



November 8, 2014
10:45 AM – 12:00 PM

Session 601: U.S. International Regulatory Compliance and Due Diligence in M&A Transactions

This presentation is designed to equip attendees to recognize red flags that will allow them to provide guidance regarding regulatory risks to parties in cross-border investment, M&A, and corporate restructuring transactions. The presentation will address topics such as export controls, sanctions, anti-corruption, anti-money laundering, and CFIUS considerations. The speakers will assess recent trends and share lessons learned. This panel will be of interest to in-house and outside counsel involved in cross-border investment, M&A, and corporate restructuring transactions. Plus, practitioners involved in or responsible for global regulatory compliance for anti-corruption, export controls, economic sanctions, anti-money laundering, and national security, will find this presentation useful.

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FCPA Risks and Examples and Risk Mitigating Strategies in Mergers and Acquisitions

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NAPABA 2014 Conference in Phoenix, AZ
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FCPA Risks In Mergers and Acquisitions

- Four Sets of FCPA-Related Risks:
 - Direct liability in connection with transaction
 - Successor liability: liability for pre-closing acts of target
 - Direct liability post-closing: “Day 1”
 - Commercial risks to acquired business

- Each type of liability likely to arise in context of third-party relationships

M&A Risks - Successor Liability

- Theory:
 - Acquirer held liable for acts of target committed pre-closing
- No litigated cases
- Recent enforcement actions confirm the theory lives:
 - *Pfizer Inc.* DOJ and SEC FCPA settlements (August 2012)
- Not confined to stock transactions?
 - See *Sigma-Aldrich* (2002)
- 2012 DOJ-SEC Resource Guide

M&A Risks – 2012 DOJ-SEC Resource Guide

- Attempt to cut through confusion – discussion of legal principles:
 - Successor liability, vs.
 - Acquirer liability for acts of an acquired subsidiary, vs.
 - Acquired subsidiary liability for its own acts (pre/post-closing)

- 6 enforcement hypotheticals, in 2 sections:
 - Where the acquisition target is subject to the FCPA
 - Where it is not

M&A Risks – 2012 DOJ-SEC Resource Guide (cont'd)

- Enforcement intentions:
 - True successor liability where no pre-closing due diligence
 - Direct acquirer liability for acquired subsidiary's post-closing acts where the acquirer knew of, approved, or participated in the conduct
 - Direct liability for post-closing acts of acquired subsidiaries unlikely where acquirer performed FCPA-focused due diligence pre- or immediately post-closing
- Confirmation: no liability for pre-closing corrupt conduct of target not subject to the FCPA
- *Halliburton* OPR 08-02 framework still stands

M&A Risks - Successor Liability: Examples

■ SEC vs. El Paso Corp. (2007)

- First SEC Iraq Oil-For-Food case
- El Paso held liable for its own violations, and those of acquired subsidiary Coastal Corp. pre-closing = “pure” successor liability
- \$5.5 million in civil penalties and disgorgement

■ SEC vs. GE, Ionics Inc. and Amersham plc (2010)

- GE held liable for acts of four subsidiaries:
 - 2 wholly-owned at time of violations
 - Liable for Amersham plc and Ionics, Inc. violations on successor theory
- \$23 million in civil penalties and disgorgement

M&A Risks – Pfizer Settlements

- DOJ/SEC policy statement in advance of release of *Guidance*
- 3 Settlements: ~\$60 million in fines, penalties and disgorgement for payments in multiple countries
 - Pfizer HCP (NY subsidiary): criminal plea agreement with DOJ, \$15 million in fines re: payments in
 - Pfizer Inc.: SEC civil settlement; \$26.3 million in penalties, disgorgement and interest
 - Wyeth LLC (acquired subsidiary): \$18.8 million in penalties, disgorgement and interest
 - Conduct related to Bulgaria, Croatia, Kazakhstan, Russia, China and others
- True criminal successor liability for Pfizer HCP (Pharmacia & Upjohn acquisition in 2003) where no FCPA due diligence
- No criminal successor liability for Pfizer Inc. in connection with Wyeth LLC acquisition where pre-closing diligence undertaken

M&A Risks – “Day 1” Liability

■ Halliburton/KBR (2008/09)

- Halliburton acquired Dresser Industries, Inc. (1998)
- Halliburton prosecuted by the SEC as the parent of KBR during the period at issue.
- Largest monetary sanction vs. U.S. company
 - Halliburton: \$559 million (\$402 million disgorgement)
 - Conduct ongoing at time of acquisition

■ Opinion Procedure Release 08-02

- “Halliburton” diligence and integration plan
 - Very strict timeframes
- Wider safe harbor than the OPR signals on its face

M&A Risks – Commercial Risks

- In addition to risks of liability to acquirer:
 - Commercial risks to value of acquisition, to the extent business depends on:
 - Improper payments in ongoing operations
 - Core assets secured through bribery

- **U.S. v. Latin Node, Inc. (2010)**
 - Acquired by eLandia International, Inc. in 2008
 - eLandia performed no FCPA due diligence
 - improper payments to procure core assets (Honduras and Yemen telecom contracts) discovered post-closing
 - Latin Node, Inc. prosecuted by DOJ - \$2 million fine
 - Within 18 mos. of acquisition, eLandia wrote down entire investment

Risk Mitigation Strategies

- Competing incentives pre-signing:
 - Acquirers seek as much information as possible/cause target to remediate, to limit liability risks
 - Target seeks to limit information flow/protect value: get to closing
- Net result:
 - Depth and breadth of due diligence a product of negotiation
- Risk-based approaches common, typically seen as reasonable
- “Halliburton” diligence and integration (OPR 08-02) a viable strategy
- Goal is to mitigate risk to acceptable level, while closing deal ***Cf. Titan/Lockheed (2005).***

Risk Mitigation Strategies (Cont'd)

- Key goals of due diligence:
 - Determine if compliance risks can be adequately covered by representations and warranties, indemnities
 - Provide factual basis for a compliance integration plan when the deal closes

- Four key steps:
 - Risk profile
 - Evaluate target's existing compliance infrastructure, internal controls
 - Focus on highest-risk operations/activities first
 - Planning for “Day 1,” post-closing integration

Risk Mitigation Strategies - Examples

■ GE/InVision (2005)

- Acquired December 2004 by GE
- From June 2002-June 2004, InVision employees, agents, distributors sold explosive detection machines to airports in China, the Philippines and Thailand,
- In each case, of which the company was aware of a high probability that its agents or distributors made improper payments to government officials in order to obtain business.
- GE strategy:
 - Pre-closing disclosure to DOJ
 - DOJ agreed to Non-Prosecution Agreement of against InVision
 - Settlement terms included payment of a penalty of \$800,000.

Risk Mitigation Strategies - Recent Cases (Cont'd)

■ Vetco Gray I (2004)

- **2004:** Private equity investors seeking to purchase the Vetco Gray companies from ABB discovered issues in due diligence
- PE fund strategy to limit liability:
 - Worldwide investigation extending to 22 countries
 - Settlement with government as a condition to acquisition
 - Penalty of \$10.5 million and \$5.9 million in disgorgement
 - \$1 million in bribes to NAPIMS officials

Risk Mitigation Strategies - Recent Cases (Cont'd)

■ Vetco Gray II (2007)

- **2007:** GE sought to acquire Vetco entities
- Strategy to limit liability: pre-closing investigation and settlement by Vetco with DOJ
- Settlement terms:
 - 3 Vetco Gray companies pleaded guilty to FCPA antibribery violations; fourth agreed to a DPA (later revoked)
 - \$26 million in fines
 - Payments through a Swiss-based freight forwarder to Nigerian Customs Service officials, to import/smuggle goods and equipment

Thank you

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Export Controls & Sanctions Risks, Examples, and Risk Mitigation Strategies in Mergers & Acquisitions

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Hypothetical A

- Company A, a U.S. satellite manufacturer, wants to acquire Company B, a U.S. manufacturer of Global positioning system ("GPS") equipment and components.
- As a manufacturer of GPS equipment and components, Company B's business involves products/technologies that are controlled under U.S. export control laws. Furthermore, Company B boasts about its worldwide customer base.
- During the acquisition due diligence process, Company B explains that it has no written export controls and sanctions compliance policy, but it assures Company A that it is not subject to any ongoing export controls or sanctions investigations.
- Company A proceeds with the acquisition, planning to extend its own compliance policies to Company B after the purchase is complete.

Hypothetical Cont'd

- A year after Company A purchases Company B, Company A learns that Company B was involved in numerous unauthorized exports of controlled GPS equipment prior to its acquisition. Does Company A have any potential liability?
- Answer: **YES.** Successor liability is alive and well in the U.S. legal system.

Export Controls/Sanctions - Overview

- International Traffic in Arms Regulations (ITAR)
 - State Department’s Directorate of Defense Trade Controls (DDTC)
 - Defense articles, technical data, and services
- Export Administration Regulations (EAR)
 - Commerce Department’s Bureau of Industry and Security (BIS)
 - “Dual use” items and technology
- Various economic sanctions laws and regulations
 - Treasury Department’s Office of Foreign Assets Control (OFAC)
 - Transactions involving sanctioned countries or entities
- *Over the course of the past decade, it has become abundantly clear that BIS, DDTC and OFAC are all willing to hold an acquiring company liable for a target company’s export controls and sanctions violations, even when those violations occurred prior to the transaction and wholly without the acquiring company’s knowledge or involvement.*

Example: Sigma-Aldrich

- The case that serves as the foundation for the broad imposition of successor liability by BIS is Sigma-Aldrich (Sigma).
- In April 1997, three Sigma entities acquired certain assets/partnership shares in Research Biochemicals Limited Partnership (RBLP).
- BIS alleged that RBLP had been making unauthorized exports of controlled biological toxins to Europe and Asia since 1995 (prior to the acquisition by Sigma), and that these unlicensed exports had continued for more than a year after the acquisition.
- BIS sought to impose liability against Sigma, both as a successor for violations occurring prior to the acquisition, and as the actual wrongdoer for violations that occurred after the transfer.
- After an administrative law judge dismissed Sigma's motion for summary judgment regarding the imposition of successor liability, Sigma agreed to pay BIS \$1.76 million to settle the case.

Example: General Motors (GM)/General Dynamics (GD)

- In 2004, DDTC entered into a settlement agreement with GM/GD in relation to export violations involving GM units that were acquired by GD after the violations occurred.
- GD voluntarily disclosed the export control violations that it discovered during due diligence.
- GD was required to pay only \$5 million of the \$20 million fine, and was allowed to spend that \$5 million on the implementation of export compliance enhancement measures in relation to the acquired GM units.
 - GM was required to pay \$8 million to DDTC, \$2 million to ICE, and was allowed to spend the last \$5 million on compliance measures.
- The lesser penalty for GD may well have been the result of GD's discovery of GM's export control violations, and the actions that it took in response to that discovery.

Additional DDTC Successor Liability Examples

- **Boeing:** In 2002, DDTC issued a charging letter to the Boeing Company alleging violations of the ITAR by Hughes Space and Communications (Hughes).
 - Boeing had purchased Hughes in 2000, and the charging letter alleged violations with respect to Hughes' launch of satellites from China in the mid-1990s.
 - Boeing and Hughes settled these charges for \$32 million.
- **AAR:** In 2010, DDTC issued a charging letter to AAR International alleging 13 violations of the ITAR and the Arms Export Control Act by Presidential Airways (Presidential) prior to its purchase.
 - In its Charging Letter, the State Department acknowledged that AAR International met with the Department prior to the purchase of Presidential to assist in resolving the export control violations.
 - The Consent Agreement resolving the dispute contained no monetary penalties.

OFAC Successor Liability Example

- In recent years OFAC has also occasionally relied on the doctrine of successor liability to impose penalties on acquiring companies.
- Monetary penalties imposed by OFAC have thus far tended to be significantly smaller than those imposed by BIS or DDTC.
- **Zimmer Dental:** In 2008, Zimmer Dental Inc., successor to Centerpulse Dental Inc., paid \$82,850 to settle allegations that Centerpulse had been exporting goods and services to Iran without an OFAC license.
 - The alleged violations occurred prior to the acquisition of Centerpulse Dental Inc. by Zimmer Dental's parent company.
 - Zimmer Dental voluntarily disclosed the violations to OFAC.

Export Controls/Sanctions: Risk-Based Due Diligence

- Due diligence review is standard practice in corporate M&A, but the need to conduct a comprehensive review of international regulatory compliance is frequently overlooked.
- As the previous examples indicate, companies that neglect such a review do so at their own risk.
 - Potential for monetary and non-monetary penalties, which could include:
 - Requiring a compliance monitor;
 - Policy of license denial; and/or
 - Complete denial of export privileges.
 - Mitigation is likely only available if export control and sanctions violations are discovered in the course of due diligence and disclosed to the Government.

Export Controls/Sanctions: Risk-Based Due Diligence

- The exact nature of the export compliance review will depend on the industry involved, the type of transaction, and the nature of the target company's business.
- Generally speaking, however, the following should be considered for preliminary due diligence:
 - Does target conduct business abroad?
 - In what countries? (Iran, Sudan, Syria, Cuba, Burma, N. Korea)
 - Does it conduct work for military customers?
 - Even slightly modified parts and components can qualify
 - Is it engaged in sensitive industries?
 - High tech, chem/bio, aviation, encryption, etc.
 - What is the nature of its workforce?
 - What is the status of its compliance program and implementation?
 - What Government agencies have jurisdiction over target's business?
 - Are there any past or present export controls or sanctions violations?

Export Controls/Sanctions: Risk Mitigation Steps

- If high risk factors, conduct more thorough due diligence to identify past and future risk
- Thoroughly investigate red flags, including:
 - target has sold to embargoed or high risk countries over the past five years;
 - target does not know the export control classification of its products; or
 - target does a substantial amount of business overseas, but does not have a comprehensive compliance policy and/or maintains inadequate records.
- Seek adequate compensation (purchase price; indemnification; escrow)
- Consider voluntary (mandatory) disclosure of violations.
 - As noted before, benefits of a voluntary disclosure are available only if the company comes forward on its own initiative; and
 - Taking the necessary corrective measures is likely to alert the government to the violation anyway (e.g., obtaining new licenses).

Export Controls/Sanctions – Prior Notifications or Authorization

- Prior notifications or authorization may be required for acquisition, for example:
 - ITAR registrants must provide DDTC with certain information within five days of the closing of a deal which results in a material change to the Registration Statement;
 - BIS requires that a Commerce licensee seek written approval in order to transfer any export licenses or other export authorizations to another party as the result of a merger or acquisition.
 - Unlike the ITAR, the EAR do not provide specific deadlines.
 - Also unlike the ITAR, the EAR do not require a notification process where the licenses will continue to be owned by the same legal entity.

Hypothetical B

- For our next hypothetical, let's imagine that Company A is a foreign satellite manufacturer, and that Company A is once again interested in acquiring Company B, a U.S. manufacturer of Global positioning system ("GPS") equipment and components.
- For purposes of this hypothetical, let's assume that in addition to selling standard commercial products, Company B also specially designs GPS equipment for certain military customers. Company B is, therefore, an ITAR registrant.
- From a U.S. regulatory perspective, what should the companies consider?

Hypothetical B, Cont'd

- **ITAR:**

- As with transactions involving only US parties, DDTC requires advance notification when an ITAR registrant is being acquired by a foreign company.
- Specifically, Section 122.4(b) of the ITAR requires at least **60** days advance notice of any sale or transfer that will result in a foreign person acquiring ownership or control of a U.S. registrant.

- **Committee on Foreign Investment in the United States (CFIUS)**

- Conducts national security reviews of certain foreign investments

CFIUS – Jurisdiction

- Jurisdiction
 - Transactions that could result in foreign “control” of US business.
 - No bright lines on “control” – as little as 10% ownership (or even less) may confer control.
 - US business means any business operating in US.
 - Does not have to be incorporated in US to be considered US business.
- CFIUS focuses solely on addressing national security issues, but “national security” is not defined.
 - Many CFIUS cases involve mergers and acquisitions within the defense industry.
 - However, CFIUS also commonly reviews transactions in the aerospace, telecommunications, engineering, energy, pharmaceutical, and transportation industries, among others.
 - In other words, “national security” has the potential to be broadly interpreted.

CIFIUS – Voluntary Process

- Generally up to parties to decide whether to file
- But President has authority to block or unwind deals
- “Voluntary” CFIUS process confers safe harbor
- CFIUS has authority to file case without the parties
 - Never been exercised – parties always file upon CFIUS request
 - If CFIUS makes request, parties have miscalculated = bad news
- Transacting parties have to think carefully:
 - Does the acquisition touch national security?
 - Err on the side of filing to avoid a potentially painful review and mitigation process at a later date.

CFIUS – Review Process

- Historically, roughly 10% of FDI has been reviewed by CFIUS
 - Typically over 100 cases/year
- Most cases last 30 days, harder cases last 75
 - Roughly 1/3 cases go 75 days
 - If CFIUS refers a case to the President (very rare), he has an additional 15 days
 - Withdrawal/re-filing sometimes used to restart the clock in difficult cases
- Each case analyzed for risk
- Risk = Threat, vulnerability, & consequence
- Possible results from CFIUS process:
 - Approval (approx. 90% of cases)
 - Approval with risk mitigation measures (approx. 5-10%)
 - Blocking/divestment (approx. 0-5%)

One Big Happy Family: CFIUS, BIS, DDTC, OFAC

- Cautionary note: CFIUS filings are circulated to BIS, DDTC, and OFAC.
 - If a CFIUS filing describes activities that are regulated under export controls or sanctions laws, these agencies will be put on notice.
- If a CFIUS filing describes activities which require a license from DDTC, for example, and DDTC knows that the company is not licensed for such activities, DDTC could initiate a separate investigation/enforcement action.
 - DDTC has been known to contact counsel where merely the nature of the products themselves suggest that they might be subject to the ITAR.
- Parties that elect to undergo CFIUS review should strongly consider filing a voluntary disclosure with the relevant agency prior to, or concurrent with, their CFIUS filing if they are aware of any past unauthorized activity relating to export controls or sanctions.

Thank you

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