Contracts Corner: Navigating Tariff Hikes and Contractual Risk in Commercial Agreements

Commercial and Contracts

Government

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Companies engaged in global trade are facing a new level of complexity due to the recent changes in tariff policies under the new US administration. And executives will be relying on in-house counsel for answers to questions like: Our suppliers are responsible for the tariff-related cost increases, right? Can we terminate our customer contract because tariff hikes are making it commercially impractical to keep delivering goods? Can we pass through the tariff-related costs to our customers? Can we renegotiate pricing or rates given market or regulatory changes?

As in-house counsel, providing business-savvy advice is paramount and with our guidance you will be ready — not reactive.

This article provides a framework for counsel to determine if their company's current commercial contracts expose it to tariff risks, what options to consider when reviewing existing contracts, and how to mitigate tariff-related commercial disputes. These tips are intended to help counsel assess existing commercial contracts and advise their business stakeholders amidst the tariff uncertainty.

First, counsel should determine if the goods supplied under the agreement are subject to tariff increases. This requires a 3-step analysis:

1. Establish the good's country of origin for US customs purposes (see *How to* below) because that determines which tariffs apply;
2. Verify the applicable tariff rate per the US Harmonized Tariff Schedule (HTS); and
3. Consider whether the goods may be exempted.

How to determine a product's country of origin?

- First, check the label for something like "Made in Italy" or "Product of Canada."
- Second, assess whether it is entirely made using materials and labor from that same country. If so, that country likely is its country of origin.
- If a product is made in multiple countries, the country of origin is usually the location where

the final production occurs.
- Also, consider applicable free trade agreements, import regulations and related exemptions as these may apply to the goods in question.

Recently, tariff rates have been shifting on a near-daily basis with some being suspended because the US and the foreign trading country negotiated a suspension or reduction, so be sure to confirm the exact tariff rate. The list of exempt goods continues to evolve; make sure to double check the latest developments.

Second, if tariffs do apply to goods sold or purchased under an existing commercial contract, then counsel should assess if the contract provisions assign tariff risk to one party and, if so, whether that is enforceable under the contract's governing law. This may be straightforward depending on the type of contract and its provisions. Or, it may not be.

Tariff-related contract provisions

For example, a fixed-price contract may include a clause explicitly stating that the contract price includes all applicable taxes, import duties and tariffs. In that case, under the contract terms, the supplier of the goods would be responsible for the tariff increases. Contracts for the sale of goods often incorporate Incoterms, published by the International Chamber of Commerce (ICC), such as DDP (delivered duty paid), indicating that the seller is responsible for the costs and duties related to the entry of goods into the U.S. or DAP (delivered at place), which means the seller is responsible for delivering the goods to the specified place, and the buyer assumes responsibility for all import duties, taxes, and customs clearance procedures at that location. So, if the party responsible for the tariff-related cost increases is specified in the commercial agreement, as in the examples above, then that aspect likely will be the starting point for tariff-related cost increase discussions with your counterparty. Also, be on the lookout for proposed changes to Incoterms (like DDP to DAP) and their unintended consequences which can easily fly under the radar.

But not every contract designates which party is responsible for import duties, taxes, or tariffs. Some may include a catch-all provision concerning a broad category of government-imposed costs. For example, a clause that allows the vendor to pass through any "government-imposed rate increases to the customer" or "any charge or fee levied by any federal, state or local governmental entity" assigns responsibility for tariff-related costs to the customer as tariffs are a type of government-imposed rate increase, levied fee or charge. If your review of your company's supplier agreements reveals clauses like this one, as counsel for the customer you likely would want to strategize with your business stakeholders about approaching the supplier to discuss ways to potentially share this cost burden and avoid a tariff-related commercial dispute.

Read more: **Wisdom of the Crowd: Tariffs and Economic Uncertainty**

What if the contract is silent on taxes, import duties, tariffs and government-related rates? US law imposes the initial payment of a tariff on the importer of record who brings the goods into US territory. So, unless the contract specifies otherwise, the party that is importer of record would be responsible for the tariff costs that are collected by the U.S. Customs and Border Protection (CBP).

Counsel may need to dispel a myth that business stakeholders are espousing, which is that your company can justify its non-performance (e.g., not delivering the goods) by relying on a force majeure clause or the doctrine of commercial impracticality. A force majeure clause relieves a party of liability for non-performance or delayed performed due to specific events beyond the parties' control like a strike, war, governmental restraint or embargo. Commercial impracticability means that one party is excused from fulfilling their contractual obligations if an unforeseen event occurs that makes their performance unreasonably difficult.

Generally, courts are reluctant to excuse performance or confirm commercial impracticability due to changes in costs, prices, or market conditions — even if such results from "governmental acts." The rationale being that changes in market conditions are reasonably foreseeable events and market stability is not a "basic assumption" on which parties enter into a commercial agreement.

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If counsel is advising their company on entering new contracts concerning goods that may expose the company to tariff hikes, they — together with their business stakeholders — should devise a strategy to negotiate favorable tariff-related terms with their counterparty. This could include expressly allocating which party will be responsible for import duties and tariffs. A vendor or seller's counsel might also attempt to negotiate a clause reserving the right to adjust prices to reflect the impact of any tariffs or other governmental charges imposed, or economic, administrative, legal or regulatory condition changes during the contract term. Alternatively, a shipper or buyer's counsel might negotiate a clause that clarifies that its obligation to pay any portion of the tariff or other cost increase will be subject to the parties' prior mutual agreement. Or, counsel may want to consider including a provision that establishes a cost sharing arrangement or price renegotiation opportunity if a tariff-related cost increase occurs.

For example, if an applicable tariff substantially increases costs for one party, then the parties will negotiate a cost increase share arrangement, in good faith, and if a cost sharing arrangement is not reached within a certain timeframe then the parties may opt to (i) reduce the duration of the contract, (ii) decrease the purchase commitment or (iii) terminate, without penalty, and any purchase commitment will be deemed satisfied upon termination. The parties might also agree to continue performing their respective contractual obligations, without interruption, during the negotiation period. Another approach is for parties to agree that if a tariff-related event occurs in a particular geographic location, they will, in good faith, renegotiate pricing to reflect the impact of that increased cost. In these scenarios, it is always important to ensure that other contract provisions, such as payment terms, governing law and dispute resolution, align to support the tariff-related provision accordingly.

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Finding a win/win with counterparties

The party that negotiated the allocation of the tariff risk to its counterparty has the right to enforce the terms of the agreement and make the counterparty absorb the entire tariff hike. However, such a strict “letter of the law” approach toward the counterparty may not make business sense.

For example, if the contract states that the supplier pays tariff-related costs and doing so would decrease supplier volume or, even worse, put the supplier out of business, especially if the supplier’s goods are key components for your company’s products, then identifying a mutually agreeable cost-sharing arrangement may be the best path forward.

Generally, finding a win/win solution — especially with your company’s long-term, strategic counterparties — is the preferred, business-oriented solution. Counsel should strategize with their business stakeholders about the approach their company wants to take to ensure strategic alignment vis-à-vis their counterparties and mitigate commercial contract disputes during this time of tariff-related economic uncertainty.

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