PRIOR DISCLOSURES

Alan C. Cohen Senior Attorney Penalties Branch, Regulations & Rulings Office of International Trade U.S. Customs and Border Protection Alan.C.Cohen@dhs.gov 202-325-0062

Disclaimer: The views represented herein represent that of the author and do not necessarily represent the positions of U.S. Customs and Border Protection.

THE BIRTH OF PRIOR DISCLOSURES:

Prior to October 3, 1978, and dating back the 1800's, 19 U.S.C. § 1592 provided:

If any consignor, seller, owner, importer, consignee, agent, or other person or persons enters or introduces, or attempts to enter or introduce, into the commerce of the United States any imported merchandise by means of any fraudulent or false invoice, declaration, affidavit, letter, paper, or by means of any false statement, written or verbal, or by means of any false or fraudulent practice or appliance whatsoever . . . without reasonable cause to believe the truth of such statement, or aids or procures the making of any such false statement as to any matter material thereto without reasonable cause to believe the truth of such statement, whether or not the United States shall or may be deprived of the lawful duties, or any portion thereof, accruing upon the merchandise, or any portion thereof, embraced or referred to in such invoice, declaration, affidavit, letter, paper, or statement; or is guilty of any willful act or omission by means whereof the United States is or may be deprived of the lawful duties or any portion thereof accruing upon the invoice, declaration, affidavit, letter, paper, or statement, or affected by such act or omission, such merchandise, or the value thereof, to be recovered from such person or persons, shall be subject to forfeiture, which forfeiture shall only apply to the whole of the merchandise or the value thereof in the case or package containing the particular article or articles of merchandise to which such fraud or false paper or statement relates.

What this stilted and archaic language meant is that, regardless of whether the importer acted with fraud or merely by simple negligence, the party was liable to a penalty equal to the domestic forfeiture value of the merchandise. *United States v. Ven-Fuel, Inc.*, 758 F.2d 741 (1st Cir. 1985); *United States v. R.I.T.A. Organics*, 487 F. Supp. 75 (N.D. III. 1980); Senate Report No. 778, 95th Cong., 2nd Sess. 1, *reprinted in* 1978 U.S. Code Congressional & Administrative News 2211, 2213. Moreover:

If an importer refuses to pay a section 592 penalty, whether or not it is mitigated, then he will be sued for the penalty in a U.S. district court. After the Government has proved 'probable cause' to believe section 592 was violated, the importer bears the burden of proving there was no violation. . . . If he fails, the court must impose the statutory penalty. The court has no power to reduce the penalty or to impose a mitigated penalty proposed by Customs. Because of the all or nothing nature of litigation under section 592, most importers pay the mitigated penalty proposed by the Customs Service under section 618 [19 U.S.C. § 1618].

Id. at 2229. Little wonder that "modern caselaw" on Section 1592 penalties was "scanty." *United States v. Ven-Fuel, supra.* at 755.

In order to encourage importers to disclose their own violations and to relieve them from the harsh provisions of an archaic civil penalty statute, at some point, it became:

[T]he established policy of the United States Customs Service with respect to voluntary disclosures of violations of . . . 19 U.S.C. § 1592, which may result in a loss of revenue, to mitigate the statutory liability in such cases, upon the filing of a petition for relief, to an amount not exceeding the total loss of revenue, provided a tender, as withheld duties, of the actual loss of revenue was made.

This policy was publicly announced in T.D. 75-21, 40 Fed. Reg. 2797, January 16, 1975, which promulgated the first regulation for what were then known as "voluntary disclosures," 19 C.F.R. § 171.1 (1975). Mitigation to an amount not to exceed one time the total actual and potential loss of revenue was limited to instances where "the disclosure was truly voluntary and not prompted by a Customs inquiry or an ongoing Customs investigation." *Id.* at § 171.1(a)(1). However, this mitigation was to be granted "regardless of whether the disclosed violation was intentional when committed." *Id.* Further mitigation was authorized "on the basis of relevant circumstances, such as diligence in disclosing a violation following its discovery." Note, however, that if the disclosing party refused to pay the mitigated penalty of one time the loss of duties or a lesser mitigated sum, it was still subject to a law suit in district court for the domestic forfeiture value of the merchandise.

Just a few months afterwards, Customs amended 19 C.F.R. § 171.1, explaining:

Although the number of voluntary disclosures of Customs violations has increased since the publication of the Customs policy in that regard, the policy has not proven to be as effective as originally contemplated. This, it has been determined, is due to the technical wording of the voluntary disclosure criteria, . . . which requires that the disclosure be truly voluntary 'and not prompted by a Customs inquiry.' This wording requires the interpretation and application of subjective criteria which do not clearly reflect the intention of the Customs Service to treat as voluntary those disclosures of violations which precede in time the initiation of a formal investigation of the transactions involving those violations by the Customs Service Office of Investigations. It is Customs policy to encourage the disclosure of such violations.

T.D. 75-234, 40 Fed. Reg. 43894, September 24, 1975. Accordingly, 19 C.F.R. § 171.1(a) was amended to provide that disclosures would be treated as voluntary "if no Customs investigation has been initiated with respect to the disclosed information." Investigations would be considered initiated on the date of referral of a possible violation to the Office of Investigations, or otherwise recorded by the Office of Investigations as the date the Office of Investigations opened its investigation. The prior disclosure regulation, in this second emanation, was clear that if there was no referral to the Office of Investigations, then the party would be free to make a voluntary disclosure. In fact, until 1998, Customs regulations would allow parties to make prior disclosures as long as there had been no referral to the Office of Investigations, regardless of the work that import specialists or inspectors had done on the case.

THE CUSTOMS PROCEDURE REFORM AND SIMPLIFICATION ACT OF 1978:

In 1978, Congress, as part of the Customs Procedural Reform and Simplification Act of 1978, performed a massive rewrite of 19 U.S.C § 1592, not only modernizing the language, but radically altering the statute. The "new" Section 1592 provided for three separate levels of culpability - fraud, gross negligence and negligence - each with a different burden of proof, and each with a different maximum penalty proportional to the culpability. The "new" statute also established the requirement for prepenalty notices prior to the issuance of penalty notices, and set forth procedural requirements for Customs to follow during the administrative process. Finally, the "new" statute codified the voluntary disclosure regulation, relabeling the "voluntary disclosures" as "prior disclosures." Prior disclosures are codified in 19 U.S.C. § 1592(c)(4), which, until January 1, 1994, provided:

If the person concerned discloses the circumstances of a violation of subsection (a) of this section before, or without knowledge of, the commencement of a formal investigation of such violation, with respect to such violation, merchandise shall not be seized and any monetary penalty to be assessed under subsection (c) of this section shall not exceed—

(A) if the violation resulted from fraud—

- (i) an amount equal to 100 percent of the lawful duties, taxes, and fees of which the United States is or may be deprived, so long as such person tenders the unpaid amount of the lawful duties, taxes, and fees at the time of disclosure, or within 30 days (or such longer period as the Customs Service may provide) after notice by the Customs Service of its calculation of such unpaid amount, or
- (ii) if such violation did not affect the assessment of duties, 10 percent of the dutiable value; or
- (B) if such violation resulted from negligence or gross negligence, the interest (computed from the date of liquidation at the prevailing rate of interest applied under section 6621 of title 26) on the amount of lawful duties, taxes, and fees of

which the United States is or may be deprived so long as such person tenders the unpaid amount of the lawful duties, taxes, and fees at the time of disclosure, or within 30 days (or such longer period as the Customs Service may provide) after notice by the Customs Service of its calculation of such unpaid amount.

The person asserting lack of knowledge of the commencement of a formal investigation has the burden of proof in establishing such lack of knowledge.

The "new" statute, on its face, differed from the preexisting voluntary disclosure regulation in several respects. The most dramatic departure was that the new statute allowed a party to make a prior disclosure, even after "the commencement of a formal investigation," provided the party could establish that it was "without knowledge of the commencement of a formal investigation of such violation." However, once a formal investigation was commenced, the disclosing party was presumed to have knowledge and bore the burden of proving lack of knowledge. In practice, if neither U.S. Customs and Border Protection (CBP) nor U.S. Immigration and Customs Enforcement (ICE) has informed the party that it is under investigation, or that the government has reason to believe that the party has violated the law, then the party may be able to meet its burden of proof by having the appropriate person or persons testify that they were unaware that the government had commenced a formal investigation.

The other major change that the statute effected from the prior regulation was the amount of the maximum penalty for most prior disclosures. Absent fraud, this penalty was reduced from one times the loss of duties, to interest from the date of liquidation to the date of payment. If the prior disclosure was made prior to liquidation, or if the violation did not involve a loss of duties, then, absent fraud, there is no interest penalty. If a party discloses that it committed fraud, then the maximum penalty is 1 time the loss of duties, or 10 percent of the dutiable value for a violation that did not involve a loss of duties. In practice, prior disclosures of fraud are extremely rare, because the prior disclosure is a confession that can be referred to the U.S. Attorney to serve as the basis for criminal prosecution. The few instances the author has encountered prior disclosures of fraud have come from subsequent owners who inherited the company from the people who had committed the fraud.

After the October 3, 1978 effective date of the new legislation, Customs, in T.D. 79-160, 44 Fed. Reg. 31950, June 4, 1979, promulgated 19 C.F.R. § 162.74, which has remained the prior disclosure regulation to this day. As stated earlier, 19 C.F.R. § 162.74 until 1998 defined the commencement of a formal investigation as a referral of the Office of Investigations (now ICE). Seven years after 19 C.F.R. § 162.74 was first promulgated, T.D. 86-119, 51 Fed. Reg. 23047, June 25, 1986, amended 19 C.F.R. § 162.74 by providing, in addition to various methods of notifications by the investigating agent from the Office of Investigations, that the disclosing party was presumed to have knowledge of the commencement of a formal investigation if:

An import specialist, regulatory auditor, inspector or other Customs officer, having reasonable cause to believe that there has been a violation of 19 U.S.C. § 1592, so informed the person concerning the type of or circumstances of the disclosed violation.

However, a formal investigation was still defined as a referral to, or commencement by, the Office of Investigations. The 1986 amendment to 19 C.F.R. § 162.74 merely allowed an import specialist, regulatory auditor, inspector, or other Customs officer who was not an investigating agent, to cut off of prior disclosure by informing the person that he or she may have violated 19 U.S.C. § 1592, but only if the Office of Investigations had commenced a formal investigation. If the Office of Investigations declined to initiate an investigation, then the party would remain free to file and obtain a prior disclosure.

AN EXAMPLE OF HOW THE PRE - CUSTOMS MODERNIZATION ACT STATUTE AND REGULATION DIDN'T WORK:

The following is a hypothetical example illustrating why some in the then Customs Service, now U.S. Customs and Border Protection (CBP), felt that the statute and implementing regulations unfairly allowed violators to obtain prior disclosures after CBP personnel who were not criminal investigators otherwise investigated, uncovered the violation and informed the party of the violation.

A Fines, Penalties and Forfeitures ("FP&F") Officer covering a portion of the U.S.-Canada border assessed a domestic value penalty of approximately \$150,000 against Mr. X, alleging a violation of 19 U.S.C. § 1592 by means of fraud. At issue were eleven entries of can openers, purportedly made in Canada, that had been entered duty-free under the then U.S. -Canadian Free Trade Agreement. The entry documents, including the invoices, identified ABC Motors Co. of Utica, New York, as the importer of record. A Customs import specialist noticed these entries and thought it was odd that a company named ABC Motors Co. would be filing commercial entries of can openers. His research confirmed that ABC Motors was a used car dealership. He then called ABC Motors and spoke to the owner, who denied that his used car dealership had ever imported or purchased large quantities of can openers. The import specialist then asked the owner of ABC Motors to confirm the address stated on the invoices and entry summaries. The owner stated that this was not the address of ABC Motors but instead was across the street and was a storage locker rental facility that ABC Motors owned. The entry documents identified a suite number – the owner stated there were no suites, just storage lockers on the property across the street, but that the suite number did match the number of one of the storage lockers that was being rented. The owner of ABC Motors then provided the import specialist the name and phone number of Mr. X, who was renting this storage locker.

The import specialist then called Mr. X, who admitted that he was the person importing the can openers, which he was selling to a major retail chain. The import specialist then arranged to visit Mr. X. At the subsequent meeting, Mr. X presented the eleven purchase orders from the major retail chain, and the corresponding eleven invoices he had issued to the major retail chain. The import specialist immediately noticed that the prices paid by major retail chain buying the can openers significantly exceeded the declared values, and that the can openers had been made in Italy and not in Canada, making them ineligible for the benefits of the U.S. – Canada Free Trade Agreement. Mr. X admitted that he had created fraudulent invoices which he had presented to the customs broker to avoid paying duties on the can openers. Mr. X assisted

the import specialist in calculating a duty loss of \$2,222 and, before the import specialist had left to return to the Customs office, Mr. X wrote out a check in that amount and handed it to the import specialist.

Mr. X's attorney argued that, under the then existing 19 C.F.R. § 162.74, his client had made a valid prior disclosure, as there had never been a referral to the Office of Investigations. Although the import specialist, "having reasonable cause to believe that there [had] been a violation of 19 U.S.C. § 1592, so informed [Mr. X] concerning the type of or circumstances of the disclosed violation," this notification did not inform Mr. X that Customs had commenced a formal investigation, because, under the regulation, a formal investigation could not commence until there was a referral to the Office of Investigations. Under the regulation that existed between the 1978 and 1993 amendments to 19 U.S.C. § 1592, Customs had to agree to accept the prior disclosure as valid, even though Mr. X's admissions could not be characterized as a "disclosure," and Mr. X's confession was not made "prior" to being confronted with his false statements.

THE CUSTOMS MODERNIZATION ACT OF 1993 AND ENSUING CHANGES TO THE PRIOR DISCLOSURE REGULATION:

On December 8, 1993, President Clinton signed the Customs Modernization Act which, *inter alia*, amended 19 U.S.C. § 1592(c)(4) to add the following at the end of the prior disclosure subsection:

For purposes of this section, a formal investigation of a violation is considered to be commenced with regard to the disclosing party and the disclosed information on the date recorded in writing by the Customs Service as the date on which facts and circumstances were discovered or information was received which caused the Customs Service to believe that a possibility of a violation of subsection (a) of this section existed.

The House Ways and Means Committee Report, reporting this amendment, commented:

With regard to prior disclosure, the Committee believes there should be a clearly defined and objective standard by which to measure when a formal investigation has considered to be commenced. That objective standard has to lie in the creation of a formal document or electronic transmission that will serve as evidence, if so required, of the formal opening of an investigation. That document or transmission must be maintained by the Customs Office of Enforcement or other central unit to be designated within Customs.

If a Customs official has reasonable cause to believe that a violation of section 592 has occurred, it will be incumbent on that official to record the salient facts and provide them to the Office of Enforcement or other central unit. That office shall determine whether the facts merit the opening of a formal investigation. Furthermore, care must be taken to record for posterity, the essential facts (e.g., names, nature of investigation, type of issue such as undervaluation, marking date and time the case is opened, etc.). Recourse to this

procedure will allay the trade community's concerns that prior disclosure benefits will be denied in the absence of tangible evidence.

The Committee does not intend that Customs disclose to the target of an investigation the fact that a formal investigation has been opened. Nonetheless, if the Customs Service determines that it is appropriate to issue a pre-penalty notice under authority of section 592(b)(1) of the Act, a copy of the written document or electronic transmission should be included as an exhibit. In that one document, it will be patently clear whether the violation alleged ties to information previously disclosed by the disclosing party. More importantly, the timing issue will be properly framed. If the importer's disclosure of the circumstances of the violation precedes the recorded disclosure date, the case should be treated as one involving prior disclosure. Conversely, if the disclosure did not precede the opening of the formal investigation, the disclosing party will be left with a single burden: to prove disclosure of the circumstances of the violation was made without knowledge of the commencement of a formal investigation

Ways & Means Committee Rep. No. 103-361 at 120, 1993 U.S.C.C.A.N. 2670 (1993). In T.D. 98-49, 63 Fed. Reg. 29126, May 28, 1998, the CBP implemented the House Committee's recommendation that the CBP attach the document(s) commencing the investigation to the prepenalty notice, when the claim of prior disclosure is to be denied. This requirement now is contained in 19 C.F.R. § 162.74(g).

(g) Commencement of a formal investigation. A formal investigation of a violation is considered to be commenced with regard to the disclosing party on the date recorded in writing by the Customs Service as the date on which facts and circumstances were discovered or information was received that caused the Customs Service to believe that a possibility of a violation existed. In the event that a party affirmatively asserts a prior disclosure (*i.e.*, identified or labeled as a prior disclosure) and is denied prior disclosure treatment on the basis that Customs had commenced a formal investigation of the disclosed violation, and Customs initiates a penalty action against the disclosing party involving the disclosed violation, a copy of a "writing" evidencing the commencement of a formal investigation of the disclosed violation shall be attached to any required prepenalty notice issued to the disclosing party pursuant to 19 U.S.C. 1592 or 19 U.S.C. 1593a.

CBP viewed the 1993 amendment to the prior disclosure statute as authorization to focus not on the date of referral to the Office of Investigations, but on the date anyone in the CBP, not necessarily an agent from the Office of Investigations, creates a writing memorializing that "facts and circumstances were discovered or information was received which caused the Customs Service to believe that a possibility of a violation of subsection (a) of this section existed." Prior to the enactment of the Customs Modernization Act, the great majority of Section 1592 penalties had been investigated by the Office of Investigations. However, for the past few years and in the foreseeable future, relatively few cases culminating in Section 1592 penalties have been investigated by the successor to the Office of Investigations - ICE. This trend has been accelerated by the horrific terrorist attack on September 11, 2001, and the heightened security concern that has developed in the wake of the attack. Congress, on November 25, 2002, enacted

the Homeland Security Act of 2002, Pub. L. 107-296, 116 Stat. 2135, which divided the Customs Service into CBP and ICE. Since then, ICE has continued to accept referrals of the most potentially serious Customs fraud cases; however, ICE must balance its resources to fulfill its mission statement on its website - "to promote homeland security and public safety through the criminal and civil enforcement of federal laws governing border control, customs, trade, and immigration." Accordingly, the bulk of Section 1592 penalties are now developed within CBP, without referral to ICE.

Thus, 19 C.F.R. § 162.74(g), quoted above, and promulgated at T.D. 98-49, 63 Fed. Reg. 29126, May 28, 1998, no longer defines "commencement of a formal investigation" as a referral to the Office of Investigations or ICE, as it had done prior to this date and prior to the Customs Modernization Act. Rather, the formal investigation commences "on the date recorded in writing by the Customs Service as the date on which facts and circumstances were discovered or information was received that caused the Customs Service to believe that a possibility of a violation existed." Moreover:

A person shall be presumed to have had knowledge of the commencement of a formal investigation of a violation if before the claimed prior disclosure of the violation a formal investigation has been commenced and Customs, having reasonable cause to believe that there has been a violation of 19 U.S.C. § 1592 or 19 U.S.C. § 1593a, so informed the person of the type of or circumstances of the disclosed violation.

19 C.F.R. § 162.74(i)(1)(i). Thus, 19 C.F.R. §§ 162.74(g) and (i)(1)(i) clearly provide that CBP alone, without involvement from ICE, may commence a formal investigation and notify the suspected violator of this fact, thereby precluding a prior disclosure.

In fact, the Analysis of Comments contained in T.D. 98-49, 63 Fed. Reg. 29126, confirm that, since the May 28, 1998 date of publication, CBP may commence a formal investigation on its own without ICE involvement, and provide the notification of the commencement of the investigation to the alleged violator. The notice summarized a number of comments proposing that "only agents from the Office of Investigations can commence formal investigations for prior disclosure purposes." Customs rejected these proposals, stating:

We do not agree that the law mandates that agents of the Office of Investigations are the only Customs officials capable of commencing a formal investigation for the purposes of prior disclosure.

Of course, CBP has always had to analyze whether the purported prior disclosure discloses the circumstances of the violation. For example, a typical prior disclosure asserts that the disclosing party was unaware of its violation, and only recently discovered its error through an internal audit. If a subsequent ICE investigation or CBP audit reveals that the disclosing party had a fraudulent double invoicing scheme and knew exactly what it was doing, then, even if the party has properly identified each entry and has tendered the duties in full, the prior disclosure would fail, because the disclosing party has not accurately disclosed the circumstances of the violation.

In analyzing a prior disclosure, CBP has to ask the following questions:

1. Did the party fully and accurately disclose the circumstances of the violation, and tender the full actual loss of duties caused by the violation?

If not, the prior disclosure is not valid and should be denied. But if the disclosure fully and accurately disclosed the circumstances of the violation, and the party has tendered all the duties as required by 19 C.F.R. § 162.74(c), then:

2. Had CBP or ICE commenced a formal investigation prior to the claimed disclosure?

If an investigation has not been commenced, then a prior disclosure which has fully and accurately disclosed the violation and its circumstances, with full payment of the actual loss of duties, should be accepted as valid. But if it appears an investigation may have been commenced, then:

- a Did CBP have a reasonable cause to believe that there has been a violation of 19 U.S.C. § 1592?
- b. Did CBP create a writing that recorded the date on which facts and circumstances were discovered or information was received which caused CBP to believe that a possibility of a violation of subsection (a) of this section existed?

If the answer to either of these questions is "no", then the prior disclosure should be valid. If the answer to both questions is "yes", then:

3. Did the party have knowledge that CBP or ICE had commenced a formal investigation of the particular violation?

CBP or ICE may have notified the party orally (as discussed in the 1998 Federal Register Notice), or in writing. In some instances, a party may acquire knowledge without being informed by ICE or CBP (e.g. when German Customs agents executed a search warrant on the U.S. party's related party seller in Germany.)

CONCLUSION:

In the ABC's of Prior Disclosures published on the CBP website, CBP states that "The official policy of CBP is to encourage the submission of valid prior disclosures!" The ABC's of Prior Disclosures goes on to state:

An important point to remember about prior disclosure is that it is rooted in fairness, to both the Government and the trade community. For example, if a party submits a valid prior disclosure, the party receives the significantly reduced penalty benefits the law

provides. On the other hand, where there is no prior disclosure and CBP or ICE discovers the violation (and the violator has knowledge of a commenced investigation) disclosure treatment is not afforded the violator. This is another reason why U.S. Customs and Border Protection has adopted a policy which encourages the submission of valid prior disclosures.

This policy remains unchanged. Whether a particular prior disclosure is valid, or not valid because CBP has commenced a formal investigation and that the disclosing party has knowledge of this fact, will be determined on a case by case basis.