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Due Diligence

Critical Steps to Take and Questions to Ask When Conducting Pre-Merger Anti-Corruption Due Diligence

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There is no doubt that the most aggressive enforcement of the Foreign Corrupt Practices Act ("FCPA") by the Department of Justice ("DOJ") and the Securities and Exchange Commission ("SEC") since the FCPA was enacted in 1977 has occurred in the last decade. These prosecutions and enforcement actions have, in large part, been focused on individuals and entities who either directly or through agents and intermediaries have engaged in some form of bribery that violates the FCPA.

While it is true that an entity, in most instances, is liable for FCPA violations only if it, or its agents or intermediaries, engaged in corrupt bribes, one significant exception is successor liability for an acquired entity's violation of the FCPA as a result of conduct that occurred prior to the acquisition. Indeed, an acquiring entity can be exposed to successor liability in a stock transfer or merger since the assets and *liabilities* of the target company are usually assumed by the acquiring entity; or in an asset purchase, if the assets purchased include the entity that has the FCPA liability and those liabilities are also assumed by the acquiring entity.

The consequences of FCPA liability in the mergers and acquisitions context can be dire. Most significantly, an acquiring entity is responsible for any fines and penalties imposed by the DOJ or SEC as a result of the target company's prior conduct. If the potential FCPA exposure is uncovered prior to the merger or acquisition, it may also have significant consequences, including: requiring the renegotiation of the transaction price and structure of the deal to account for the potential exposure and to include additional warranties and indemnifications; the delay or termination of the proposed deal; and corporate integration issues related to the implementation of anti-corruption compliance policies and practices after the acquisition or merger. Accordingly, companies subject to the FCPA or considering acquiring companies that are subject to the FCPA should carefully consider the potential FCPA exposure created by mergers and acquisitions and take the necessary steps to avoid that exposure.

The Importance of Pre-Merger Due Diligence

As previous DOJ and SEC enforcements and settlements have demonstrated, the critical factor that will determine whether an acquiring entity is exposed to FCPA liability is whether that entity conducted appropriate pre-merger due diligence that is specifically focused on assessing whether the target company previously engaged in any conduct that may be considered a violation of the FCPA. For instance, in 2004, Lockheed Martin Corporation considered acquiring Titan Corporation, a communications and military intelligence company. As a result of Lockheed's pre-merger due diligence, Lockheed discovered that Titan, through its agents, engaged in conduct several years earlier that may have violated the FCPA. Lockheed and Titan disclosed jointly their findings to the DOJ and delayed their merger several times pending the DOJ's investigation.[1] Because Titan was

unable to resolve the potential FCPA liability expeditiously, Lockheed did not go forward with the deal.[2] Titan subsequently pled guilty to violating the FCPA and agreed to a criminal fine of $13 million and a civil disgorgement penalty of $15.4 million – fines and penalties that Lockheed would have been responsible for had it completed the transaction.[3]

Also in 2004, General Electric sought to acquire InVision Technologies, Inc. ("InVision"). General Electric's pre-acquisition due diligence uncovered that InVision's agents had made payments to foreign officials that violated the FCPA. Both entities subsequently disclosed their findings to the DOJ. As a result of their disclosures, InVision entered into a non-prosecution agreement with the DOJ and agreed to a criminal penalty of $800,000 and General Electric agreed that upon acquiring InVision it would incorporate InVision into its FCPA compliance program, that it would retain an independent consultant, that it would oversee InVision's obligations under the non-prosecution agreement, and that it would disclose to the DOJ any evidence relevant to its investigation.[4] Because the parties were able to resolve InVision's FCPA's exposure, the parties were able to consummate the merger.[5] Notably, as in Lockheed's potential merger, because General Electric discovered the potential FCPA violations during its pre-merger due diligence, it was able to avoid significant penalties and fines.

Conversely, prior enforcement actions by the DOJ also demonstrate that the failure to discover potential FCPA violations prior to a merger results in substantial exposure and liability to the acquiring entity. In 2006, ENI, S.p.A. ("ENI") sold its subsidiary, Snamprogetti Netherlands, B.V. ("Snamprogetti"), to Saipem, S.p.A. ("Saipem"). Four years later, the DOJ and SEC charged Snamprogetti with violating the FCPA as a result of pre-merger conduct.[6] Saipem, as Snamprogetti's parent company, and ENI jointly agreed to pay fines and penalties of $365 million.[7] Similarly, in 2005, Dimon, Inc. ("Dimon") and Standard Commercial Corporation ("SCC") merged to form Alliance One ("Alliance").[8] Five years later, in 2010, the DOJ commenced a criminal action against Alliance alleging that, as a result of conduct by Dimon's and SCC's subsidiaries prior to the merger, Alliance violated the FCPA.[9] Alliance ultimately pled guilty and agreed to pay $9.25 million in penalties for the pre-merger conduct.[10]

Determining the Type and Level of Due Diligence

While it is clear that conducting the appropriate pre-merger due diligence is crucial to avoiding and managing potential FCPA exposure in the mergers and acquisitions context, the type and level of due diligence that an acquiring entity should undertake to reduce the risk of FCPA exposure is not as clear. There is not a uniform due diligence approach that can be used for every transaction. Each transaction requires a different due diligence strategy – a strategy tailored to the transaction based, among other things, on the level of risk associated with the target company, its industry and the parts of the world in which it operates – that should remain flexible and capable of being modified as new facts are discovered. There are, however, certain inquiries that every acquiring entity should make as part of its pre-merger due diligence.

At the outset, the acquiring entity should conduct a high-level risk-based assessment. This assessment entails determining the countries in which the target company engages in business and those specific countries' ranking on the Transparency International Corruption Perceptions Index. This analysis will help determine whether the target company has exposure

to any country-specific corruption dangers, such as heavy government involvement in business affairs.

The acquiring entity, in its initial risk assessment, should also evaluate whether the target company has any industry risks that are associated with the type of business interests that it holds in those countries and whether there are any identified, country-specific corruption problems related to those industries. For instance, it would be relevant to this analysis whether construction kickbacks are particular to the licensing requirements of a country. Finally, the risk-based assessment should include an assessment of the target's business model and the target company's potential for engaging in conduct that would violate the FCPA in carrying out that business model. It would be useful, for example, to determine whether the target company sells products or services to government or government owned companies or whether its business is heavily reliant on obtaining licenses from government officials. Once a risk-based assessment has been completed, the acquiring entity should prepare a targeted due diligence approach focused on answering any questions raised by the assessment as laid out below.

Phase 1: How Does the Target Company Conduct Business?

This phase of the due diligence process should be focused on determining how the target company conducts business in the countries identified in the initial risk assessment and should seek to answer the following questions:

1. What is the target company's business model in each of the respective countries?
2. Are licenses or other forms of government approval needed as part of the target company's business operations, including the process of obtaining those licenses or approvals?
3. Do the target company's employees have relationships with local government officials?
4. Do the target company's officers, directors, employees, or friends and family members of the aforementioned hold any foreign government positions, serve on any boards of directors for foreign government-owned entities, or are any of the aforementioned persons currently running for political office?

Phase 2: Is There Any Evidence of Prior Corrupt or Illegal Conduct?

Determining whether there is any evidence that the target company previously engaged in corrupt or illegal conduct is significant as it may lead to individuals or circumstances demonstrating potential FCPA violations. This phase of the due diligence process should seek to determine the following:

1. Has the target company bribed foreign government officials in the past?
2. Has the target company ceased conducting business in any country and if so, what was the reason for ceasing business in that country and whether it is prevented from re-starting its business in that country?
3. Has the target company been previously accused or convicted of violating any law (foreign or U.S.), including (i) the circumstances surrounding the incident, (ii) the outcome of the lawsuit or investigation, and (iii) the individuals within the target company that were involved?
4. Has the target company ever been the subject of any bribery, money laundering, or anti-kickback investigation

by any government authority in the U.S. or abroad, including whether any fines or penalties were levied against the target company?

5. Does the target company maintain records, including hotline logs, relating to allegations of corruption and whether a review of those records raises potential violations of the FCPA anti-bribery and record-keeping provisions?
6. Has the target company previously conducted any internal investigation of impropriety involving bribery, money laundering, or anti-kickback laws in the U.S. or abroad?

Phase 3: Does the Target Company Use Third Party Agents and Intermediaries?

In many instances, companies engage in corrupt conduct through agents or intermediaries, such as consultants, that are hired to facilitate business dealings in foreign countries. Therefore, this phase of the due diligence process should seek to determine whether the target company's use of agents and intermediaries exposes it, and the acquiring entity if the merger goes forward, to potential FCPA violations and should seek to answer the following:

1. Does the target company engage agents, consultants, distributors, or third-party intermediaries to assist in its business?
2. Do the third-party agents and intermediaries act as conduits for unsanctioned payments to foreign officials?
3. Whether the target company conducts due diligence of the agents and intermediaries it uses and whether that due diligence reveals (i) connections to foreign officials, (ii) past violations of U.S. or foreign law, and (iii) their reputation for ethical conduct?
4. How does the target company pay its third-party agents and intermediaries and whether those payments are reasonable?
5. Whether the target company has written procedures relating to the due diligence review of its foreign agents, consultants, or third-party intermediaries and whether those procedures are adequate and thorough?
6. Whether the target company maintains due diligence files and/or contract or engagement files for agents, consultants, or third-party intermediaries and whether those files provide any indication of potential FCPA violations?
7. Whether the target company conducts periodic reviews and certifications of its foreign agents, consultants, or third-party intermediaries and whether those reviews or certifications provide any indication of potential FCPA violations?
8. Whether the target company maintains commission, retainer, and expense reimbursement information for all persons who have acted as agents, consultants, or third-party intermediaries regardless of whether or not the target company executed a formal agreement with such persons, and whether that information provides any indication of potential FCPA violations?
9. Whether the target company has audit procedures related to its agents, consultants, or third-party intermediaries' expenses, commissions, retainers, etc. and whether the results of those audits provide any indication of potential FCPA violations?

Phase 4: What Are the Target Company's Policies and Practices Pertaining to Gifts, Expenses, and Charitable Donations to Foreign Officials?

The acquiring entity should also consider reviewing and assessing the target company's policies and practices pertaining to gifts, expenses, and charitable donations made

to foreign government officials and this phase of the due-diligence process should seek to determine the following:

1. Whether the target company provides anything of value, including hospitality, entertainment, gifts, or trinkets to foreign officials, officials of political parties, candidates for political office or the friends and family members of any of the aforementioned parties, and whether those expenses were reasonable and were properly recorded in the target company's books;
2. Whether the target company has written procedures relating to the approval of requests for expense reimbursements and whether those procedures were complied with in the context of these payments;
3. Whether the target company sponsors travel of foreign officials, their families, or friends, and (i) the circumstances surrounding those arrangements, (ii) whether the costs and expenses sponsored were reasonable, and (iii) how those expenses were recorded;
4. Whether the target company makes any charitable, social, or political contributions in the foreign countries in which it operates, and whether those contributions are legal and reasonable.

Phase 5: Does the Target Company have an FCPA and Anti-Corruption Compliance Program?

Finally, an acquiring entity should determine whether the target company has an FCPA and anti-corruption compliance program and determine the following:

1. Is the program complete and thorough in light of the target company's home country?
2. Is the program regularly updated?
3. Is the compliance program effective and is it actually followed?
4. Has the target company assigned responsibility for its compliance program to one or more high-level management employees, and based on interviews of those individuals, are they effective compliance persons?
5. Does the target company conduct periodic internal compliance audits relating to potential FCPA anti-bribery and books and records violations and will it provide the results of those audits?

When Information is Difficult to Obtain

In the ideal merger or acquisition, the acquiring entity should have the right and ability to engage in thorough and robust due diligence. In reality, however, there are situations where the acquiring company is only permitted to conduct limited due diligence prior to closing. In those instances, the acquiring company should consider obtaining a written agreement containing some or all of the following terms, representations and warranties to provide some protection from latent FCPA violations:

1. A representation about the identity of all shareholders, directors, officers and other stakeholders of the target company;
2. A representation that no officer, director or shareholder of the target company is a foreign official under the FCPA;
3. A representation with respect to any business a party provides or may provide to the target company, that either the party has neither paid nor offered to pay any political contributions, or that it will disclose all political contributions;
4. A representation that the target company has no

undisclosed sub-agents or third parties who will have a role in the relationship;

5. A representation that the target company has not been convicted of, or pleaded guilty to, an offense involving fraud, corruption, or bribery and it is not now ineligible for, or proposed for suspension from, government procurement programs;
6. A representation that target company has not made, and will not make, directly or indirectly, any payments or give anything of value to any foreign officials in connection with the company's activities or in obtaining any other business from any government entity;
7. A covenant that all representations are accurate and complete and that target company will promptly inform the acquiring company of any changes;
8. A provision entitling the acquiring company to terminate the proposed merger or acquisition: (i) in the event the target company fails to inform the acquiring company about a material change in a representation or warranty; or (ii) in response to an event that materially alters a representation; and
9. A representation that the target company will permit an independent audit of its books and records to ensure compliance with the FCPA.

The DOJ's and SEC's prosecution of FCPA violations against successor entities that did not themselves engage in any misconduct is a strong warning that companies engaged in mergers and acquisitions should take the necessary precautions to ensure that the target company that they may potentially acquire does not have latent FCPA liability. The safest course for all acquiring entities is to engage in appropriate pre-merger due diligence, which will permit them to deal with any potential FCPA exposure prior to the merger or acquisition.

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[1] Renae Merle, *Lockheed Martin Scuttles Titan Acquisition*, Washington Post, Jun. 27, 2004.

[2] *Id.*

[3] Press Release, U.S Securities and Exchange Commission, SEC Sues the Titan Corporation for Payments to Election Campaign of Benin President, Litig. Release No. 19107 (Mar. 1, 2005); News Release, Office of the United States Attorney Southern District of California (Mar. 1, 2005).

[4] Press Release, InVision Technologies Inc. Enters into

Agreement with the United States, Dept. of Justice Release No. 04-780 (Dec. 3, 2004); Press Release, Securities and Exchange Commission, SEC Settles Charges Against InVision Technologies for $1.1 Million for Violations of the Foreign Corrupt Practices Act, Litig. Release No. 19078 (Feb. 14, 2005).

[5] Press Release, General Electric Agrees to Acquire InVision, (Mar. 15, 2004).

[6] *United States v. Snamprogetti Netherlands B.V.*, H-10-460 (S.D. Tex. Jul. 7, 2010).

[7] Press Release, Dept. of Justice, Snamprogetti Netherlands B.V. Resolves Foreign Corrupt Practices Act Investigation and Agrees to Pay $240 Million Criminal Penalty (July 7, 2010).

[8] Press Release, Dept. of Justice, Alliance One International Inc. and Universal Corporation Resolve Related FCPA Matters Involving Bribes Paid to Foreign Government Officials (Jan. 1, 2011).

[9] *Id.*

[10] *Id.*