



FCPA Issues in Mergers & Acquisitions and other Business Combinations

Christine S. Fields
Eli Lilly and Company

Paul V. Gerlach
Sidley Austin, LLP

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Intersection Between Pharma and the FCPA

- “A Perfect Storm”
 - Senior government attorney warns that the Pharma sector is rife with potential FCPA problems
 - Combination of big pharma business model, interaction with government regulators, and widely publicized international cases of corruption and fraud contribute to the susceptibility of the industry
 - Specifically in M&A context, the large number of mergers and acquisitions by “major players” of small start-ups bring FCPA issues to the attention of the government

FCPA and Pharmaceutical Industry

- Accepted principles:
 - “Public officials” include employees of a government institution, such as doctors employed in government-run hospitals
 - Within the ambit of “obtaining or retaining business” are benefits intended to influence registration, reimbursement and pricing of products, and placement on hospital formularies

FCPA Enforcement in the M&A Context

- Expectation by SEC/DOJ that companies perform due diligence in M&A context with voluntary disclosure of issues
- Recent cases where FCPA violations have been discovered in the course of pre-acquisition due diligence
 - Collapse of Lockheed Martin's proposed \$1.6 billion acquisition of Titan
 - Deferred prosecution agreement entered into by Invision Technologies, Inc. prior to acquisition by GE

Potential FCPA Exposures in the M&A Context

- Acquisition involving government-owned or controlled entity or where government official has ownership interest
- Need for government authorization of private entity acquisition
- Inherit liability for past FCPA violations when acquire private entity (successor liability)

Successor Liability

- Successor liability generally attaches in stock transfer or merger
 - Transfer of equity typically transfers both the assets *and* the liabilities of the target entity after closing
- Successor liability may attach in an asset purchase
 - Involves a nuanced inquiry into the facts and circumstances regarding the specific acquisition
 - One of several broad exceptions to general rule of no successor liability in the context of an asset purchase is when *the purchasing entity is merely a continuation of the selling corporation*
 - Purchase agreements may specify which liabilities transfer with assets

Successor Liability

Two significant factors in determining successor liability:

- The extent of the due diligence conducted to identify and address potential issues; and
- The extent and effectiveness of safeguards adopted to prevent reimbursement by the acquiror of improper actions and to prevent them in the future

The Buyer's Perspective

- The Buyer wants to avoid:
 - Paying penalties and other fines
 - Other additional expenses, including costs of hiring and maintaining a compliance monitor
 - Debarment
 - Other civil actions, including shareholder actions and RICO violations
 - Negative publicity
 - Cancelled transaction
 - See e.g., Titan Corp., during pre-acquisition due diligence Lockheed discovered significant FCPA violations that not only resulted in the cancellation of the proposed transaction, but also stiff penalties imposed upon Titan

Buyer's Goals

- Avoid acquiring liability for past or ongoing FCPA violations (Successor Liability)
- Ensure that seller covers costs of violations
- Maintain maximum value of acquired entity
 - Key personnel
 - Key contracts and markets
 - Key relationships

Seller's Perspectives

- Increased enforcement actions also effect a Seller's actions
- Goal of Seller:
 - Ensure that disclosures regarding material contractual provisions such as representations are not misleading
- Result:
 - Internal assessments, also referred to as “health checks”
 - Health checks assess seller's FCPA compliance program and other internal controls
 - Also allow sellers to anticipate whether the sales price can be challenged due to unknown FCPA problems

Case Study

SYNCOR (2002)

- During the course of pre-acquisition due diligence, it was discovered that Syncor had made more than \$600,000 in corrupt payments to physicians employed by public hospitals to influence improper purchasing of radio-pharmaceuticals
 - Included improper commissions to doctors to influence purchasing decisions
- Resulted in hefty civil penalty, cease and desist order, the hiring of an independent consultant to audit and recommend corrective compliance programs for the Seller

What Protective Steps Are Necessary?

- Due diligence on target prior to signing the purchase agreement
- FCPA-related provisions included in the purchase agreement
- Further due diligence, and begin compliance training between the signing of purchase agreement and closing
- Extensive compliance training and other internal controls to identify potential compliance violations

Factors to Consider in Designing Pre-Merger Due Diligence Steps

- Little available authority on required due diligence steps – “an art, not a science”
- Educate diligence team on FCPA issues
- Factor in necessary time for FCPA review – process likely will require phases of review as review team receives information and encounters red flags
- Follow-up on identified red flags and risk areas
- Document due diligence steps

Pre-acquisition FCPA due diligence checklist

1. Assess corruption levels of the country in which the target entity does business
 - Transparency International Index

2. Investigate identity of the target entity
 - Internet / other background check on target
 - Search for government affiliations, political party affiliations and any other relationships with government officials or government affiliated agencies
 - Dun & Bradstreet reports, Commerce, State, Treasury restricted parties lists and US Embassy check

Pre-acquisition FCPA due diligence checklist

3. Review of the target entity's existing FCPA compliance program and controls
 - Clear policies and procedures
 - Senior management oversight
 - Third party agent due diligence and certifications
 - Regular training
 - Hotline reporting mechanisms
4. Test adequacy of the target entity's books and records / internal controls.
 - Financial controls
 - Red flag transactions

Pre-acquisition FCPA due diligence checklist

5. Evaluate target's risk profile

- Frequent interactions with government officials either as customers or regulators
- Reliance on third party agents and consultants
 - Demonstrated business need and correlating compensation
 - Due diligence files
 - Anti-bribery certifications
- Compliance with local laws and regulations

6. Identify any prior instances of FCPA issues or violations

- Government investigations, settlements, plea agreements
- Internal investigations
- Internal audit reports
- Annual report / SEC filing disclosures
- Hotline reports

Protection through the Purchase Agreement

- Representations and Warranties
 - Participation in transactions permitted by local law
 - No portion of the proceeds paid by the company will be used to fund payments in connection with securing government approvals, improper advantages, etc.
 - No corrupt payments were made to foreign officials in connection with entering into or securing necessary approvals
 - Absence of government officials as owners or in other relevant positions
 - Books and records are accurate and complete

Protection through the Purchase Agreement

- Termination
 - Right to terminate relationship if any representations are materially untrue or if other covenants breached
- Indemnification
 - Right of indemnifications for any damages caused by material breach

Post-Acquisition Compliance Steps

- **DOJ Opinion Procedure Release 03-01:** Purchaser learned in the course of pre-acquisition due diligence that target had made potentially improper payments to foreign officials, and promised to take the following corrective steps:
 - (1) continue to cooperate with the DOJ, SEC and foreign law enforcement agencies;
 - (2) ensure that the responsible employees or officers are disciplined;
 - (3) disclose any additional discovered pre-acquisition payments made by the company to the DOJ after the deal closes;
 - (4) implement its existing compliance program throughout the acquired company; and
 - (5) ensure that the acquired company implements a sufficient system of internal controls and maintains accurate books and records
- Based on the foregoing, DOJ allowed the transaction to proceed and stated any enforcement action against the Purchaser

FCPA Compliance Program Considerations

- How ethics codes and specific FCPA compliance policies are distributed to management, employees and agents
- Whether and how FCPA training is regularly conducted
- The monitoring of compliance through the use of internal audits, surprise forensic investigations, appointment of FCPA officers
- Whether and how FCPA due diligence procedures are performed on agents, consultants and other business partners, including how well written records are maintained

Other Business Combinations

- Asset Purchase
 - Generally, does not convey potential legal liabilities, however...
 - Form does not trump substance
 - Depends on knowledge and intent of the Buyer
 - Also may depend on terms of purchase agreement
 - Thorough due diligence still required
 - Must establish that any illicit conduct was in no way related to the assets being purchased

Other Business Combinations

- Joint Venture Company
 - Potentially still liable for actions of the JVC, including the JV partner
 - Must act in “good faith” to ensure that the JVC satisfies the FCPA’s accounting provisions
- Purchase of Minority Share
 - Degree of risk depends on level of ownership, voting power and other corporate governance

Voluntary Disclosures

- The FCPA does not mandate disclosure, but other statutes (e.g. other US securities laws or foreign laws) may so require
- DOJ and SEC both encourage voluntary disclosure
- Agencies have not quantified how much credit or leniency a company will receive for voluntary disclosure

Benefits of Disclosure

- Avoids risk of involuntary disclosure by third parties (e.g. foreign government investigations, whistleblowers)
- Mitigation of penalties
 - *BJ Services Company*: voluntary disclosure of improper payments discovered during a routine audit resulted in settlement involving a cease and desist order, but no fines; SEC noted the company's remedial actions and cooperation as reasons why fines were not imposed
- McNulty memorandum

Negatives of Disclosure

- Delay of transaction
- Risk of additional liability or proceedings
 - Possible expansion of investigation scope
- Waiver of rights and privileges
- Risk of collateral sanctions
- Speculative benefit
 - *Baker Hughes* and *ABB/Vetco Gray* – both companies engaged in “extraordinary cooperation,” but still levied records fines on top of the massive resources already spent on investigation

Hypothetical

- A U.S. pharmaceutical company (“Company A”) is interested in acquiring a small but innovative Chinese pharmaceutical company (“Company B”)
- There is anecdotal evidence, however, that Company B and/or its managers may have engaged in activities that might be in violation of the FCPA
- It is discovered during due diligence that Company B also uses a distributor that is known to engage in illicit conduct

Questions

- What steps should Company A take in response to the preliminary indication of a potential FCPA violation?
- If further investigation reveals a likely FCPA violation by Company B, what should Company A do?
- What contractual terms should Company A insist on?
- Should Company A notify the DOJ or SEC?
- What actions should Company A take after the transaction has closed?

Questions

- If Company A acquired a minority share in Company B, could it be subject to successor liability?
- Could company A avoid FCPA successor liability by structuring the transaction as a purchase of Company B's assets?
- If Company A set-up a joint venture with Company B, could it be subject to FCPA successor liability?

Further Questions?

Paul V. Gerlach

Sidley Austin LLP

1501 K St. NW

Washington, DC 20005

(202) 736-8582

pgerlach@sidley.com