MAKE OR BREAK THE DEAL: THREE THINGS YOU SHOULD BE THINKING ABOUT IN TRANSACTIONAL COMPLIANCE DUE DILIGENCE

Transactional compliance due diligence is the new norm

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Like never before, robust pre-transaction compliance due diligence has become increasingly common in most mergers, acquisitions, equity investments, and joint venture transactions, even where the investor is only taking a minority stake. What may have been limited in the past to one row in a check-the-box due diligence checklist, has now been routinely expanded to include fulsome inquiry into anti-bribery and anti-corruption, anti-money laundering, sanctions and export control, data privacy and cybersecurity, and, in the wake of #metoo awareness, diligence into sexual and other forms of illegal harassment, as well as the use of child labor and modern slavery.

Some skeptics may continue to disregard the significance of compliance risk, insisting that expansion in the scope and depth of diligence is unnecessary or, at best, a weight that slows down a transaction; they worry that the results of diligence may put the brakes on commercial efforts that may have been in the works for some time before compliance diligence was considered.

Principles of successor liability have historically governed the degree to which an acquirer can be liable for the transgressions of a target. However, the risk calculus does not end there, and even asset transfers are not without risk. Law enforcement authorities expect that companies contemplating an investment will conduct rigorous, risk-based diligence. The U.S. Department of Justice (DOJ), U.S. Securities and Exchange Commission (SEC), and U.K. Serious Fraud Office (SFO) have all made it abundantly clear that buyers and shareholders are not free from the risk of facing criminal or civil liability for the violations of the companies they acquire or in which they invest. The U.S. Treasury Department's Office of Foreign Assets Control (OFAC) sends the same message and has not hesitated to take action against investors in the context of mergers and acquisitions, with three such enforcement actions for sanctions violations in 2019 alone. The authorities are clear: There are real financial and reputational consequences that flow from enforcement actions precipitated by poor transactional due diligence. These exceed the costs of due diligence; and so as the mantra goes: "Don't buy trouble."

The challenge remains, however, as most compliance counsel will agree, in finding the right equilibrium between the two seemingly competing tensions: the business demands to move a transaction forward at low cost, and the mandate to ensure that compliance risks are identified and appropriately accounted for in decision-making. Perhaps the first step as compliance counsel is to obtain business buy-in: point to any number of DOJ, SEC, or OFAC enforcement actions that speak to how weak pre-transaction compliance due diligence can leave a business exposed to unnecessary and avoidable risks that in turn have very real commercial impact in the form of steep fines or settlement payments that hit profitability, and cause immeasurable reputational harm. Speak to the potentially catastrophic loss of investment value when contracts obtained through bribes, and business models dependent on corrupt practices have to be abandoned and rebuilt; an entire investment can be entirely

wiped out by the costs that will be incurred to remediate improper business practices. The next step is to tailor pre-transaction compliance due diligence in a manner that drives the deal to the right equilibrium. In this article, we look at three considerations that should be front and center when planning and implementing pre-transaction compliance due diligence.

#1: Issue Spotting – What Are the Risk Areas?

The areas to be examined in transactional compliance due diligence should be determined based on careful risk assessment. Avoid boiling the ocean, but instead, carefully calibrate the potential risk areas. We suggest some of the following as key considerations when developing the risk profile of a transaction:

- In what industry does the business operate? Is the industry heavily regulated? What particular risks are common to this industry? Has the industry been the subject of recent enforcement activity?
- What jurisdiction(s) does the business operate in? Are these high-risk jurisdictions for particular compliance areas?
- What are the investee's history and reputation? Can you leverage on existing information to identify potential liabilities and uncover known problems? If not already commissioned, should you consider conducting a targeted background check?
- Does the nature of the investee's business flag particular risk areas for special attention? For example, if the business depends on data, is that data secure? Has it been collected, processed, and disclosed in accordance with applicable law? Is any technology on which the business depends subject to export controls?
- What is the size of the investment? What is the investor's exposure to risk for the investee's wrongdoing?

Developing a risk profile helps identify specific areas of compliance that demand pre-transaction attention, prioritizes those risks, and "right-sizes" the due diligence exercise. In this way, the due diligence process is customized to address the relevant risk areas, while keeping commercial cost sensitivities in view.

#2: Time Is of the Essence – Begin Early

To properly develop the prospective investee's risk profile, reviewing publicly available information will not suffice. Best practices require that the buyer or investor request documents and information and follow up with the target's management, with a view to examining the investee's business practices, risks, and internal controls in a manner commensurate with the risk posed. The process can be time-consuming and, in some cases, can result in a large volume of information to review. Plan ahead for this – compliance professionals should work with their business colleagues to ensure that they and/or external counsel are brought on board as soon as an acquisition or investment is considered, so that all parties get to the intended finish line at the same time. To get to this place, the compliance team will need to sensitize their business colleagues to compliance risks early and often. Training, which is periodically updated to stay current, on the risks facing the business is indispensable in this regard.

#3: A Can Do Attitude – A Potential Issue Does Not Have to Kill a Deal

It may be that due diligence uncovers violations of relevant laws and regulations that are so severe that a transaction no longer makes business sense. However, that is not always the case. In some instances, even where red flags are identified, a company may still wish to proceed with the deal, depending on its risk appetite. Indeed, enforcement agencies have made clear that they do not intend for the risk of enforcement action to halt good business activity and they have provided guidance for conducting diligence and disclosing violations to the government under certain circumstances in order to minimize future liability.

We suggest the following questions as broad guidelines when considering the steps to implement in order to minimize risk exposure as a buyer or investor:

- What is the degree of severity of the risk?
- Did the offending conduct occur in the past or does it continue (or is it likely to continue) in the present?
- Have steps been taken to require that the investee company cease the offending conduct? What steps can be taken to ensure that the offending conduct has in fact ceased?
- Is the risk of a nature that it needs to be addressed or corrected pre-signing or pre-closing, or can it be addressed through post-closing covenants?
- Is disclosure by the investee company or the acquirer to the relevant enforcement agency or regulator necessary to mitigate risk?
- What enhancements are required to the investee company's current compliance policies and training programs?
- What disciplinary action needs to be taken against employees who have been involved in illicit activity? Should they be terminated?
- What warranties or representations are required in the deal documents?

Carefully examining the potential risks and possible mitigations elevates you from being seen as simply the harbinger of bad news, to being part of the solution. It enables you to present a risk-based solution to the business, equipping them to make an informed decision about whether to proceed with a transaction.

Conclusion

Transactional compliance due diligence is the new norm. Against this backdrop, we provide guidance to in-house compliance counsel looking to step into their ever-expanding role as an advisor to the business, providing practical, risk based solutions.

Expert Biography

Daniel Levison *has more than 20 years of experience in advising clients on complex multi–jurisdictional investigation, litigation, arbitration, and compliance matters across the Asia–Pacific region. As head of Morrison & Foerster's disputes and compliance practice in Singapore, Mr. Levison is experienced in handling highly sensitive matters, which have included fraud and corruption, cartel and other competition matters, anti-money laundering, export control, privacy and data security, and regulatory and product safety investigations. In addition, he also helps clients protect their businesses with pre-acquisition and third-party compliance due diligence, and developing, reviewing and implementing compliance policies, procedures and training programs. Mr. Levison has been recognised by Chambers Asia-Pacific every year for the last three years as a top practitioner (Band 1) in his field for Corporate Investigations/Anti-corruption. He was also recommended as a global leader in Investigations in Singapore by Who's Who Legal/Global Investigations Review 2019 and 2020.*

Sheryl George *is a disputes and compliance associate in the Singapore office of Morrison & Foerster. Her practice focuses on investigations and white-collar matters, regulatory and global compliance, including compliance due diligence for corporate transactions, as well as complex commercial disputes. Sheryl has particular expertise in fraud and corruption, anti-money laundering, economic sanctions, cybercrime and cybersecurity, and a broad range of complex commercial matters. Prior to joining the firm, she was a Deputy Public Prosecutor/ State Counsel in the Singapore Attorney-General's Chambers, where she served as the lead prosecutor and state counsel on a wide variety of financial crime and regulatory matters.*