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Compliance due diligence tips for mergers and acquisitions

By Lisa Beth Lentini Walker and Maria Lancri

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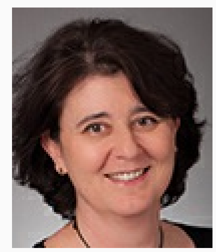

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Mergers and acquisitions (M&A) transactions have always been considered a form of the Holy Grail. These deals allow the lawyers involved to share with their clients the details of their business and financial strategy and help share the future of a company.

M&As may take different forms: sale of a whole company, a specific amount of shares, or a minority/majority interest; a merger; a creation of a joint venture; or sale of some assets. But at the end of the day, they all share one common hope: that the M&A is a positive transaction that leads to new possibilities. But the hope and promise of M&A can be shattered without proper precautions—particularly in the form of adequate due diligence.

M&A due diligence

M&A transactions are regularly preceded by preacquisition due diligence, either financial or legal. The rationale for due diligence is to help determine the appropriate structure of the deal, the price and guarantees that should be requested from the seller, and whether the deal is appropriate given the sellers' wants, needs, and objectives.

Through the years, compliance due diligence has increasingly been added to the mix of information sought during the preclosing process as the risks associated with compliance issues increase in frequency and gravity. Oftentimes, the extent and thoroughness of due diligence varies based on whether the compliance officer is involved in M&A processes. If the people in charge of the development of a company are acting independently, this type of due diligence may remain limited—often much to the detriment of the company.

The most common compliance due diligence issues relate to antitrust, data protection, corruption, money laundering, or international sanctions and export controls, but depending on the types of industries and key compliance risk factors, other areas such as product compliance, health and safety, intellectual property, and other areas may be reviewed.

Similarly, some activities are traditionally riskier than others, depending on various factors:

- **The industry**: Highly regulated industries such as healthcare and financial services often have quite a few more regulations associated with activities and industries. Construction and mining are also viewed as more risky.

- **The product**: The type of product certainly affects the level of risk.
- **The customer**: Transactions should be scrutinized more seriously when dealing with public agents or representatives of governments or state-owned entities, especially in less developed countries. Commercial counterparties, so long as they are a company with a strong reputation, tend to carry less risk than government contracts.
- **The country**: It is advisable to refer to international indexes such as the Transparency International Corruption Perceptions Index to determine the level of risk and trade sanction and embargo lists to ensure that there isn't carryover liability.

The level of materiality

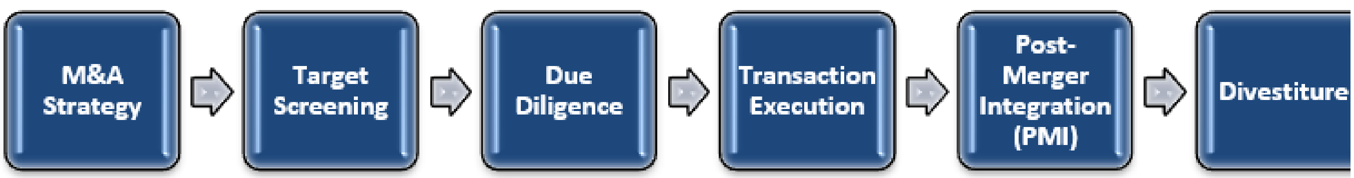
It is very common to say that when you are building a house, you can (1) have it well built, (2) do it cost effectively, or (3) be finished quickly. Rarely can you get two of the three, and almost never will you get all three things.

The same holds true for compliance due diligence; you can: (1) be exhaustively thorough, (2) conduct it without much expense, or (3) be fast. This speaks to the balancing act of making risk-based decisions. Depending on how the risk is perceived beforehand, the due diligence must make key decisions to limit scope, such as focusing on contracts over a certain amount at stake and for certain activities or subsidiaries only.

It may be that, in view of the first audits and where the risks seem the highest, the decision is to review contracts of a lower amount or regarding a certain activity.

The timeline

Figure 1. The acquisition process



The findings from due diligence often have a direct impact on the transaction and may affect structure and/or price negotiations. The acquirer may also ask to add certain guarantees in the agreement.

Generally, the process of acquisition is in multiple steps (Figure 1), which can include an initial letter of intent, an exclusivity or lock-up period for negotiation, developing the terms of the deal, and finally ending with signing and closing the transaction. (Please note it is increasingly common to have a simultaneous sign and close for agreements.)

It is also common to introduce in the agreement a material adverse change clause. Traditionally, these provisions were designed to deal with a financial loss in between initial letter of intent and the final closing. Today, they may aim at allowing an indemnification of the acquirer in case of the occurrence of a certain event that would reveal how "noncompliant" the target company is.