# Companies acquisition and export control: the importance of due diligence and ICP

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In this paper, three subjects will be analysed:

1- Why conducting due diligence;
2- Which aspects are verified by an effective due diligence;
3- What are the advantages and the burdens of performing an effective due diligence

## Due diligence as an integral part of the business development: Know who you are dealing with.

Successful business decisions related to mergers and acquisitions, joint venture, investment, divestments etc. require a substantial amount of due diligence where buyer, or the company performing the due diligence before the Joint Venture – hereinafter referred to as "Company A" – needs to understand the obligations and risks that will be assumed before committing to the transaction. In case of the due diligence process does not give the a fully compliant picture or, even worse, noncompliant scenarios have been discovered the structure of the transaction can be altered, the contract(s) between the parties might be rewritten and consequentially the purchase price adjusted in favour of the acquiring company ("Company A"). In some cases, the full cost of violations, remedial measures and integration could adversely affect the business case and allow some room for negotiations for heightened risks may lead to additional measures implementation.

The failure in ensuring compliance within the future acquired company - hereinafter referred to as "Company B" - may result in severe consequences[1] for the "Company A" which is unwittingly assuming on-going violative practices, for which it will be held independently liable, or even assuming liability for export violations committed long before the acquisition.

When the acquiring company has decided to growth, the selling company's export control exposure is one of the areas that is frequently overlooked especially during pre-acquisition[2] in order to verify whether the target entity has complied with those laws in the past and is potentially familiar with EC and ABC processes, procedure. Minimum number of trained export control resources are required to integrate export control. These professional resources, along with secure information systems are the key to keep the compliant process always aligned with those needs over time.

From day one, after the official acquisition where "company A" now stands in the shoes of the acquired company in terms of compliance responsibility, key role is played by policies and supporting procedures, either in full (amended where appropriate to make them joint venture policies) or the

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[1] While monetary penalties can be steep, there can be even more damaging consequences such as suspension of export privileges, reputational damage, debarment from government contracts, and the imposition of costly auditing and monitoring programs.

[2] Compliance professional play a fundamental role is to help minimize that buyer's remorse by taking reasonable steps to ensure that your company does not "buy" into somebody else's mistakes

acquired company, “Company B”, may use entirely different policies that meet these minimum standards (joint venture partners often have their own equivalent policies). It is important that the existing policy meets the same minimum standards as the mother company’s policies. When the acquired company – in case of acquisition – or the partner company – in case of joint venture – is in a foreign country with a different official language, policies and procedures have to be translated into additional languages to ensure understanding by the relevant employees. The latter have to get the clear message that breaches of company policies may result in disciplinary action up to and including dismissal.

Likewise, in establishing and maintaining an internal compliance program, in performing a due diligence, the “company A” has to understand the “company B” nature of the product, end-use, end-user and destination.

## The Export Control checks over an effective due diligence approach.

In preparation for an acquisition or a Joint Ventures, the “Company A” customarily conducts a review of the target company to assess any risks or liabilities which may be associated therewith. If the target company engages in any international operations, such review should include a thorough due diligence investigation for potential liabilities under the export control laws. An exhaustive due diligence list can contain hundreds and hundreds of items but in this section, the focus will be mainly on the export control checks.

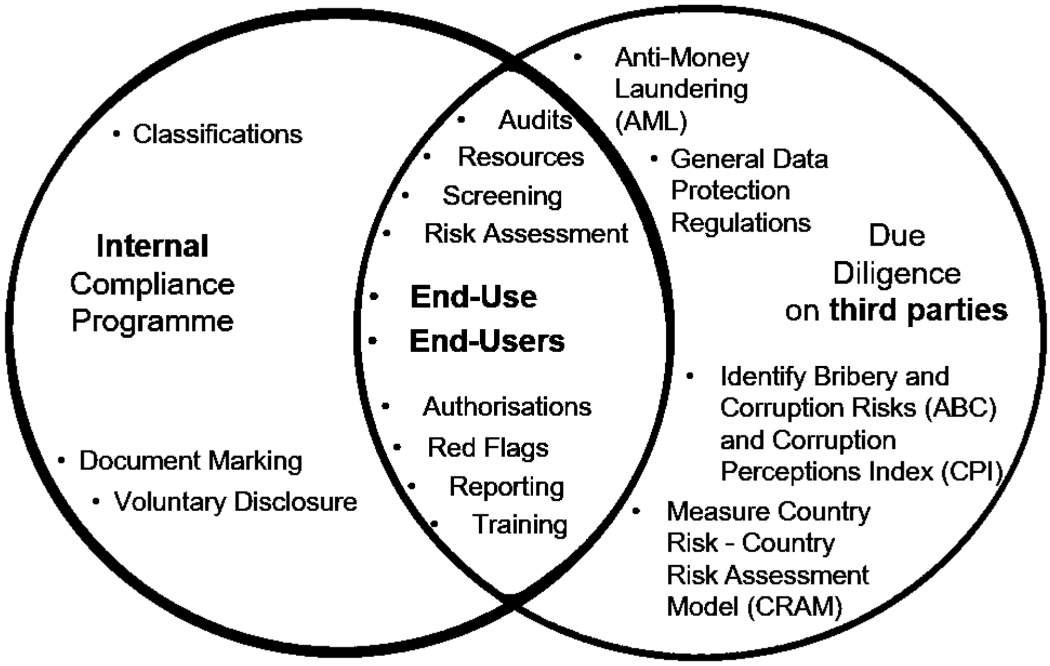
At the end of the due diligence, at the very least, the buyer should know the answers to the following questions before making the deal :

- Does the future acquired company manufacture products listed Military and/or Dual Use List? If so, which jurisdiction(s) applies?
- Does the future acquired company have foreign customers? If so, where?
- Does the future acquired company deal with US-origin content? If so, De-Minimis rule applies? Does the future acquired employment of foreign nationals require an export license?
- Does the future acquired company make informational exports via training or seminars abroad?
- What sort of export controls, if any, does the future acquired company have in place? Screening measures?
- Does the future acquired “Company B” have any policies dedicated to EC and ABC business compliant conduct? If so, which aspect of an Internal Compliance Programme (ICP) and of the Know Your Customer (KYC) procedure are encountered?

As it easy to visualise from the picture below, as quite often departments such as anti-bribery and corruption and export controls collaborate and sometimes may overlap in performing their checks to ensure compliance.

See below :

**A reliable Internal Compliance Programme combined to an effective Due Diligence for a responsible business**




From an ABC perspective Identify Bribery, Corruption Risks and Measure Country Risks are the first steps.

Lack of transparency being a huge problem for businesses, because bribery and corruption undermine predictability and, therefore, successful business relationships are based on predictability of outcomes, the ABC department's main tool is the Transparency International (TI). It regularly publishes data about corruption specifically the Corruption Perceptions Index (CPI) which is one of the most important of its publications; and the Country Risk Assessment Model (CRAM) performed by the Organization for Economic Co-operation and Development

(OECD) which shows the level of the country risk. A high-risk Country according to CRAM means a risky business as well.

In this section, we are going to analyse the due diligence process only from an export control verification standpoint. These focal aspects which must be always verified:

**Licenses and Authorisations** - List of government authorisations and registrations that should be provided by country; this includes the analysis of issuing authorities and, for each license or authorisation held, the nature of the permission (e.g. individual license, general license, technical assistance agreement)

Particularly for US authorisations is important to include:

- Export licenses;
- Re-Export licences;
- Exceptions (EAR);
- Exemptions (ITAR).

Any circumstance whether there are likely to be any potentially significant export licensing challenges need to be known and investigated.

**Export Controlled Goods and Technology** – knowing which of the traded or manufactured product (including software) is subject to export control by virtue of being included in a national, or common in case of EU, control list of military or dual-use, is the first step.

Secondly, it is important to know all export control classification as well of all parts and components that form part of the products manufactured.

Related to this point, it is worth also mentioning the importance of knowing whether any of the technology used or developed for products and software is subject to export control and how this transfer of technology is recorded, stored and ease of access (e.g. in a central database, on locally maintained spreadsheets).
Knowing who is involved in determining and signing off on the export control classification of items and how often product classifications and those of their parts and components are updated and what triggers this process are equally to this point.

**Screening of denied Parties** - Denied party screening is undertaken prior to doing business with a new customer, vendor, end-user, contractor, visitor or business contact and on the updated addresses of any party.
A description of the screening process should be provided highlighting whether it is a one-time activity or undertaken on a regular basis. If undertaken on a regular basis the explanation should include details of when the screening activity is repeated. The description should also include where the results of screening are kept.
If we take as an example scenario the joint ventures, these are heavily reliant on third parties to support businesses, particularly third parties that companies would consider higher risk (for example, commercial agents, consultants, distributors or other intermediaries). If compliance concerns are integrated into the principal/intermediary relationship, the intermediary may serve as the “first line of

defense"[3] for the principal in assuring compliance with international trade regulation.

**Sanctions and Embargoed Countries** – In this section, the investor, or "Company A", prior to conclude the transaction should inquire whether the "Company B" has contracts, company's sites or other relationships with end-users in destinations subject to sanctions imposed by the UN, EU, OSCE and US (notably countries include Iran, Cuba, North Korea, Sudan and Syria.) Where the answer is affirmative a description of the activity that has occurred over the last few years, normally from 3 to 5 years, should be provided.
Details should also be provided if there have been any business or other dealings with entities, or individuals and entities owned or controlled by those individuals, that appear on the US List of Specifically Designated Nationals, the EU or any national financial sanctions lists or other international or national lists of designated parties.

**IT: Servers and Resources** – Quite sensitive is the discussion around the location (country) of the servers used to store or share export-controlled technology/technical data. In more specific details, the investor must be aware of whether the network and systems support for these servers and users are provided domestically or from another country. In the latter case, whether the support it is provided from another country, the location(s) should be absolutely provided, and licences or authorisation confirmation facilitate this support should be given. This

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[3] https://www.thompsoncoburn.com/insights/publications/item/2012-03-08/export-controls-and-forwarder-due-diligence.

scenario becomes even more restricted and sensitive when US origin technology/technical data is stored or accessed via servers outside the US. This export should not only be covered by an appropriate US authorisation in place, still, US requirements to give access to technology by foreign national employees and contractors should be explained. This needs to include foreign nationals employed by network and systems support services.
Company policy and procedures on employees taking electronic devices containing export-controlled technology abroad, or accessing such material while abroad, need to be issued within the IT context. Not accordingly verified data storage, IT network and IT system support may lead to unintended export control violations

Non-Compliance – It extremely important for "Company A" be aware of declared or yet to be declared non-compliances. If any of them, the following details should be provided as soon as possible:

- details of any export control related non-compliance findings from any government regulator over the last few years;
- details of any pending non-compliance/voluntary disclosure issues from any government regulator;
- government regulator details for any non-compliance/voluntary disclosure issues that have yet to be raised;
- details of any supplier non-compliance issues should also be included.

On the “non-compliance aspect” if procedures are in place to ensure compliance by sub-tier suppliers, these should be explained as well.
A mechanism for employees and business partners to raise concerns confidentially and anonymously should be made available and equally communicated to employees who have to be informed that they always have the option to report any concerns. This is known as “whistleblowing system”. If, at any time during the course of action, the due diligence officer who is conducting the due diligence spots that a joint venture partner or the acquiring company’s business constitutes a breach of the “Company A’s” Code of Conduct or export control procedures, then he/she should highlight and address these concerns. In extreme circumstances, it may be necessary to consider withdrawing from the joint venture or from the acquisition entirely. Code of Conduct must contain clear statement that bribery, corruption and breach of international regulations will not be tolerated.

**Policies and Training** - An explanation of the general approach to organising export control compliance framework should be provided. This should include a copy of any relevant policy statements, procedures or work instructions. The document should cover governance and accountabilities and the breadth and depth of resources devoted to the activity. An overview of the effort devoted to export control training should be provided including the topics covered by the training material. This should explain who is mandated to receive, whether possible, tailored training, whether it is a one-off or taken on a regular basis and whether attendance at or completion of training is

recorded. General training on ABC and Export Control issues should be provided to joint venture employees – the format may vary depending on the size and nature of the joint venture. The individuals working then for this new entity, in case of Joint Venture, may be full time employees of one of the joint venture partners and it may be enough to simply rely on ABC training they have received from their employer instead.
High consideration should be given to mandating more specific training to employees in higher risk areas (e.g. sales, procurement, finance and management) or more specific training on the policies listed above.
In addition, employees who are directors of, or otherwise working at, joint ventures should ensure they have been through the appropriate training for their positions and role within the company

**Internal Audits report** against export control procedures and compliance will give a detailed info on the joint venture partner or acquired "company B" with the terms and conditions of licences or authorisations held are conducted. The reports provided need to contain a brief description of the process supplied including the number of audits carried out (and by whom) over the last few years, normally from 3 to 5 years. The results of the audits, the corrective and preventive actions and lessons learnt (whether applicable) should also be provided.

**Compliance Resources** – An internal employee within the acquired company should be assigned overall responsibility and accountability for ensuring that acquiring company's programme on ABC and EC are implemented. This person has to become the first point of contact for any related queries. The individual may be a full-time ABC or Export Control resource or may have these duties in addition to their full-time role. Whether it is necessary to have a full-time resource will largely depend on the size of the joint venture or acquisition and whether there are any specific ABC and EC risks identified within the joint venture/acquisition. Compliance resources are keys. Once the joint venture/acquisition has established its (new or rolled out) ABC and Export Control programme, it is important having trained resources to keep monitoring and regularly review, supported by the "Company A", the ABC and Export Control controls which have been put in place. Adequate internal resources are critical to ensure that businesses do not engage in transactions that would harm wider company interests, damage reputation or lead to penalties for violation

## Due Diligence: Big advantages along with burdens

The process of risk assessment starts with the determination of the risk context.

The Due Diligence is an exhaustive investigation of all available information, either internally and externally, on Legal, Operational and Finance aspects pertaining to the business. Existing or potential risks are in order or can be identified and addressed well before the final date of closing.

While it is not possible to eliminate that risks, it is definitely possible to mitigate them. Specific steps can be taken to identify existing and potential risks, analyze and evaluate them, and take the proper precautions.

Processes and procedures are keys in the due diligence approach work. Once the risk context is known, it needs to be addressed. Risk assessment typically starts with the identification of risk, an analysis of that risk, and the evaluation of that risk. The last step in the chain is the treatment of risk

Following on this, make the list of beneficial aspect of conducting a due diligence, obvious:

- Business protection from encountering unnecessary risks (e.g., no financial or legal difficulties);
- Business knows their customer better, making for a stronger and more transparent working relationship;
- Dispel initial reservations and enter into new business relationships with full confidence;
- Avoiding penalties and fines by showing sufficient evidence a due Diligence process has been conducted conscientiously.

Despite these added valuable aspects to a successful transaction, the due diligence can result quite lengthy and difficult especially when checks are not limited just to the entity itself but will also include known associates, subsidiaries and other related entities. Based on the size of the “Company A” and/or the amount of the transaction, the due diligence process can take from a couple of weeks up to several months or longer to go with accuracy through the whole investigation process. Sometimes the process can be even longer when the selling company or the Joint Venture counterpart does not assist because of lack of understanding of the requirements, lack of trained resources or not willing to disclose internal risk. The latter has to be identified as red flag treated.

The deal cost can go right up due to actions which are needed to remedy risks. The resources required can be significant.

Not less important is the amount, the specific skills and the cost of human resources and systems to be devoted to compliance. Frequently, due diligence tasks are on top of the daily task for the employees.

The due diligence process, depending the size of the business and the transaction can imply multiple team composed by internal and sometimes external resources as well which mean more cost for the acquiring “Company A’s” well.

Burocracy and amount of document and signatures which go with it are quite burdensome. As already stated, an exhaustive due diligence check list counts hundred and hundreds of items on legal, operation and finance aspects to go through, assess, verify and eventually address.

## Conclusions

Notably, the discovery that export compliance "mistakes were made" in the past need not be a deal-killer[4] but need to be known and have evidence that actions have been taken to take care of them. When a company take full or partial ownership and control of another entity, it inherits the full consequences of non-compliances and violations. Carefully negotiated disclosures made to the relevant export licensing agencies can limit collateral consequences and determine penalties.

For healthy companies managing risks effectively is critical to ongoing success. Risks are taken, according to each company risk appetize, where they can create value but especially when those risks can be compliantly managed to deliver companies' commitments, protect their reputation and improve their cash and reputation.

A robust risk management system, which includes an enhanced due diligence approach, will ensure a successful resilient and sustainable business.

Under the principle of Successor Liability, this risk-based approach aims to handle carefully potential issue to avoid that the acquiring company finds itself unwittingly inherit a potential target's trade compliance violations and liabilities. This process gives to the buyer the opportunity to identify legal violations and at the end of the review and to choose how to deal them. Here, a non-exhaustive list of few options available, depending

[4] See https://www.stimmel-law.com/en/articles/export-control-restrictions-and-due-diligence-part-any-shore-pre-transaction-analysis.

upon the severity of the problem(s) detected. The most common reactions are :

- adjustment of the purchase price;
- restructuring the transaction (often from a stock purchase to an asset purchase) to attempt to protect from successor liability;
- postponement of the transaction until the legal violation is resolved; and
- the termination of the transaction

Even if the cost of fines can be covered, the reputational and wider impact cannot.

Companies have to manage risks, if they do not, risks will manage their businesses.

To conclude here the golden rule of managing risk “It is about information and understanding. You cannot manage the risk of that which you do not know. You cannot manage the risk of that which you do not understand”

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