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Risky Business? When a New Acquisition Brings More than You Bargained For

By Susan Divers, November 9 2015

Mergers and acquisitions are a major source and opportunity for growth for many companies, but while the business teams are popping champagne corks to celebrate the deal, the ethics and compliance team may be reaching for the Ibuprofen.

As the Department of Justice and Securities & Exchange Commission's 2012 Guide to the Foreign Corrupt Practices Act states—

Companies acquire a host of liabilities when they merge with or acquire another company, including those arising out of contracts, torts, regulations, and statutes...including those arising under the FCPA.

The risk of acquiring a major “landmine” in the form of past or ongoing FCPA violations is real, particularly if the target company has not been subject to the FCPA beforehand. When an FCPA “landmine” explodes after the acquisition or merger closes, it can have a severe financial impact on the acquirer, even if the improper conduct has stopped.

Consider RAE Systems. Headquartered in San Jose, California, RAE makes chemical and radiation sensors and monitoring systems. According to the DOJ, the company did business in China from 2005 to 2008 through two subsidiaries, RAE-KLH and RAE-Fushun. Customers included Chinese government departments, state-owned businesses, regional fire departments and other semi-governmental bodies. RAE did due diligence before acquiring a majority stake in the joint venture that became RAE-KLH and became aware of improper commissions and kickbacks, yet the internal controls the company implemented only went “halfway,” and the problem payments continued. Similar corruption indicators cropped up when RAE took control of the joint venture that became RAE Fushun but this time, RAE did no due diligence on pre-acquisition corruption. RAE then failed to put effective controls in place, according to the DOJ, or account for improper payments in its books and records, according to the SEC.

The company ultimately paid a \$1.7 million fine and disgorged \$1 million in profits from the illegal activity predating the acquisition. The SEC routinely requires such disgorgement as part of a settlement, even if the illegal activity has stopped after the acquisition closes. That can blow apart the financial underpinnings for the transaction.

What are some practical steps to take to avoid M & A landmines, whether they are FCPA violations or other problems?

Here are some best practices:

1. A thorough due diligence from a reputable provider before the M & A effort gets underway can save money, time and regret later on. If the target has a reputation for unethical practices or is on the regulators' radar, the acquirer should assess the risks, the effort and the cost of dealing with potential problems and/or remediating them before going ahead.
2. Ethics & Compliance needs to be a full partner on the due diligence team for an acquisition, merger or joint venture formation, not merely a recipient of limited data.
3. Make sure E & C attends due diligence discussions with the marketing teams, not just the legal or corporate staff. Marketing discussions give good insights into how a target gets business and keeps it and the extent it deals with government officials.
4. Internal audit should participate and review the target's internal controls. A target with lax petty cash controls, weak reconciliation practices and opaque accounts is a target that will need substantial overhaul and controls when a deal closes. Providing Internal Audit with a chance to familiarize themselves with the company gives them a leg up on what needs to be done.

Okay, we own it, now what?

Once an acquisition closes, the work of the E & C team becomes even more critical. Integrating a company that was never subject to public disclosures, securities laws and internal controls takes work and planning. Helping new colleagues understand Sarbanes Oxley, conflicts of interest, FCPA, sanctions and the host of new laws and regulations is the first step.

LRN recommends Code of Conduct training as soon as practical after an acquisition closes, to welcome new colleagues into the culture and set expectations. Proactive, 100% participation Code training on the heels of closing sends a strong signal about values and helps prevent resistance to new practices from building up. LRN's team can help update a Code to make sure it communicates broadly and effectively the partner's values and is translated into necessary languages.

Integrating an acquisition successfully is a long term project.

Here are some other best practices:

1. Setting out a project plan with key objectives for integration and responsibility and a timetable for meeting them promotes accountability and prevents risk areas from falling off the radar.
2. Analyzing the risk profile of the acquired company and tailoring a suite of training materials to rapidly bring them up to speed on key areas is also prudent. For example, strong internal controls are a key element of SOX and FCPA compliance as well as good business practice. LRN's library includes resources on FCPA, conflicts of interest and financial integrity, including the Speaking Up and Financial Reporting Vignette. Combined with in person training, this helps establish relationships and clarify expectations at the outset.
3. Working in partnership with Internal Audit, the E & C team should identify the key areas for strengthening or remediation of the acquired company's compliance. Scheduling an audit for six months after closing, in which the E & C team participates, helps set a timeframe for implementing changes and an incentive to get them done.
4. Developing a regular communication plan that involves senior managers, middle managers and regular events focused on values and speaking up is an essential element for success. LRN Advisory Services can help structure one that works and promotes cultural integration.
5. Coaching the acquired company's management on values-based leadership will help ensure that ethics and compliance is internalized into behavior, not merely a set of rules. LRN's GCLA team is highly experienced in this area.