

FCPA Due Diligence in Mergers & Acquisitions

Assessing and Avoiding Pre-Closing Risks and Implementing Post-Closing Protection Strategies

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FCPA Due Diligence in Mergers & Acquisitions: Pre-closing Due Diligence

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Successor Liability

Successor liability poses great risk to would-be acquirors.

- U.S. courts recognize several theories that allow an acquiror to bear liability for the past illegal acts of an acquired entity.
- Under such principles of successor liability, an acquiror can inherit the FCPA liability of a target.
- U.S. enforcement agencies focus on FCPA issues that arise in the context of mergers and acquisitions—in recent years, approximately one-third of corporate FCPA enforcement actions have implicated successor liability issues.

*Relevant Considerations for entering a Deferred Prosecution Agreement: “(a) following discovery of the FCPA violations during the course of acquisition-related due diligence, the Company initiated an internal investigation . . .”
-Diebold, Inc. DPA, at 3 (October 22, 2013)*

Successor Liability: Collateral Consequences

Acquirors also may confront collateral consequences that can fatally undermine the purpose of the transaction.

- The financial penalties can outstrip any revenue anticipated by the acquisition.
- Key personnel may need to be fired, seriously damaging the acquired business.
- As part of remediating any violation, the target may have to cancel significant contracts, including key customer and vendor relationships.
- As with any FCPA case, *both* the target and the acquiror can expect significant negative publicity.
- Also always consider: Once the target implements the control systems of the acquiror, its business model may no longer be profitable.

The Government's Consistent Warnings on M&A Due Diligence

DOJ seeks to impose successor liability “only when supported by the particular facts and circumstances of the case and the law. [DOJ] does not hold acquirers strictly liable for the acts of their predecessors . . . [but] seek[s] to impose successor liability on a case-by-case basis” For example, DOJ “formally declined” to prosecute a parent corporation “for a number of reasons . . . , including because: (a) the parent corporation voluntarily provided information to the Department; and (b) the parent conducted extensive post-acquisition due-diligence and training that gave rise to its discovery of the potential FCPA violations.”

— Greg Andres, Deputy Assistant Attorney General, Criminal Division (June 16, 2011)

“Companies that fail to respond to red flags can be held liable for the acts of their joint venture partners.”

— Former SEC FCPA Unit Chief (Dec. 10, 2010)

The “nature and quality” of pre-acquisition due diligence is “one of the most critical factors” that DOJ considers when making charging decisions in the M&A context.

— Former DOJ FCPA Unit Chief (Sept. 11, 2008)

M&A: Cautionary Tales – eLandia/Latin Node

A “cautionary tale” of what can happen when an acquiror conducts “little, if any, [FCPA] due diligence.”

— Former DOJ FCPA Unit Chief (Nov. 17, 2009)

- In June 2007, eLandia acquired Latin Node, a telecom services provider.
- In August 2007, during a post-acquisition financial integration review, eLandia discovered evidence that Latin Node had paid approximately \$2.25 million in bribes to Honduran and Yemeni government officials between March 2004 and June 2007.
- eLandia voluntarily reported the payments to DOJ, eventually paying a \$2 million fine and placing Latin Node into bankruptcy.
- The first FCPA enforcement action based entirely on pre-acquisition conduct that was unknown to the acquiror when the transaction closed.
- eLandia’s entire \$22+ million investment in Latin Node reportedly wiped out due to inflated acquisition price of corrupt company and investigation costs.

M&A: Cautionary Tales – Ball

- In 2011, the SEC alleged that Ball Corp. (“Ball”), a manufacturing company based in the U.S., acquired Formametal SA, an Argentinian company that Ball learned had made illegal payments in the past.
- The SEC further alleged that Ball failed to institute sufficient compliance policies to prevent future bribery, and that Ball helped the Argentinian company cover up one of the payments by reclassifying it on its books.
- In 2011, Ball reached a settlement with the SEC for \$300,000.
- Compliance take-away from the cautionary tales:
 - Acquisitions, mergers, and joint ventures carry risks of FCPA violations. Acquirors should conduct adequate due diligence on all potential acquisitions and adequately respond to “red flags.”
 - New businesses resulting from transactions likely will require new compliance policies, tailored to address specific situations.

M&A: Pfizer – A Case Study

Pfizer H.C.P.

- In August 2012, DOJ entered into a DPA with Pfizer H.C.P., a subsidiary of Pfizer Inc. (“Pfizer”), to resolve charges that the company made more than \$2 million in improper payments to government officials in Bulgaria, Croatia, Kazakhstan, and Russia.
- The payments were made by a subsidiary that Pfizer H.C.P. acquired in 2003, Pharmacia & Upjohn (“Pharmacia”), from 1997 to 2006 to publicly employed hospital administrators, members of regulatory and purchasing committees, and other health care professionals to influence government decisions regarding the approval and registration of Pfizer products, the award of pharmaceutical tenders, and the level of sales of Pfizer products.
- None of the Pfizer H.C.P. DOJ or SEC settlements mentions any FCPA-related due diligence, investigation, compliance or remediation efforts in connection with Pfizer’s 2003 acquisition of Pharmacia & Upjohn (“Pharmacia”).
 - Thus, the agencies presumably held Pfizer liable for Pharmacia’s pre-acquisition conduct.

M&A: Pfizer – A Case Study

Wyeth

- In a related action, Wyeth LLC (“Wyeth”), another subsidiary of Pfizer, entered into a DPA with the SEC to pay \$18.8 million in disgorgement for FCPA violations of its own subsidiaries made both before and after its acquisition by Pfizer in 2009.
- Pfizer’s due diligence of Wyeth included conducting a comprehensive worldwide review of Wyeth’s compliance program and integrating Wyeth into its own internal controls environment. Pfizer “undertook a risk-based FCPA due diligence review of Wyeth’s global operations” within 180 days of closing and sought to integrate Wyeth into Pfizer’s internal controls environment.”
- Following Pfizer’s acquisition of Wyeth, Pfizer diligently and promptly integrated Wyeth’s legacy operations into its compliance program, comprehensive worldwide review of its compliance program and cooperated fully with SEC investigators.
- Pfizer’s and Wyeth’s timely disclosure of the improper payments and extensive remedial measures supported the DPA.
- DOJ cited Pfizer and Wyeth’s thorough internal investigation and resolution with the SEC as factors influencing its decision not to pursue a criminal resolution for the improper conduct of Wyeth’s subsidiaries prior to Wyeth’s acquisition by Pfizer.

Possible Limitations to Pre-closing Due Diligence

- Insufficient time to conduct a thorough due diligence review.
- Local legal restrictions that limit what information can be shared in advance of closing.
- If the acquiror and the target are in the same industry, access to information may be restricted to avoid running afoul of antitrust laws.
- In certain regulated industries, companies may not be able to share sensitive information.
- Confidentiality obligations that run to third parties.
- Importantly, if the target has not maintained a robust anti-bribery compliance environment, it is possible that improper conduct has occurred undetected and the company's internal control system has not even created an auditable paper trail of such conduct that could provide identifiable red flags.
- Access to information can be delayed by a lack of internal communication between management and employees responsible for compiling detailed information.

DOJ/SEC Guidance on M&A Due Diligence

A Resource Guide to the U.S. Foreign Corrupt Practices Act

- Issued jointly by SEC and DOJ on November 14, 2012.
- Issued in order to help businesses “better understand the FCPA.” The Resource Guide assembles, in one convenient place, DOJ’s and SEC’s “guiding principles of [FCPA] enforcement.”
- The *Guide* is “non-binding, informal, and summary in nature,” and “does not in any way limit the enforcement intentions or litigating positions” of U.S. enforcement authorities.

“Perhaps most commonly, inadequate due diligence can allow a course of bribery to continue—with all the attendant harms to a business’s profitability and reputation, as well as potential civil and criminal liability.”

-Resource Guide, at 62



DOJ/SEC Guidance on M&A Due Diligence

A Resource Guide to the U.S. Foreign Corrupt Practices Act

- The Resource guide stresses that due diligence is no panacea:

“DOJ and SEC evaluate whether the acquiring company promptly incorporated the acquired company into all of its internal controls, including its compliance program. Companies should consider training new employees, reevaluating third parties under company standards, and, where appropriate, conducting audits on new business units.”

- *Resource Guide*, at 62.

“DOJ and SEC have only taken action against successor companies in limited circumstances, generally in cases involving egregious and sustained violations or where the successor company directly participated in the violations or failed to stop the misconduct from continuing after the acquisition.”

-*Resource Guide*, at 28



DOJ/SEC Guidance on M&A Due Diligence

FCPA Opinion Procedure Release 2008-02, *cited in Resource Guide*, at 29.

- Halliburton’s attempt to acquire British firm Expro International Group PLC resulted in DOJ’s release of a groundbreaking statement on an acquiror’s successor liability for FCPA violations by a target company.
- DOJ agreed to grant Halliburton a 180-day grace period post-closing during which Halliburton could self-report pre- and post-acquisition FCPA violations without itself being prosecuted, provided Halliburton adhered to a stringent post-acquisition due diligence and integration plan.
- In detailing the procedures that Halliburton must follow in order to avail itself of the protection afforded by 2008-02, DOJ has set forth its view on “best practices” for post-acquisition compliance integration.
- DOJ reserved the right to proceed against Expro for any FCPA violations; DOJ stated that it does not intend to pursue any enforcement action against Halliburton.

DOJ/SEC Guidance on M&A Due Diligence

Best Practices for Post-acquisition Compliance Integration

- Immediately upon closing, imposing the acquiror's Code of Business Conduct on all the target's operations and meeting with DOJ to discuss whether the information that the acquiror has learned to that point shows potential pre-acquisition FCPA violations;
- Within 10 days of closing, preparing and presenting to DOJ a comprehensive FCPA due diligence work plan that addresses and categorizes each of the following into high-, medium-, and low-risk elements: use of third-party representatives, commercial dealings with state-owned customers, joint ventures, teaming or consortium agreements, customs and immigration matters, tax matters, and government licenses and permits;
- Utilizing in-house resources, outside counsel, and third-party consultants (e.g., forensic accountants) as appropriate to conduct post-acquisition due diligence, including a review of the target's e-mails and financial records and interviews of legacy employees;

DOJ/SEC Guidance on M&A Due Diligence

Best Practices for Post-acquisition Compliance Integration (Continued)

- Requiring legacy third-party representatives that the acquiror intends to use post-acquisition to sign new contracts with Halliburton that incorporate audit rights and FCPA and other anti-corruption provisions;
- Providing FCPA training to legacy employees “whose positions or job responsibilities warrant such training on an expedited basis” within 60 days of closing and providing such training to all other employees within 90 days; and
- Disclosing to DOJ all “FCPA, corruption, and related internal controls and accounting issues that it uncovers during the course of its 180-day due diligence.”

ESSENTIAL ELEMENTS OF FCPA DUE DILIGENCE IN M&A CONTEXT

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Key Objectives of Buyer FCPA Due Diligence

- Assess risk of historical and ongoing FCPA violations by target
- Evaluate buyer's successor liability risk
- Determine adequacy of target's FCPA compliance program
- Incorporate diligence into M&A negotiations and post-closing integration plans

Typical Sources of Due Diligence Information

- High-level interviews with senior management of target and compliance team
- Due diligence questionnaire focused on FCPA risks
- Review of data room documents relating to FCPA risks
- Financial due diligence on internal controls, disbursements, petty cash and other processes
- Third party agent reviews (questionnaire, desktop reviews, interviews)

High-Level Risk Assessment Considerations

- Business Presence in Higher-Risk Jurisdictions
- Extent of Sales to Government Customers
- Level of Interactions with Regulatory Officials
- Type of Sales and Business Model
- Extent of Third Party Agent Network
- Nature of Marketing and Relationship Building Practices

Target's FCPA Policies and Procedures

- Determine whether target has written FCPA policies and procedures
- Evaluate sufficiency of those FCPA policies and procedures
- Assess whether policies and procedures are followed and understood
- Evaluate effectiveness of training program

Interactions with Foreign Government Officials

- Sales to Foreign Government Customers
- Extent of Sales in High-Risk Jurisdictions
- Nature of Sales Channel to Government Customers (direct, through sales agents, through distributors, as part of a consortium, etc.)
- Level of Regulatory Interactions with Government Officials
 - Customs clearance
 - Licensing
 - Facility Inspections
 - Tax Audits
 - Litigation Settlements

Travel, Gift and Entertainment Practices

- Extent of marketing and relationship building activity with government officials and other business partners
 - Sponsored travel to conferences, seminars or facility visits
 - Gift-giving practices associated with holidays, family or other events
 - Meals, entertainment and hospitality practices
- Transparency of expenditures and sufficiency of supporting documentation required by target
- Review and approval process for different types of travel, gift and entertainment expenses
 - Cash advances
 - Per diems
 - Reimbursement to employees
 - Reimbursement to government officials
 - Direct payments to vendors

Political and Charitable Contributions

- Extent of Political Activity (directly or through lobbyists or other advocacy groups)
 - Connections with local politicians
 - Importance of maintaining good relationships with local government
- Extent of Charitable Activity
 - Purpose and magnitude of charitable giving
 - Possible connection with business objectives

Target's Internal Financial Controls

- Evaluate adequacy of target's internal financial controls and related policies and procedures
- Gain understanding of how transactions are approved, financed and recorded in books and records
- Determine whether any "off-the-books" funds are used and for what purposes
- Examine petty cash practices

FCPA Compliance History

- Prior Violations by or Investigations of Target
 - Desktop Diligence Review
 - Court records search
 - Any prior investigations, suspicions or media reports?
- Reputation of Key Principals
 - Desktop Diligence Review
 - Background and reference checks
 - Any red flags?

Third Party Agent Risk

- Identify and Assess Level of Risk Associated with Different Types of Intermediaries
 - Sales Agents
 - Distributors or Resellers
 - Customs Brokers
 - Consultants, Lawyers, Accountants, Lobbyists
- Design Due Diligence Review of Third Parties Based on Risk Assessment
 - Desktop Review for low-risk agents
 - Full interviews for higher-risk agents based on jurisdiction, amount of revenues and nature of interactions with government officials

Questions?

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Mergers & Acquisition Due Diligence: Challenges and Best Practices

Kathryn Cameron Atkinson
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M&A Due Diligence: Compliance and Coordination

- M&A-related compliance program elements becoming standard as new requirements from Bizjet appear in Data Systems, Nordam, Tyco, et al.
 - Due diligence
 - Reporting on due diligence findings
 - Integration – policies, training
 - Auditing

M&A Due Diligence: Special Considerations

- Transaction may not permit ideal due diligence approach:
 - Auction
 - Hostile bid
 - Antitrust concerns
 - Other restrictions
- Halliburton Release: DOJ will tolerate but discourage restrictions on pre-acquisition due diligence
- DOJ: If lack of access outside your control, must conduct post-acquisition due diligence

M&A Due Diligence: Be Prepared

- As soon as possible in a transaction, obtain written safeguards to ensure rights to due diligence and to map out response to issues
- Push to maximize pre-closing access
- Mine public data sources: news articles, websites, NGOs
- Consider retention of outside investigators/business intelligence
- Consider whether/how lack of pre-closing access should affect decisions:
 - Safeguards
 - Personnel decisions
 - Corporate structure decisions

M&A Due Diligence: Be Prepared

- Consider in advance how you will handle a violation of anti-corruption laws discovered during due diligence:
 - A “materially adverse effect” giving the buyer the right to terminate or renegotiate the merger agreement?
 - Indemnities?
 - Escrow?
 - Change in transaction value?
- Consider in advance pros/cons of disclosure, Opinion Procedure

M&A Due Diligence: Be Prepared

- Consider in advance possible report structure, but maintain flexibility:
 - Oral report to Board?
 - Comprehensive written report?
 - Close dialogue throughout: do not wait until you're done
- May have multiple reports: pre- and post-closing

M&A Due Diligence: Recent Lessons

- Recent enforcement actions raise the bar on post-closing actions, whether or not pre-closing due diligence was “thorough”
- Expectation of thorough post-closing due diligence
- Expectation of post-closing training, audits
- Equal focus on pre- and post-closing behavior

M&A Due Diligence: Recent Lessons

- Watts Water (2011)
 - Issues evident in pre-closing due diligence, but communication gaps between in-house personnel and external counsel
 - Improper conduct left unaddressed post-closing
 - Slow movement post-closing (3 years)
 - Grace period is short: months, not years

M&A Due Diligence: Recent Lessons

- Ball/Formametal (2011)
 - 3 months post-acquisition, accountant discovered questionable payments at Formametal
 - Reported to management
 - Response insufficient to stop payments
 - SEC: Post-acquisition due diligence undertaken, but response insufficient = Ball liable for the conduct

M&A Due Diligence: Recent Lessons

- **Pfizer's Tale of Two Acquisitions:**
- Risk-based FCPA due diligence review, reported within 180 days of closing
- Post-acquisition review identified potential improper payments
- Investigated, disclosed results
- Promptly integrated Wyeth's legacy operations into its compliance program
- Despite these efforts, post-closing improper payments by Wyeth, no Pfizer knowledge
- DOJ explicitly credited Pfizer Inc. for its acquisition-related due diligence related to Wyeth, no criminal enforcement action against Pfizer Inc. for the pre-acquisition payments
- Pfizer DOJ DPA and SEC complaint do not include Wyeth's improper payments, which were resolved in a separate settlement with Wyeth.

M&A Due Diligence: Recent Lessons

- **Pfizer's Tale of Two Acquisitions:**
- April 16, 2003, Pfizer stock-for-stock acquisition of Pharmacia Corporation
- SEC Complaint: Pfizer Russia continued and expanded a Pharmacia Russia practice of paying sales discounts owed to Russian distributors into offshore bank accounts
- In 2003 and 2004, Pfizer Russia entered into similar arrangements for the benefit of two other Russian distributors
- From 1997- 2004, Pfizer HCP Croatia, Pharmacia Croatia made payments and provided benefits to doctors employed by the Croatian government
- Although Pfizer HCP Croatia ended stopped most payments, it permitted the program to continue with respect to one Pharmacia product until 2005
- DOJ and SEC held Pfizer Inc. liable for pre- and post-acquisition payments

M&A Due Diligence: Recent Lessons

- Diebold
 - Pre-acquisition due diligence of two distributors found evidence of bribes to employees of privately-held banks
 - Regional and corporate management learned of the bribes and killed the deals, but continued relationship with distributors for 1-3 years without further remedial action
 - Charged as civil and criminal FCPA violations under books and records provisions
 - \$48.1 million in fines, penalties, disgorgement
 - 3-year DPA, monitor imposed

M&A Due Diligence: Best Practices

- Maximize pre-acquisition access and due diligence efforts
 - Best way to reduce risk, value deal, and prepare for integration
- Position defenses as early as possible
- Prioritize post-acquisition due diligence
 - Don't assume you know everything
- Move quickly on program integration
 - Training, audits
 - Policy implementation

M&A Due Diligence : Best Practices

- When a violation is discovered:
 - Move quickly to address
 - Ensure response is thorough and effective
 - Document response
- If agencies involved, proper planning and execution will affect prosecutorial discretion
 - ❖ Declination
 - ❖ Enforcement against target company only
 - ❖ Enforcement in name of target, fines paid by purchaser
 - ❖ Self-reporting v. monitor

Questions?

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