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# M&A ACADEMY

## FCPA IMPORT/EXPORT AND OTHER INTERNATIONAL RISK AREAS IN M&A TRANSACTIONS

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# Conducting Risk-Based International Compliance Due Diligence in M&A Transactions

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# Key International Compliance Risk Areas and Associated Liabilities

1. Anti-Corruption (FCPA and UK Bribery Act, as well as applicable local anti-corruption laws)- liabilities can include criminal and civil fines, jail time for individuals, debarment, deferred prosecution agreements or consent decrees, follow-on civil litigation
2. Sanctions Laws (US and EU- Iran, Syria, North Korea, Cuba, Sudan, Crimea, Ukraine-related Russian sanctions, blocked persons or SDNs and other OFAC programs) –liabilities can include criminal and civil fines, jail time for individuals, debarment, deferred prosecution agreements or consent decrees.
3. Export and Re-Export Laws (US and EU)--liabilities can include criminal and civil fines, jail time for individuals, denial of export privileges, deferred prosecution agreements or consent decrees.

# Key International Compliance Risk Areas and Associated Liabilities

4. Anti-Boycott Laws (US) – liabilities can include criminal and civil fines and loss of tax benefits.
5. Customs/Import Compliance and Trade Actions/Remedies -- liabilities can include increased duties, penalties and forfeitures, exclusion of products from the United States, follow on civil litigation, including FCA claims.
6. Privacy (not covered in this program) – liabilities can include fines and inability to share protected information
7. National Security (CFIUS/Exon Florio/FOCI/NISPOM) (not covered in this program) – liabilities can include blocked transactions, loss of government contracts, debarment, criminal and civil fines and penalties.

# Recent DOJ Guidance on Corporate Compliance in M & A Transactions

In February 2017, DOJ released guidance on how it evaluates corporate compliance generally and noted these questions that it will ask specifically in the M & A context .

- **Due Diligence Process** – Was the misconduct or the risk of misconduct identified during due diligence? Who conducted the risk review for the acquired/merged entities and how was it done? What has been the M&A due diligence process generally?
- **Integration in the M&A Process** – How has the compliance function been integrated into the merger, acquisition, and integration process?
- **Process Connecting Due Diligence to Implementation** – What has been the company's process for tracking and remediating misconduct or misconduct risks identified during the due diligence process? What has been the company's process for implementing compliance policies and procedures at new entities?

# Successor Liability

- In certain areas of international compliance, including the FCPA, sanctions and export and import controls there is clear precedent establishing the liability of the buyer for misconduct of the target company occurring before the closing under the theory of successor liability.
- In the FCPA area, DOJ/SEC have provided specific guidance in the joint 2012 FCPA Guide how to minimize successor liability.
- In the trade area, the Department of Commerce began asserting successor liability in 2002 in the *Sigma Aldrich* case.
- In the customs areas, successor liability was found in the following cases: *Shields Rubber Corp* (1989), *Ataka America* (1993), *Adaptive Microsystems* (2013) and *CTS Holding* (2015).

# DOJ/SEC Guidance -FCPA

## **According to the DOJ/SEC, to avoid successor liability for FCPA violations a purchaser must:**

1. Conduct thorough pre-acquisition risk-based FCPA due diligence on the target.
2. Ensure that, post-acquisition, the acquiring company's policies and procedures are applied to the target as quickly as practicable.
3. Train personnel (including, in some cases, agents and business partners) at the target on anticorruption laws and company policies.
4. Conduct an FCPA-specific audit during post-closing integration.
  - DOJ and SEC report that, in a number of instances, they have declined to bring enforcement actions against companies that have voluntarily disclosed and remediated conduct in the M&A context.

# DOJ/SEC Guidance --FCPA

- Another suggestion of the DOJ is to use the Opinion Release procedure for M&A transactions. While there are several opinion releases in the M&A context, this process is both time consuming and may, according to the DOJ, contain more stringent requirements that may be necessary in all circumstances.
- It is important to emphasize that while, by following the above advice, you may be able to avoid or minimize successor liability for the acquiring company, you will not avoid the liability for any past FCPA violations of the target company being acquired, and such liability can materially adversely affect the value of the proposed investment.

# Risk-Based Due Diligence

- There is very little guidance on what level of risk-based international compliance due diligence is required for a particular target and the scope of due diligence will depend upon the amount of time and resources you have available and the particular international compliance risks associated with the target.
- There is a fundamental difference between responding to a governmental enforcement action or pursuing an internal investigation, on the one hand, and performing M&A due diligence on the other.
- While the client or deal time will want you to estimate potential exposure it is very difficult to do that accurately because of the wide range of potential monetary and non-monetary liabilities and long -5 year-statute of limitations. It is particularly challenging when the target has limited compliance programs in place and may have unknown violations.

# Risk-Based Due Diligence

- Governmental enforcement cases and internal investigations focus on discovered conduct that may be a violation. The work required includes reviewing and producing many documents and interviewing many witnesses. This process can take many months and even years.
- In contrast, risk-based international compliance due diligence attempts to identify the international compliance risk areas of a target in a relatively short period of time – often with limited access to critical documents and personnel.

# Risk-Based Due Diligence

The risk assessment should focus on the following:

1. The nature of the target's business and reputation in the market.
2. The industry and the countries in which the target operates.
3. The extent to which the target is exposed to certain international compliance risk areas and how it approaches compliance in these areas.
4. The extent to which the target utilizes third parties in dealing with customers and regulators.
5. The extent to which the target interacts with government officials or has government customers.
6. The strength of the target's existing compliance program and internal controls.

# Practical Approaches

1. Form an international compliance due diligence team, which should include both transactional lawyers and members of the compliance and finance departments, and possibly outside consultants depending upon the extent and scope of international operations.
2. Determine the amount of time, scope of international compliance due diligence and allocation of responsibilities. Transactional lawyers focus on the high-level areas of risk given the target's business model and international operations; the compliance department focuses on the target's compliance program and past incidents; and the finance department focuses on books and records and accounting controls, including any material weaknesses in internal controls.

# Practical Approaches

3. Because information concerning international compliance issues is rarely included in publicly available materials or in a data room, it is critical create a separate work stream to conduct international compliance due diligence. Often a supplemental international compliance questionnaire is submitted followed by one or more interviews of the target's compliance and business personnel to understand the international compliance risks and to focus on areas for further inquiry.
4. If enforcement cases or internal investigations are discovered or disclosed, it may be necessary to bring in outside litigation counsel to assess the potential impact on the target and its business/value pursuant to a common interest agreement to prevent waiver of the privilege.

# Practical Approaches

5. One of the biggest challenges in conducting due diligence is determining when a desk-top review or interview of target personnel may be insufficient and when certain potentially high-risk transactions should be audited in more detail. This kind of audit can be very time consuming and international compliance issues are often difficult to detect without a full investigation.

# Practical Approaches

6. Another challenging area is discovering potential violations of the target's foreign subsidiaries.
  - Note that, to the extent there is a limited opportunity to conduct pre-acquisition international compliance due diligence, it is essential to conduct more in-depth post-acquisition international compliance due diligence to eliminate ongoing compliance problems. Also critical is the integration of the acquired company into the acquiring company's international compliance program.

# Key Diligence Questions

Key risk areas to focus on include the following:

1. Does the target operate in a high-risk industry?
  - For example, the target or its competitors are in an industry of particular focus for US governmental authorities and there have been enforcement cases involving the target or its competitors.
  - Industry examples: Oil and Gas, Telecommunications, Medical Devices, Pharmaceuticals
  - Diligence Goal: Understand the regulatory environment and enforcement patterns to plan diligence resources and effort.

# Key Diligence Questions

2. Does the target operate in a high-risk country?
  - For example, the target is located in or operates in a country that has a reputation for corruption.
  - Locations of concern include countries such as China, Brazil, Argentina, India, Indonesia, The Philippines, and other countries with poor scores on the Transparency International Corruption Perceptions Index.
  - Locations of concern can also vary depending on the target's industry.
  - Diligence Goal: Understand the target's business model, including its ethics culture, compliance structure, and methods for operating in challenging ethical environments.

# Key Diligence Questions

3. Does the target have extensive international sales, foreign subsidiaries or many points of contact with foreign government officials (or politically exposed persons)?
  - For example:
    - The target has an Asian subsidiary focusing on a market consisting of many government customers.
    - The Asian subsidiary is managed by a foreign national who has significant family contacts in the government.
    - The target has multiple business-related licenses issued by various levels of government.
  - Diligence Goal: Understand and apply the level of diligence effort necessary to reasonably assess risk.

# Key Diligence Questions

4. Does the target rely on the use of third-party intermediaries to make sales or to handle government relations? Are you able to easily identify the target's third parties in its records and accounting systems?
  - For example:
    - The target relies heavily on third-party intermediaries with success fees or other incentive compensation.
    - The target has third parties involved in handling government relations activities, including obtaining critical permits/regulatory approvals.
    - Contracts with third parties do not have FCPA clauses, or they have limited provisions, and there is little evidence that third parties have been trained in the FCPA.
  - Diligence Goal: Identify and evaluate high-risk intermediary activities and the target's preengagement diligence on and continuing oversight of third parties.

# Key Diligence Questions

5. Does the target rely on business gifts and entertainment, including travel, as well as charitable and political contributions as part of its sales and marketing?
  - For example:
    - The target's sales representatives have a history of being reimbursed for significant sales and marketing expenses without appropriate documentation.
    - Many customers have been reimbursed for travel.
    - Significant charitable or political contributions have been made in other countries (potentially for purposes of market access).
  - Diligence Goal: Assess (i) whether the business has been built on a foundation of corrupt activities, (ii) the strength of the target's accounting controls, and (iii) the cultural risks inherent in the business.

# Key Diligence Questions

6. How strong is the target's compliance program and culture, including the tone at the top? If the target has no program, how strong are its accounting controls and business processes?
  - For example:
    - The target has an underfunded compliance program which appears to be a document taken off the shelf and not customized to its business.
    - The target has a newly adopted compliance program.
    - Training and auditing are infrequent and the tone at the top is focused on the achievement of sales objectives.
    - There is little or no use of a company reporting "hotline" or other reporting mechanisms.
    - There are no compliance cases or sanctions imposed on anyone for violating the company's code of conduct.
  - Diligence Goal: Understand the target's ethics culture.

# Key Diligence Questions

7. How cooperative is the target with the diligence process?
  - For example:
    - The target is slow to produce compliance documents.
    - The target has numerous documents produced in the local language only.
    - Internal experts are uninformed concerning key diligence areas.
  - Diligence Goals: Determine whether a lack of cooperation reflects compliance weaknesses that require enhanced diligence inquiries in one or more areas. Consider engaging diligence specialists for targeted diligence efforts.

# Key Diligence Questions

8. Does the target have an ongoing internal or government investigation, or have international compliance concerns been otherwise reported?
  - For example:
    - The target has disclosed the existence of a government investigation or subpoena.
    - The target has produced compliance hotline reports reflecting international compliance allegations.
  - Diligence Goal: Understand nature of the allegations, exposure, employee and third-party involvement, affected business units, and current control environment.

# Key Diligence Questions

## 9. Does the target have export licenses or are such licenses required?

- In an asset transaction, a plan will need to be developed to transfer these licenses with minimum interruption to the business.
- If the target is registered with the Directorate of Defense Trade Controls (DDTC) as a manufacturer or exporter of products or technology controlled by the International Traffic in Arms Regulations (ITAR), then certain notifications will have to be made before the closing in the case of non-US acquirers or after closing in the case of US acquirers.
- Certain unsophisticated companies do not realize that their exports or re-exports may require licenses and then an assessment needs to be made of whether violations have occurred and how to handle them in the transaction.

# Key Diligence Questions

10. Does the target conduct business in any countries subject to US sanctions or screen against the OFAC SDN or other blocked person lists?

--It is critical to understand if the target conducts business in any countries subject to US sanctions and, if so, if the target has proper authorization to do so.

--In addition it is critical to understand if the target screens its counterparties against the OFAC SDN or other blocked persons lists. Particularly tricky is the OFAC 50% rule that requires looking at the beneficial ownership to make sure that the counterparties are not owned 50% or more in aggregate by blocked persons.

# Key Diligence Questions

## 11. Does the target conduct business in any boycotting countries?

--The US has laws and regulations that prohibit compliance with the Arab boycott of Israel (and other unsanctioned boycotts) and imposes both substantive prohibitions and reporting obligations. To complicate matters there are two sets of regulations – the Treasury and Department of Commerce Regulations – and they are not entirely consistent.

--If the target does business in any boycotting countries, it is critical to determine if the target has an adequate compliance program in place.

# Key Diligence Questions

12. Is the target's business dependent upon imports and are such imports subject to US Customs and Border Protection audit or trade remedies/actions?

--It is important to assess whether the target's business could be affected by US Customs and Border Protection audits/enforcement cases for misclassification or underpayment of duties or pending trade remedies or actions, such as antidumping or countervailing duty or Section 337 cases.

# Use Of Due Diligence

Once the risk-based international compliance due diligence is concluded, you need to assess the effect of what you have found on the overall transaction. Options include:

- (a) proceeding as planned or renegotiating to account for risks,
- (b) delaying closing until further due diligence is done or active cases/investigations are resolved and then reassessing or renegotiating, or
- (c) walking away.

# Use Of Due Diligence

## Questions to consider include:

1. How much of the target's revenue stream/business model could be affected?
2. How many key employees, intermediaries, or customers may be affected or need to be retrained or terminated?
3. Is the target's business model/culture so different that it will be difficult to integrate it into your compliance program without the business being materially affected?
4. How much uncertainty is there concerning whether you have had sufficient time to assess compliance risks or to resolve known compliance issues and quantify associated costs and liability?
5. Can identified risks be addressed through contractual provisions or revaluation? Or are they so serious that they should be resolved prior to closing?

# Need for Specialized Contractual Provisions

- It is market practice to include specialized FCPA and other international compliance representations and warranties in transactional documents and not to rely on general compliance with laws representations and warranties, which are often qualified with no material adverse effect language.
- These specialized representations and warranties serve two purposes; first, to force disclosure of compliance issues and, second, in private company transactions where representations and warranties survive the closing, to set up special indemnities, which may be secured by special escrows.

# Considerations for Sellers

Sellers should consider the following with respect to international compliance issues:

1. Prepare due diligence for buyers by doing a self-assessment of ongoing compliance issues, including hotline complaints, internal investigations, or external enforcement cases.
2. Prepare any required disclosure information and determine at what time and in what manner to disclose it to buyers.
3. Be prepared for a discussion with buyers concerning the potential materiality of international compliance issues in terms of purchase price adjustments in public deals where representations, warranties and indemnities do not survive the closing or special escrows in private deals where they do.
4. Be prepared for a requirement by buyers that the international compliance issues be disclosed to enforcement authorities as a condition of closing.

# Considerations for Buyers

Buyers should consider the following with respect to international compliance issues:

1. Prepare due diligence plan and allow for adequate time where possible; do not let the sellers delay disclosure until the 11th hour.
2. Adjust the due diligence plan and resources depending upon what is learned.
3. Discuss with sellers and buyers' own counsel potential materiality of international compliance issues and level of uncertainty.
4. Consider international compliance representation and warranty insurance products.
5. Consider adequacy of proposed special escrows in private deals where issues have been identified.
6. Consider whether forcing disclosure to enforcement authorities will lead to timely resolution of international compliance issues before closing.
7. Prepare pre-acquisition the post-acquisition international compliance integration plan.
8. If the target is a public company, consider SEC disclosure obligations and potential issues relating to material weaknesses in internal controls.

# Cautionary Case: LatiNode

Florida-based company eLandia discovered the target's history of bribery in its post-acquisition diligence on target LatiNode.

- Violations were disclosed to the DOJ by eLandia within three months of discovery.
- No enforcement action was taken against eLandia.
- Target LatiNode pled guilty to violating the FCPA and paid the statutory maximum \$2 million fine.
- Four executives from LatiNode were convicted of violating the FCPA, and three received prison terms.
- The investment was essentially written off because of enforcement actions.

**QUESTIONS?**

# Biography



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Margaret Gatti represents US and non-US companies, universities, and financial institutions in matters involving economic sanctions, export controls under the International Traffic in Arms Regulations (ITAR) and the Export Administration Regulations (EAR), customs and import regulations, free trade agreements, antiboycott regulations (EAR and IRS), anticorruption laws (FCPA and UKBA), anti-money laundering legislation, international commercial sales terms (INCOTERMS), international e-commerce, and Bureau of Economic Analysis (BEA) reporting, as well as national security issues.

As part of her export control and national security practices, Ms. Gatti also is involved in filings before the Committee on Foreign Investment in the United States (CFIUS), and has represented both foreign buyers and investors in and domestic sellers of U.S. businesses in reviews by that Agency. She has substantial experience in negotiating and mitigating Foreign Ownership, Control, and Influence (FOCI) issues that may be presented as conditions to clearance of a proposed transaction.

She also advises on internal investigations, enforcement cases, and dispute resolution proceedings relating to her transactional and regulatory practice.

# Biography



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Carl Valenstein focuses his practice on domestic and international corporate and securities matters, mergers and acquisitions, project development, and transactional finance. He counsels extensively in the life science, telecom/electronics, and maritime industries, and he has worked broadly in Latin America, the Caribbean, Europe, Africa, Asia and the Middle East.

Carl advises clients on international risk management, including compliance with the foreign investment review process (Exon-Florio/CFIUS), export control and sanctions, anti-money laundering, anti-boycott, and anticorruption (FCPA) laws and regulations. He also advises on internal investigations, enforcement cases, and dispute resolution proceedings relating to his transactional and regulatory practice.

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