

# Compliance Due Diligence for Corporate Transactions

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# Compliance Due Diligence for Corporate Transactions



- Legal Requirements Covered by this Program
  - Anti-Corruption Laws
  - Economic Sanctions
  - Export Controls
  - Government Contracting Rules
  
- Reasons for Compliance Due Diligence
- Compliance Due Diligence Plans – Factors that Should Determine Breadth and Character of Due Diligence
- Diligence Steps
- Challenges
- Addressing Due Diligence Findings
- Hypotheticals

# Anti-Corruption Laws

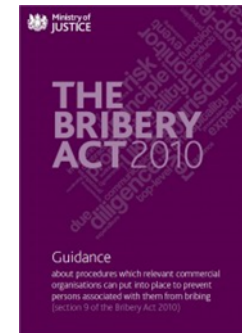
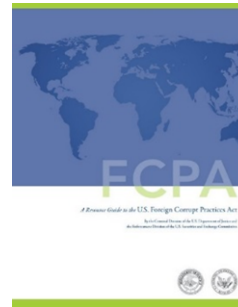


## ➤ U.S. Foreign Corrupt Practices Act (FCPA)

- Prohibits corrupt payments to a foreign official (broadly defined) and payments to third parties with reason to know that they will make a corrupt payment
- Also imposes accounting requirements for public companies

## ➤ UK Anti-Bribery Act

## ➤ OECD Convention



# Economic Sanctions



- U.S. Treasury Department's Office of Foreign Assets Control (OFAC)
  - Enforces 20+ U.S. economic sanctions programs against countries, regions, governments, organizations and individuals
  - Frequently changes scope of sanctions programs in response to world events
- EU Restrictive Measures – must be enforced by Member States



# Economic Sanctions



Sanctions generally prohibit persons from directly or indirectly engaging in or facilitating business with or relating to target countries, regions, governments, organizations and individuals

- Territorial sanctions (U.S. only): Crimea, Cuba, Iran, Syria, and North Korea; Sudan embargo lifted Jan 17
- Person-specific sanctions (U.S., EU and others): ban most direct and indirect dealings with designated individuals and entities and some related entities
- Regarding Russia: more limited financial and other sanctions regarding designated banks, energy companies and defense companies and some related entities



# Export Controls



- U.S. Export Administration Regulations (EAR)
  - Administered by U.S. Department of Commerce
  - Cover “dual use” goods, software and technology
  
- U.S. International Traffic in Arms Regulations (ITAR)
  - Administered by U.S. Department of State
  - Cover “defense articles” and “defense services” – military-related goods, software, technology *and services*
  
- EU and other jurisdictions administer similar export controls
  
- U.S. controls apply to “deemed” exports – release of technology of software to foreign persons

# Government Contracting Rules



- U.S. Federal Acquisition Regulation (FAR)
  - Regulations govern acquisition of goods and services throughout U.S. federal government
  - Federal agencies administer supplemental acquisition regulations, e.g., Defense FAR Supplement (DFARS)
  - Typical area of contract exposure – miscertification of cost or pricing data to awarding agency
  - Government commonly enforces under False Claims Act
  - Industrial security rules – National Industrial Security Program Operating Manual (NISPOM)
  - Other jurisdictions administer similar acquisition rules

# Reason for Compliance Due Diligence: Avoid Target Value Misunderstanding



- Target of investment can have latent liability exposure
- Can materially affect target's value
- Instances in which anticorruption liability resulted in M&A target value actually being \$0



# Reason for Compliance Due Diligence: Avoid Successor Liability



- U.S. statutory law does not explicitly provide for enforcement based on a theory of successor liability
- Nevertheless, DOJ, the SEC and other agencies have taken the position that a successor company can assume predecessor company's liabilities
- Common for mergers and stock acquisitions – but successor liability can be assessed following asset acquisition

# Reason for Compliance Due Diligence: Satisfy Legal Requirement



- For IPOs, securities rules are beginning to mandate compliance due diligence and disclosure of results by issuer
- E.g., Hong Kong Stock Exchange requirement

# Compliance Due Diligence Plan



## Acquirer Should Develop Compliance Due Diligence Plan

- Breadth and character of plan dependent on transaction-specific factors
- Transaction may warrant far-reaching diligence in one area and modest diligence in another area
- Plan may range from:
  - Few informal questions apparent risk areas
  - Full-scale compliance investigation

*Optimizing plan requires judgment – can be too limited; can be too extensive*

# Compliance Due Diligence Plan: Anti-Corruption Laws



## Factors that Should Affect Character and Breadth of Anti-Corruption Diligence Plan

- Size of transaction
- Ownership stake being acquired in Target
- Degree to which Target does business in high-risk locations
- Degree to which Target does business with government-owned or government-controlled entities
- Degree to which Target employs sales intermediaries (e.g., sales agents)
- Average value of Target sales transactions
- Target's anti-corruption compliance record and compliance program

# Compliance Due Diligence Plan: Sanctions/Export Controls



## Factors that Should Affect Character and Breadth of Sanctions/Export Controls Diligence Plan

- Size of transaction
- Ownership stake being acquired in Target
- Degree to which Target does business in countries subject to embargo or containing high numbers of sanctioned persons
- Whether Target works with export controlled items, especially items subject to military export controls (U.S. ITAR)
- Degree to which Target produces and exports export-controlled products
- Target's sanctions and export control compliance record and compliance program

# Compliance Due Diligence Plan: Government Contracting Rules



## Factors that Should Affect Character and Breadth of Government Contracting Diligence Plan

- Size of transaction
- Ownership stake being acquired in Target
- Extent of Target's prime contracts, subcontracts (number and value)
- Extent of cost-reimbursement contracting (often more risky than fixed price contracting)
- Whether Target engages in classified contracting
- Target's government contracting compliance record and compliance program



## Options

- Review of public record
- Written requests for documents and information
- Interviews
- Site visits
- Audits

# Challenges



- Competitive bidding for target – bidding structure, business considerations and timing factors often limit diligence opportunities
- Antitrust restrictions – restraints on ability to examine confidential financial and sales information
- Limits on Target personnel “under tent” (cannot engage because unaware of transaction)



# Addressing Due Diligence Findings



- Expert analysis under legal requirements
- Change in target behavior – suspend noncompliant or risk activity
- Contract protections – representations, warranties, closing conditions, indemnities
- Engaging regulators – securing government approvals, guidance or opinion (e.g., DOJ FCPA opinion procedure); voluntary disclosure by seller
- Restructuring of transaction – excluding from transaction operations that involve compliance risk

# Hypotheticals: Scenario 1



- Transaction involves acquisition of 100% of Target for \$425 million
- Target is software producer that sells entirely to private parties
- Foreign sales account for roughly 60% of Target's revenues, and sales to China, India, Russia and Brazil account for 30% of Target revenues
- Target's software contains encryption
- Target has no sanctions or export controls compliance policy
- Target makes no sales, directly or indirectly, to the U.S. government

# Hypotheticals: Scenario 1



## ➤ FCPA Due Diligence

- Large value of transaction, acquisition of entire Target and extensive sales to high-risk countries weigh in favor of extensive compliance due diligence
- Lack of sales to government entities weighs against extensive compliance due diligence
- Moderate level of due diligence warranted

## ➤ Sanctions/Export Controls Due Diligence

- Large value of transaction, acquisition of entire Target, lack of compliance policy, sales to high-risk countries and encryption all weigh in favor of extensive compliance due diligence
- Lack of evidence of sales to embargoed jurisdictions weighs against extensive due diligence
- Relatively extensive level of due diligence warranted

## ➤ Government Contracting Due Diligence

- Large value of transaction and acquisition of entire Target weigh in favor of extensive compliance due diligence
- No direct or indirect sales to U.S. government weighs against extensive due diligence
- Low level of due diligence warranted

# Hypotheticals: Scenario 2



- Transaction involves acquisition of 100% of Target for \$15 million
- Target sells to both public and private parties
- Foreign sales account for roughly 40% of Target's revenues, and sales to China, India, Russia and Brazil account for 10% of Target revenues
- Target has no sanctions or export controls compliance policy
- Many of Target's products are subject to export licensing requirements
- Target makes modest sales to the U.S. government

# Hypotheticals: Scenario 2



## ➤ FCPA Due Diligence

- Acquisition of entire Target weighs and sales to foreign government entities weigh in favor of extensive compliance due diligence
- Small value of transaction, modest sales to high-risk countries weigh against extensive compliance due diligence
- Moderate level of due diligence warranted

## ➤ Sanctions/Export Controls Due Diligence

- Acquisition of entire Target, products subject to export control and lack of compliance policy weigh in favor of extensive compliance due diligence
- Small value of transaction weighs against extensive due diligence
- Moderate level of due diligence warranted

## ➤ Government Contracting Due Diligence

- Acquisition of entire Target and sales to USG weigh in favor of extensive compliance due diligence
- Small value of transaction weighs against extensive due diligence
- Low level of due diligence warranted

# Hypotheticals: Scenario 3



- Transaction involves acquisition of 35% of Target for \$115 million
- Target is sold to both public and private parties
- Foreign sales account for roughly 10% of Target's revenues, and all foreign sales to Western Europe
- Target has sanctions and export controls compliance policies
- Many of Target's products are subject to ITAR control
- Target makes extensive sales to the U.S. government

# Hypotheticals: Scenario 3



## ➤ FCPA Due Diligence

- Size of transaction weighs in favor of extensive compliance due diligence
- Minority interest in Target, no sales to high-risk countries weigh against extensive compliance due diligence
- Low level of due diligence warranted

## ➤ Sanctions/Export Controls Due Diligence

- Size of transaction and ITAR control of Target products weighs in favor of extensive compliance due diligence
- Minority interest in Target, existence of compliance policies weighs against extensive due diligence
- Moderate level of due diligence warranted

## ➤ Government Contracting Due Diligence

- Size of transaction and extensive sales to USG weigh in favor of extensive compliance due diligence
- Minority interest in Target weighs against extensive due diligence
- Moderate level of due diligence warranted



# ADDITIONAL SLIDES





## **The most common areas in which anti-corruption problems are discovered include:**

- Sales to governments and government-owned entities
  - Including relationships with sales agents, distributors, local partners and joint venture partners.
- Customs
- Visa Issuers
- Acquisition of Permits
- Interaction with Tax Authorities
- Gifts, hospitality and travel services
- Joint Ventures



## IN RE THE GOODYEAR TIRE & RUBBER CO. (2015)

### Enforcement Agency: SEC

- Summary: Goodyear acquired a majority interest in a tire distributor in Kenya in 2006. It failed to detect over \$1.5 million in payments made by the subsidiary to employees of “government-owned or affiliated entities” and private parties from 2007 to 2011
  - The subsidiary approved the use of false invoices and false accounting entries
- Penalties
  - \$14 million in disgorgement and \$2 million in prejudgment interest
  - Goodyear agreed to divest interest in the subsidiary
  - Goodyear required to self-report to the SEC on its remediation efforts for a three-year period
- Pitfall Lesson:
  - Conduct can be concealed through false documentation, which can be difficult to uncover



# DOJ FCPA OPINION PROCEDURE RELEASE 14-02 (2014)

## Enforcement Agency: DOJ

### ➤ Summary:

- Acquisition by a U.S.-based public, multi-national company of a foreign seller and its wholly owned subsidiary (the “Target”)
- Pre-acquisition due diligence revealed that the Target had made improper payments to government officials. None of the payments, however, had a nexus to the United States.

### ➤ Penalties

- The DOJ did not take any action with regard to the pre-acquisition bribery, but noted that any post-acquisition bribery could give rise to liability. It advised the acquirer to implement anti-corruption policies, engage in training and remediation, conduct an “FCPA-specific audit,” and disclose to the DOJ any corrupt payments “as quickly as practicable” after closing
- The Opinion notes that adherence to these elements will help determine whether and how the DOJ would impose post-acquisition successor liability in the event of a future violation

### ➤ Pitfall Lesson:

- Quickly implement policies and procedures that will prevent post-acquisition successor liability



## WATTS WATER TECHNOLOGIES, INC. (2011)

### Enforcement Agency: SEC

#### Summary:

- Acquired a Chinese entity that conducted business primarily with state owned entities (“SOEs”) in an asset transaction in 2006.
  - Did not conduct specific pre-acquisition anti-corruption diligence.
  - Did not implement compliance controls after acquisition.
  - Did not discover written policy of paying kickbacks/rebates as part of an incentive program.
  - Discovered sales personnel were making improper payments in 2009.
- Penalties: \$2.8 million in disgorgement, \$800k in prejudgment interest, and \$200k civil penalty.
- Pitfall Lesson:
  - Diligence is important—even in asset transactions—to stop ongoing misconduct.
  - Anti-corruption compliance controls need to be implemented after acquisitions to identify and stop misconduct.



## IN RE RAE SYSTEMS INC. (2010)

**Enforcement Agency: DOJ, SEC**

➤ Summary:

- RAE Systems acquired interests in two Chinese companies that were then organized as JV's.
- Pre-acquisition due diligence was conducted on one company and uncovered improper payments to customers, including government officials by the company's sales force.
- Despite awareness of improper commissions and kickbacks, internal controls were not properly implemented.
- No FCPA pre-acquisition due diligence was conducted before acquiring interest in second company.
- Improper payments continued after acquisitions.

➤ Penalties: \$1.7M criminal penalty and approximately \$1.2M in disgorgement of profits and prejudgment interest.

➤ Pitfall Lesson: Companies cannot escape liability by:

- Deciding not to conduct diligence in the first instance; or
- Turning a blind eye to unpleasant diligence findings.



## LATIN NODE, INC. (2009)

### Enforcement Agency: DOJ

#### ➤ Summary:

- The buyer, eLandia International Inc., was to acquire Latin Node, Inc. from Retail Americas VoIP.
- eLandia relied on representations made by Latin Node prior to closing.
- eLandia discovered potential FCPA violations by Latin Node post-closing, including payments to Honduran and Yemeni officials of state-owned telecommunications companies.
- eLandia conducted an internal investigation and made a voluntary disclosure to DOJ and SEC.

#### ➤ Penalties: \$18.2M allocated to FCPA investigation, resulting penalties, termination of Latin Node senior management, and loss of business.

- Latin Node's guilty plea resulted in dissolution of operations.
- eLandia paid \$2M fine on Latin Node's behalf, but no criminal charges.
- Collateral litigation with seller and executives.

#### ➤ Pitfall Lesson: Pre-acquisition diligence is critical.



## **SMITH & NEPHEW**

### **Enforcement Agency: DOJ, SEC**

#### ➤ Summary:

- S&N acquired Swiss firm Plus Orthopedics Holding AG in 2007.
- Post-closing discovered irregular sales practices in Plus' Greek business.

#### ➤ Consequences:

- \$100 million in lost revenue and \$25 million in lost profits as a result of the necessary post-completion “clean-up.”
- Share price tumbled almost 13%.
- Ultimately, S&N reached an agreement with the vendors of Plus Orthopedics to reduce the previous purchase price.

#### ➤ Pitfall Lesson:

- Diligence is critical to appropriately valuing a target, in addition to identifying misconduct.

#### ➤ Notes:

- S&N settled enforcement actions with the DOJ and SEC in 2012 related to improper conduct in Greece. It paid a \$16.8M criminal penalty and \$5.4M in disgorgement of profits and prejudgment interest.



## HSBC BANK (2012)

**Enforcement Agency: DOJ, OCC, FED, FinCEN**

➤ Summary:

- Acquired a Mexican bank and folded its operations into HSBC Mexico
- Did not conduct adequate diligence to understand money laundering risks
- Did not implement compliance controls after acquisition
- Did not inform other HSBC subsidiaries, such as HSBC USA of money laundering issues at HSBC Mexico even though HSBC USA was engaging in hundreds of millions of dollars of transactions with HSBC Mexico

➤ Penalties:

- \$1.9 million in fines, 5 year Deferred Prosecution Agreement and imposition of a monitor.

➤ Pitfall Lesson:

- Diligence is important—even in an overseas asset purchase
- Anti-Money Laundering compliance controls need to be evaluated and implemented from a company-wide perspective
- New acquisitions need to quickly assimilate into parent companies existing good practices





## **DOJ OPINION PROCEDURE RELEASE 08-02**

**June 2008: Halliburton sought an opinion from the DOJ in relation to its proposed acquisition of Expro International plc (“Target”), a U.K. oil services group.**

- Halliburton sought guidance on:
  - Whether proposed transaction itself would violate FCPA
  - Acquisition of Target’s FCPA liabilities
  - Criminal liability for any post-acquisition unlawful conduct by Target prior to completion of FCPA and anti-corruption due diligence.
- U.K. legal restrictions in the bidding process allowed insufficient time and inadequate access to information to complete appropriate FCPA and anti-corruption due diligence pre-closing.
- Confidentiality agreement with Target restricted Halliburton from making disclosures to DOJ.



## DOJ OPINION PROCEDURE RELEASE 08-02 (CON'T.)

- Halliburton's post-acquisition plan included:
  - Meeting with DOJ to disclose FCPA issues learned of pre-closing;
  - Presenting to DOJ an FCPA and anti-corruption due diligence work plan;
  - Reporting results of diligence plan within specific time periods; and
  - Maintaining Target as a wholly owned subsidiary during DOJ investigation.
- Target and its subsidiaries and affiliates would remain liable for past and future FCPA violations.
- No enforcement action against Halliburton based on:
  - The acquisition of Target in and of itself;
  - Any pre-acquisition unlawful conduct by Target disclosed within 180 days of closing; and
  - Any post-acquisition conduct by Target disclosed within 180 days of closing, provided conduct did not continue beyond the 180-day period.

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