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The International Comparative Legal Guide to:

Private Equity 2016

2nd Edition

A practical cross-border insight into private equity

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EDITORIAL

Welcome to the second edition of *The International Comparative Legal Guide to: Private Equity*.

This guide provides the international practitioner and in-house counsel with a comprehensive worldwide legal analysis of the laws and regulations of private equity.

It is divided into two main sections:

Four general chapters. These are designed to provide readers with a comprehensive overview of key private equity issues, particularly from the perspective of a multi-jurisdictional transaction.

Country question and answer chapters. These provide a broad overview of common issues in private equity laws and regulations in 25 jurisdictions.

All chapters are written by leading private equity lawyers and industry specialists and we are extremely grateful for their excellent contributions.

Special thanks are reserved for the contributing editors, Dr. Lutz Zimmer and Simon Rootsey of Skadden, Arps, Slate, Meagher & Flom LLP, for their invaluable assistance.

Global Legal Group hopes that you find this guide practical and interesting.

The *International Comparative Legal Guide* series is also available online at www.iclg.co.uk.

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Know Your Target – Compliance Due Diligence in M&A Transactions

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In the last 10 to 15 years, compliance issues have become increasingly prominent in the business and legal communities. Historically, attention was focused primarily on investigations initiated by public authorities (namely, the US Securities and Exchange Commission (SEC) and the Department of Justice (DOJ)), but it has since become clear that there are many other important considerations to be aware of. Legislators in various countries, in addition to regulatory authorities, have now become increasingly aware of compliance-related issues. Consequently, many new laws and regulations have been promulgated and existing ones amended or interpreted more strictly.

Against this backdrop, paying attention only to the initiation and conduct of investigations and eventual remediation has been shown to not be sufficient. As a means of prevention, companies have to put appropriate control and risk management systems in place. Management of companies must be aware that non-compliance may result in personal liability which actually will be enforced.

It does not come as a surprise that compliance issues may become relevant in connection with the acquisition of companies as well:

- A buyer has to consider whether the control and risk management systems within the target company are appropriate and meet its own standards. This is to ensure that business operations can be continued seamlessly after the acquisition without substantial integration efforts and disruptions. This will have a direct bearing on the business plan and thus the valuation of the target.
- If violations have occurred in the past and are not discovered until after the acquisition, the valuation of the target may prove to be inaccurate and the acquirer may suffer material damage, in particular if authorities initiate investigations and remedial action is required. It may also result in the loss of business if business partners decide to discontinue or reduce their dealings with the target as a result of past violations.
- Public authorities such as the SEC and the DOJ expect that acquirers investigate compliance issues prior to an acquisition and, if appropriate, plan any necessary investigation and/or remediation. Otherwise, the acquirer may face the initiation of proceedings should violations of law or regulations be unveiled that have previously occurred in the target company.
- A seller has to consider to what extent it exposes itself and the target company to the risk that so far unknown compliance risks are revealed and negatively affect the transaction process, but also to what extent it should provide the opportunity to conduct a compliance review to avoid any allegations of fraudulent or similar conduct.

It is against this backdrop that a new "field of due diligence" has evolved in the last decade, i.e., the field of compliance due diligence.

What is Compliance Due Diligence?

The term "compliance due diligence" encompasses a wide variety of areas. Anti-corruption issues have always been, and continue to be, an important element of any compliance due diligence. Other relevant "compliance" risks include areas such as tax and environment, which are traditionally covered by specific due diligence work streams anyway. However, there are other areas that have not been in focus until now, even though they may have a material impact on the success of an acquisition. The most prominent areas are anti-trust and competition laws, data protection, sanctions as well as money laundering.

As regards anti-trust and competition laws, the relevance of a review becomes obvious when taking a look at the activity of anti-trust authorities in the recent past. Anti-trust authorities have not only become highly sensitive to these issues and more vigorous in pursuing non-compliance; they have also expanded the range of companies that they pursue by raising allegations against both the companies that themselves violate applicable rules and their controlling companies. In this context, "control" may not necessarily require that the controlling company owns a majority shareholding; it is decisive whether controlling influence is exercised from a commercial perspective. Anti-trust authorities do not always accept arguments that may be viable in other fields of law, e.g., that, from a tax perspective, control may not be given and be intended by the shareholder to be established or exercised. Instead, anti-trust authorities tend to apply distinct standards that rely on different arguments, for instance, that the management of portfolio companies is economically controlled in that it is subject to leaver provisions under its participation programme or that nomination rights for board members exist. This approach has namely been adopted by the EU Commission and Dutch anti-trust authorities. Economic consequences may be substantial for both the acquired company as well as the acquirer.

As regards data protection and data privacy, the public, in particular, has become more and more sensitive to these issues. Therefore, the economic consequences of violations may be less relevant than the reputational damage caused by media coverage and public reaction. This can also affect day-to-day business operations because of employees' reactions and a change in the general atmosphere within a company.

Further areas typically covered by a compliance due diligence review may include money laundering and compliance with applicable sanctions regulations. These two areas have gained substantial relevance in the last couple of years, particularly with regard to transactions involving countries in the Middle East, Russia and Iran.

Why Should a Compliance Due Diligence be Carried Out?

As already described, a compliance due diligence review shall prevent "surprises" after the acquisition has been consummated. Unwanted "surprises" can affect integration, synergies and, of course, the valuation of the acquired company. In addition, an investor has to be aware of management liability issues.

The management of strategic investors will have to consider the scope of the duties owed to the acquiring company. Principally, the decision on whether to consummate an acquisition will be subject to the so-called business judgment rule. Management has to take a decision in consideration of an appropriate, comprehensive basis of facts. Compliance issues are a part of this factual basis. If management does not comply with this requirement it may become liable for breach of its duties.

Looking at private equity investors, in the first instance this obligation applies to the management of portfolio companies. Depending on the organisational form of the portfolio company management, liability may be waived by the shareholders or management may be offered a respective indemnification from relating liabilities. For example, from a legal perspective in Germany, such a waiver may principally be granted in a limited liability company (*GmbH*).

Yet, it should not be overlooked that the management of private equity funds themselves are under certain obligations to the management company and the fund investors. Such obligations, as well as the standard of care owed, will normally be set out in the specific fund agreements. The standard of care may differ from the one applicable to management of strategic investors. The management of strategic investors will normally be liable for ordinary negligence and this standard may not even be amended by mutual agreement. Again, as an example, the German legal regime in a German stock corporation (*Aktiengesellschaft*) stipulates a mandatory standard of care pursuant to which managing directors (*Vorstand*) are liable for mere negligence.

How courts will interpret relevant fund documents and determine whether a breach of duty is given will always depend on the specific circumstances. It should be taken into account that courts may have a close look at the standard of care applied by other market participants in comparable situations, including other private equity players but, potentially, strategic investors as well as these also carry out M&A transactions. It appears to be a fair conclusion that if most strategic investors conduct a compliance due diligence as an integral part of their overall due diligence, this may also affect the scope of duties of private equity managers, particularly in cases when they compete in the same auction processes. Refraining from conducting compliance due diligence at all or limiting the relevant review to a minimum may then be regarded as a breach of duty, even more so if a compliance due diligence review has become well-established and is considered best/industry practice among strategic investors. This will essentially depend on the standard of care required under the fund documentation which is often found to be set as "gross negligence".

During the last decade, more and more strategic investors have started to conduct compliance due diligence in essentially every acquisition. The more established this practice gets, the more likely it will become that abstaining from compliance due diligence absent good reason will give rise to allegations of breach of duty. Therefore, private equity investors may increasingly consider following the example of strategic investors. As a matter of fact, it appears that more and more private equity players have commenced implementing compliance due diligence as a standard work stream.

How is Compliance Due Diligence Conducted?

In contrast to other due diligence work streams, compliance due diligence may cover a wide variety of business areas. It regularly includes legal, financial, accounting and tax aspects. For this reason, it is necessary that the acquirer and its advisors define the scope and goal of an upcoming compliance due diligence. Such definition will be based on the scrutiny of the business model and operations of the target company, thereby taking into account specific business areas presumed to be adamant to particular risk, the history of the company's business operations, the general industry environment and the conduct of competitors, the countries where the company conducts business and their risk rating, etc.

Depending on the situation, the process might not be explicitly referred to as "compliance due diligence" *vis-à-vis* the seller, particularly if there is reason to believe that the seller may be reluctant to respond to a request for the performance of a compliance due diligence. As stated above, this may be due to the wish for a lean process, but also to avoid any disturbance of the sale process.

Against this backdrop, it should not be overlooked that a compliance due diligence review will usually have to include specific, compliance-related information which will not be among the information contained in the data room destined for the legal and financial due diligence. This may be information on compliance policies, organisation or training, the use of whistle-blower hotlines and information generated or specific accounting information.

The particular steps, their sequence and the depth of the due diligence review will, among others, depend on the acquisition process contemplated by the seller. In particular, a seller will evaluate when to disclose very sensitive data to which party. The greater the sensitivity, the later the seller will disclose this data and the smaller the group of recipients will be. A seller may decide to only provide access when one party has been chosen as buyer or even after a contract has been signed which will, of course, result in a need for appropriate protection of the purchaser through, e.g., closing conditions or indemnifications.

Thus the review will largely be determined by the timeline, but also the existence of competing bidders, as well as already existing knowledge at the outset or findings made in the course of the review. These factors will have a bearing on whether and when certain tools that have become well-established in the context of, e.g., investigations will be utilised. This tool set includes the analysis of relevant agreements, policies, financial and accounting records, the review of publicly available information and interviews with management and employees. Especially when an acquisition shall be executed in a very short time frame and in a competitive environment, a purchaser may have to execute all these steps more or less simultaneously or even skip certain steps. This may result in inefficiencies and negatively affect the reliability of results.

Given that publicly available information can be analysed independently from the seller's assistance, this should usually be an integral part of a compliance due diligence from the beginning. Of course, this is also one of the least targeted techniques that may be applied.

Similarly, the review of relevant legal and financial, as well as accounting, information that is already contained in the data room may commence from the beginning. Yet, such information will usually not pertain to the specific compliance issues referred to above; therefore, further requests may be necessary.

One would normally expect that, beyond documentary due diligence, the acquirer is given the opportunity to conduct interviews with management and/or employees. Absent specific findings or knowledge, such interviews will have a fairly general scope. They should help acquire a principle understanding of the risk environment and the content and interpretation of existing compliance policies, their implementation, the general view on compliance within the company ("tone from the top") as well as pertinent past practice. Depending on the specific acquisition process, particularly in competitive and time-sensitive scenarios or where efforts shall be limited (for the time being), interviews with key individuals at the target may constitute a core element of the review process. To prepare these interviews, questionnaires need to be developed that are based on a comprehensive understanding of the target's business. It should not be overlooked that the knowledge acquired will normally be general only and quite limited so that further review may be advisable.

Should the due diligence have resulted in particular findings, interviews will also cover these in order to obtain a proper understanding and supplement the information received so far. Needless to say, the seller may be induced to review the process and evaluate information himself when being confronted with specific findings. In addition, it should not be forgotten that business continues throughout the due diligence process and new issues may arise.

What are the Results?

As with other due diligence work streams, the results of the compliance review are summarised in a report. Given the nature of the topic, the content will differ substantially from, e.g., a legal report.

On the one hand, the compliance due diligence report will summarise the content of documents regarding compliance policies, organisation, trainings as well as whistle-blower hotlines, and certain financials or specific legal provisions in documents that are considered potentially critical. It will thus resemble the common content of financial and legal due diligence reports. In contrast, the information emanating from the due diligence may relate to a wider range of relevant business areas and fields of law.

On the other hand, the documentation and information received will regularly not be conclusive or comprehensive in light of the goal. For instance, as regards anti-corruption financial statements, these will – due to the very nature of the matter – not be comprehensive or relevant agreements will not immediately reveal that certain payments were inappropriate. Interviews will not change this because interview partners should not be expected to expressly state that corrupt payments, etc. were made. As regards compliance with policies, training schedules, etc., the report must rely on either the assumption that – as in case of, e.g., agreements, permits, articles – stipulated standards are abided by (even though such assumption may often prove inaccurate) or the report may allude to interviews with relevant employees, namely members of the compliance or internal audit department.

It is for these reasons that the information compiled will often only be able to point to critical areas where risks may exist or further review or remedial action may be necessary but might not be sufficient to establish whether applicable laws or regulations were violated or not.

Conclusions Drawn From the Results

Conclusions drawn will relate to the analysis of the particular risks or violations of law identified, whether the transaction involves risks inherent to the acquired business, existing control systems and their integration into the acquirer's systems or their enhancement, the need for remedial action and further work recommended in the event that the acquisition is consummated. They will form a basis for the management's decision regarding the execution of the transaction and the valuation of the target company.

The results of the compliance due diligence may also have an impact on the negotiation of transaction documents. Depending on their specificity, the acquirer may ask for the inclusion of particular respective warranties or – if specific instances of violations are known – of indemnities. It should be noted that as regards protection through warranties, a qualification by knowledge may not reach the envisaged goal: compliance breaches will often not come to the attention of management and the qualification may substantially decrease the level of protection. The seller, on the other hand, may consider the impact of the purchaser's arguments on his own expectations, as well as the impact on the option to discontinue the sale process and continue to hold the business that is up for sale. Similarly, the seller will find himself in such a situation if in the course of the process, possibly even between signing and closing, independent from the due diligence by interested parties, he is confronted with allegations of compliance breaches.

If the acquirer has not been allowed to conduct a comprehensive compliance due diligence, he may try to negotiate a pertinent closing condition. Essentially, this would entitle him to conduct a further review between signing and closing, and he would only be obliged to close the transaction if the review and result were satisfactory to him. Yet, it is obvious that a seller will usually resist such a request, particularly in the context of an auction process when other interested parties do not have the same need. But even absent a competitive situation, a seller may not be willing to agree to a pertinent closing condition given its impact on transaction security.

The findings and analysis will finally be a basis for reporting to competent authorities. As mentioned above, particularly US authorities, e.g., the SEC, may wish to be provided such information. Also, they may serve as, basis to justify the sufficiency of any compliance-related action taken after the acquisition in the event that an authority requests certain action to be taken already prior to the acquisition or that, after the acquisition, compliance violations in the past are discovered.

Summary

Compliance due diligence is a fairly complex work stream in the overall due diligence carried out in M&A processes. However, it has become well-established; financial advisors in particular do not always consider it essential for various reasons, even though it may have a material impact on the execution of transactions, their structure as well as transaction terms and may prevent unwanted "surprises" after a transaction has been consummated. Scope and execution should be thoroughly planned by both sellers and purchasers as key factors.

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We represent private equity firms in connection with all aspects of their businesses, including structuring and organising fund sponsors and their investment funds; executing acquisitions, financings and exit transactions; and providing corporate, securities, financing and litigation advice to portfolio companies.

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