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The Importance of FCPA Due Diligence in International Mergers, Acquisitions & Joint Ventures

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Joseph B. Tompkins, Jr.
Sidley Austin LLP
Washington, DC

Leslie A. Shubert
Sidley Austin LLP
Washington, DC

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
- Specifically in pharma context, the large number of mergers and acquisitions by “major players” of small start-ups bring FCPA issues to the attention of the government
- 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
  – SEC / DOJ settlements by Syncor, Inc. prior to acquisition by Cardinal Health
  – ABB, Ltd. and ABB Vetco settlement involving $10.5 million criminal fine and $5.9 million disgorgement.

Potential FCPA Exposure in 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
- FCPA due diligence considerations when entering joint venture partnership

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 <u>may</u> 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 upon acquisition to prevent reimbursement by the acquirer 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 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

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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 compliance program push-down immediately after closing

Factors to Consider in Designing Pre-Merger FCPA 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
   - Do not ignore small or remote operations
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

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DOJ Opinion Procedure Releases

- **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
- Purchaser promised to:
  - (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 stayed any enforcement action against the Purchaser

DOJ Opinion Procedure Releases

- **DOJ Opinion Procedure Release 08-02**: DOJ endorsed a pragmatic approach to a situation where legal and practical impediments prevented Halliburton from performing thorough, pre-acquisition due diligence.
- DOJ reinforced expectation that an acquiring company combine thorough pre-acquisition due diligence with rapid post-acquisition push-down of its compliance program into the acquired company.
- DOJ reemphasized its view that voluntary disclosure and prompt remedial efforts are critical when FCPA issues are uncovered.

Other Business Combinations

- Asset Purchase
  - Generally, does not convey potential legal liabilities
  - However, form does not trump substance
- 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