoice or a pop-up disclosure in a portal. The credit team should track the tariff cost in a separate ledger account in order to support the tariff surcharge.

Passing the Tariff Cost, Customer Carve-Out and Preferred Pricing

The credit team rolling out a tariff surcharge across its customer base may get pushback on two fronts - the customer and the sales team. In both instances, the credit team may need to educate both as to the requirements of the antitrust law, the Robinson Patman Act (RPA), and the obligation to avoid preferred pricing. The issue of RPA violation may arise where the customer or sales team seeks a customer carve-out from the tariff surcharge.

The RPA, among other things, makes it illegal for suppliers to give more favorable prices to one customer without extending comparable prices to all similarly situated customers. The RPA bars discriminatory pricing amongst like, competing customers.

How may the credit team use the RPA so they may push back from the customer or sales team's request for a carve-out from the tariff surcharge? If another customer occupies the same like-class under RPA, the supplier may use the RPA to push back on the customer and sales team's carve-out demand.

Compliance with the RPA's like-customer rule does not consider the customer pressuring the supplier to concede the tariff surcharge carve-out. If the price set materially differs from that of similarly-situated customers, the supplier may have committed price discrimination.

Consider a different setting with evaluating RPA's like-customer rule and tariff surcharge carve-out: the customer requests a carve-out based on the supplier's competitor offering a carve-out. The customer is attempting to use the supplier's competitor's carve-out to force the supplier to make the same concession.

RPA has an exception titled 'meet-the-competition' where a supplier can offer more favorable pricing - here a tariff surcharge carve-out, to meet a competitor's price. The credit team's best practice is to have the customer pledge they have received a tariff surcharge carve-out.

Tariff Exclusions

The US Trade Representative announced in June 2018 an application process for US companies to be excluded from the tariff imposed on products manufactured in China. Under the exclusion program, US companies request an exclusion based on the type of product imported, the financial hardship the tariff causes the US company, as well as whether the tariffed goods can be obtained from another country.

Regarding the steel tariff, as of October 2018, over 49,000 companies submitted tariff exemption applications, of which over 11,000 were approved. Regarding the aluminum tariff, as of October 2018, over 905 companies submitted tariff exemption applications, of which over 750 were approved.

Tariffs Chip Away at US Corporate Earnings and the Impact on Customer's Financial Standing

At the start of 2018, US company earnings held a steady growth rate, but due to the escalating trade war between the US and China, its effects are starting to weigh heavily on US companies by slowing earnings, and the fundamentals of the trading markets are being tested by trade tensions.

The US steel import tariffs, for example, are costing manufacturing companies millions of dollars. While the two largest economies continue to fight a trade war, corporate earnings remain pressured.

Re-evaluating Credit Risk with Customers Importing Tariffed Goods

Focusing on credit risk with customers importing tariffed goods requires the credit team to re-evaluate the risk profile of these customers. The data points for credit re-evaluation include:

- Estimated revenues impacted by tariffs
- Can the customer pass costs to their customers, or are they forced to absorb them?
- Does the customer qualify for a tariff exclusion?
- How are the tariffs impacting their margins?

With the small and mid-sized customer, the credit team should implement a condition of customer financials with those customers saddled with tariff expenses.

Credit Enhancement to Offset Tariff Risk

The credit team may consider backstopping customer tariff risk through credit insurance.

Takeaways for the Credit Team

The credit team, in working with other departments, should establish a best practice for evaluating and passing tariff costs to manage margins. The credit team should also consider qualifying for a tariff exclusion. If customers will pay for the supplier's tariff costs, then a disclosure protocol should be adopted. The disclosure can be through an email notification to the customer base, or through a portal disclosure.

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