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A new dynamic in M&A due diligence

BY CLAIRE SPENCER

The current risk-averse climate has added to corporate responsibility in M&A transactions. Buyers must use due diligence more effectively to avoid taking on the liabilities of a newly acquired target. Investigating the company's integrity, business ethics and legal compliance prior to completion is vital. It should have a significant bearing on whether the deal proceeds. Risks are part of business but a buyer needs to be fully aware of them. If the deal goes through, due diligence should form the basis for regular auditing and monitoring of the target.

An acquirer that fails to perform adequate checks may only find out about the target's practices after it has taken ownership. "The company may have engaged in corrupt practices in order to obtain operating licences or major contracts for the operation of its core business. It may have links to terrorist organisations or terrorist members. It may have links or board member affiliations with organised crime or drug cartels. Or it might be a sham company engaged in nefarious and unlawful acts as a primary business and would violate applicable proceeds of crime laws," says Sharie Brown, a partner at Foley & Lardner LLP. If any one of these scenarios is not identified, the purchaser could damage its reputation or face financial penalties down the line. It could be prosecuted under various anti-corruption or anti-bribery laws. "The purchaser could be subject to successor civil and criminal liability under the US Foreign Corrupt Practices Act or local anti-bribery laws for failing to identify existing and detectable public corruption and bribery, as well as false books and records, and inadequate internal controls," adds Ms Brown.

It can be tempting to omit integrity investigations in cross-border deals, particularly when competing against other buyers. Speed of execution may take priority. But in an unfamiliar market it is even more important to properly assess the target company. A US acquirer, for example, might find itself in breach of the Foreign Corrupt Practices Act. "Should a corporate become embroiled in foreign corruption, such as in the recent Baker Hughes case, this can lead to substantial financial penalties, disgorgement of profits and the risk of criminal prosecution," says John McNally, Head of the Forensic Investigations Group at CRA International. "In the case of Baker Hughes, despite self reporting on a historic issue identified in a foreign acquisition in Kazakhstan in 2000, in April 2007 the company agreed to a $44.1m civil settlement with the Securities and Exchange Commission. The company also has to retain a compliance monitor for a further period of three years." A buyer entering a foreign market for the first time should start by researching the country thoroughly. Transparency International's corruption perception index is useful in determining the current and potential impact of a nation's business practices on a foreign acquirer's investment.

Regulators are enhancing their enforcement of anti-corruption, anti-money laundering and anti-terrorism legislation. This puts acquirers under intense pressure to remain compliant. In cross-border deals, the risks are exacerbated by geographical and cultural differences, which should dissuade buyers from rushing into a deal. "Persons suspecting a breach of legislation by a target should not sign or consummate the transaction until those concerns are fully resolved both to their own satisfaction and, where appropriate, to the satisfaction of the relevant authorities," says David Levin, a partner at Eversheds. "Breach of this legislation – including by collusion in or association with such breaches – can lead to significant fines and other criminal sanctions, such as prison or restrictions on business, for both corporates and individuals."

Digging deep into the target's operations

Much of the due diligence process will focus on the integrity of financial statements. Their accuracy is essential to arriving at an appropriate valuation. But a buyer should also identify value-destroying risks, which include existing and future liabilities. According to Mr McNally, risk management should be approached both strategically and tactically. "At the strategic level, a buyer should look into how long the target has operated in its jurisdiction, the effectiveness of its internal controls, the stability of the local political infrastructure and economy, whether local companies are audited to recognised international accounting standards, and whether the country has a Financial Intelligence Unit that is a member of the Egmont Group of FIUs," he says. "At the tactical level, due diligence should cover an assessment of historic fraud or FCPA risk in the company's books and records, whether the company has appropriate systems and controls, whether the company's books and records accurately reflect expenditure, whether any unexplained vouchers or miscellaneous accounting entries exist, or whether contracts exist between the target company and its agents, consultants or representatives." Missing information should ring alarm bells. In these circumstances it can be useful to engage a team of corporate investigators. They can be particularly valuable when a buyer is operating in unfamiliar territory.

Buyers should find out as much about the company and its directors as possible. They should talk to past and present business partners, and use the internet to gather a portfolio of information. Doing this should hint at any possible signs of corruption, and may save a lot of time and money further down the line. Unfortunately, too many acquirers overlook this step and suffer for it.

If it is unclear how the target makes or spends its cash, a potential buyer should be on its guard to avoid implicating itself in a money-laundering scandal. There are usually indications that such activities are occurring. According to Ms Brown, buyers should conduct checks for possible terrorist or other prohibited party affiliations. They should also prepare contract representations and warranties which place the responsibility for detecting and reporting misconduct amongst the parties. "Most purchasers should already have those controls in place, but knowing your customer, partner or acquisition is a broader extension of those requirements," she says. "Purchasers will also want to be guided by the Financial Action Task Force Recommendation and anti-money laundering guidelines for risks in dealing with parties in certain non-cooperative countries, or countries that have highly publicised money laundering and terrorist financing activities." An acquirer that fails to disclose or report the target's previous offences before entering into a partnership is likely to be viewed as complicit. Moreover, even if money laundering has not actually occurred, a buyer which lacks the right systems and controls can face corporate liability while its senior managers can risk personal prosecution.

But no matter how thorough the business integrity checks are, every buyer will need to protect itself in the transactional documentation. As Mr Levin points out, due diligence is sometimes limited in its scope. It is affected by time and cost constraints. Often, the amount of information available on a target company is incomplete. "Due diligence is by no means a guarantee that a target company is risk free," he warns. "Purchasers should look to negotiate a full set of warranties which can be tailored to cover specific business integrity concerns, as well as considering other forms of protection such as indemnities, escrow and/or retaining part of the purchase price. Warranties may also flush out issues in the disclosure letter that may not have been apparent during the due diligence process." Ms Brown agrees. "It is helpful to include rigorous transaction provisions that include anti-bribery, anti-corruption, anti-money laundering, and anti-terrorism representations and warranties," she says. "Purchaser rights to audit and investigate prior to closing on suspicion of misconduct are also important, as are rights to terminate the transaction or relationship upon learning of misconduct."

Promoting business integrity post-transaction

Many buyers have discovered that once they have taken ownership of the target, matters are a lot worse than they anticipated. Depending on the seriousness of the target's business practices, they can either report it to regulatory and enforcement agencies, or try to resolve it in-house. However, keeping regulators in the loop is advisable as this can mitigate the severity of any future penalties.

In an ideal world, every company would go beyond legal requirements and adopt best practices in all areas of business. Of course, there are practical obstacles which prevent this becoming a reality. But regulators seem intent on introducing new laws which move company directors towards this aim. Mr Levin points to section 172 of the UK Companies Act 2006, which came into effect on 1 October 2007. "This provides that a director of a company must act in the way he considers would be most likely to promote the success of the company for its members. In doing so, he must take into account the impact of the company's operations on the community and the environment, and the desirability of the company maintaining a reputation for high standards of business conduct. Adopting ethical best practices and codes of conduct may assist directors in complying with this duty," he says.

But this can be expensive and difficult to achieve across multiple jurisdictions, where standards differ. It may be an unrealistic ideal. "In a hypothetical world companies might operate to the same standards of business practice in their respective markets. However, reality in a global business economy is somewhat different," says Mr McNally. "Companies seek to differentiate themselves from their international peers – by differentiating on cost, business strategy, or through promoting unique attributes in a product or service. In striving for that competitive edge a risk exists that people will ignore or become complacent about the internal controls which are meant to protect the company, its employees and the marketplace." A company should perform a risk assessment before introducing local compliance and ethical procedures. After all, local risk in a foreign jurisdiction may not be reflected in an acquirer's existing standard procedures. Risk-based procedures should comply with the standards of the jurisdiction in which the entity operates, as well as the acquirer's group standards based on industry best practice. It is unlikely that a single model will readily apply across multiple jurisdictions.

Senior management of the new company will be in an ideal position to decide how their investigations into business integrity will inform the company's future. No two situations are exactly alike. Directors should draw on their experience and use the tools available to them – including legal teams and corporate investigators – to ensure that due diligence is completed effectively. Avoiding risk altogether is impossible, but shareholders will feel safer in the knowledge that all reasonable steps were taken. Auditing and monitoring the business post-acquisition is also essential, and if nothing else, the regular updates will help insulate the company against external risks. ■

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