Due Diligence: Implications of Dodd-Frank’s Whistleblower Provisions for Acquirors

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Potential acquirors should redouble their efforts to determine whether acquisition targets have violated securities laws and instituted compliance programs that deter and detect such violations. The enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act and the related SEC rules (the “Rules”) is likely to result in a dramatic increase in investigations by the SEC into possible securities law violations by U.S. companies. This could make acquisitions more costly for acquirers which do not detect targets’ securities law violations or which, having detected such violations, fail to make appropriate adjustments to representations, indemnities or the purchase price.

Dodd-Frank contains whistleblower provisions that provide for the payment of substantial financial awards to whistleblowers who voluntarily provide the SEC with information about violations of federal securities laws where resulting judicial or administrative actions result in monetary awards or settlements of $1 million or more. Under Dodd-Frank, whistleblowers are eligible to receive awards or bounties equal to 10% to 30% of such awards or settlements. Whistleblowers can be employees, customers, suppliers, consultants or others, including, in certain circumstances, in-house counsel and others responsible for legal compliance.

Dodd-Frank’s bounty provisions provide whistleblowers with considerable financial incentive to report possible securities law violations to the SEC, particularly violations of the Foreign Corrupt Practices Act, a securities law the violation of which has resulted in very large penalties and settlements in recent years. The FCPA prohibits corrupt payments to foreign officials and employees anywhere in the world and requires SEC reporting companies to maintain accounting records and internal controls pursuant to standards set forth in that statute. Recently, the SEC and the Department of Justice (the “DOJ”), the agencies that enforce the FCPA, have increased their FCPA enforcement actions, and in 2010, those agencies recovered $1.8 billion of penalties under that statute. A number of those actions involved settlements in the hundreds of millions of dollars.

This is the time for acquirers to adjust their acquisition due diligence strategies to increase the likelihood of identifying any securities law violations by targets, better understand targets’ compliance culture and, where possible, quantify related risks. This article outlines how acquirers can assess the risk that acquisition targets are violating securities laws, and structure and conduct due diligence to increase the likelihood of exposing such violations. It also identifies some practical considerations that may inhibit effective due diligence concerning potential securities law violations.

The Goal of Due Diligence Concerning Possible Securities Law Violations

The objective of due diligence on a target’s compliance with securities laws should be to:

- determine whether the target has violated any securities laws;
- identify specific and systemic legal, compliance and financial risks related to possible securities law violations by the target;
- determine the extent to which the target has an effective compliance culture and procedures;

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1 The opinions expressed in this article are those of the author and not necessarily those of Jones Day or any of its clients.
5 Dodd-Frank provides significant protections for whistleblowers by prohibiting employers from retaliating against whistleblower employees and subjecting employers to significant penalties for retaliatory conduct. Dodd-Frank also vests employees with a private right of action against retaliating employers in federal court.
• assess whether the acquisition is desirable given the risks associated with the target’s actual or potential securities law violations;

• provide the basis for negotiating appropriate provisions in the purchase agreement, including compliance with laws representations, escrow and indemnity provisions and, if appropriate, pre- and post-closing covenants;

• provide the basis for negotiating purchase price reductions or other concessions from the sellers or target;

• evaluate whether to adjust personnel, contracts, markets and relationships post-closing to minimize the risk of securities law violations;

• determine the feasibility and cost of implementing compliance procedures and remedial measures post-closing;

• begin communicating the importance of securities law compliance to the target’s personnel; and

• document the acquirer’s good faith inquiry as a factor for reducing possible penalties or sanctions by the SEC, DOJ or other government agencies that may investigate securities law violations by the target after the closing.

How to Assess the Risk

Before initiating a due diligence review, an acquirer should assess the legal, compliance and financial risks associated with possible securities law violations by a target and tailor its due diligence investigation accordingly. To do so, an acquirer should consider the following questions, some of which pertain to possible FCPA violations:

• Who owns and controls the target? Is it an entity or person with a history of compliance violations?

• How actively do the target’s board and officers manage compliance and risk?

• In what countries does the target do business and what level of risk do those countries present with respect to potentially corrupt business-related conduct?

• Are any of the entities with which the target does business state-owned enterprises or foreign governments?

• Does the target do business in industries known for presenting heightened risks of corruption?

• How does the target conduct its sales? Does it employ sales agents and distributors?

• What financial relationships does the target have with other companies or individuals?

• How much authority do the target’s non-U.S. representatives have?

• What regulatory permissions and approvals are required for the target to do business?

• Who at the target interacts with government agencies and officials? What checks and balances are in place with respect to their authority?

• Is the target in an industry where there is a risk of securities law liability for failure to make disclosures about particular risks?

• Has the target disclosed significant deficiencies or material weaknesses in its financial controls or internal reporting mechanisms?

• Has the target ever been the subject of a government investigation or criminal or civil suit related to securities law violations or accounting irregularities or inadequacies?
Determining the Scope of Due Diligence

The answers to these questions will help an acquirer assess the appropriate scope and depth of its legal, accounting and financial diligence on the target. Of course, the nature and extent of the acquirer’s diligence will be affected by several additional factors, including, for example:

- whether the target is being sold pursuant to an auction, the time available to conduct diligence and how diligence will affect the timing of closing;
- whether the proposed purchase price is sufficiently low to induce the acquirer to assume certain risks that it might not otherwise assume;
- the comfort the acquirer can derive from the extent of the seller’s or target’s representations and indemnities;
- the speed with which diligence must be conducted as a result of the parties’ business imperatives or the availability of financing;
- the acquirer’s own compliance history and whether its reputation, ability to do business or relations with its regulators or constituents (including shareholders, suppliers, customers, employees and the public) might be adversely affected if it were to acquire a target that has violated the securities laws;
- the potential financial effect on the acquirer or target of adverse consequences for securities law violations, particularly relative to the value of the transaction and its benefits to the acquirer; and
- the possibility of successor or acquirer liability for the target’s pre-closing securities law violations.

Conducting Due Diligence

A prudent acquirer will assess its exposure to securities law violations and tailor its due diligence efforts based on the specific facts related to each transaction. A good starting point for reducing acquisition risk related to securities law violations is to make appropriate and comprehensive legal, financial and accounting document requests that address matters such as the existence and details of:

- the target’s whistleblower hotlines and compliance policies and handbooks;
- policies concerning violations of law, including securities laws;
- compliance training for directors, officers, managers and employees;
- hotline reports and the manner in which the target has responded to and resolved them;
- historical and on-going internal and government investigations for violations of securities laws;
- securities litigation affecting the target and its directors, officers and employees;
- employee handbook provisions and other policies prohibiting retaliation against target employees who report securities law violations internally, to the SEC or to another government agency; and
- policies and rules designed to prevent violations of the FCPA, including prevention of corrupt payments and adherence to accounting norms.

Such document requests and reviews can be supplemented by an analysis of publicly-available information, and, as appropriate (and if allowed by the target) with interviews of the officers and managers who play a significant role in the target’s securities law compliance, reviews of the target’s books and records by forensic accountants, in-depth exploration of various communications, and meetings with the target’s sales agents, distributors, other intermediaries and customers.
Some Practical Considerations

An acquirer's ability to conduct effective diligence may be affected by certain practical considerations related to Dodd-Frank. First, an acquirer should balance the benefits of sharing information on a target's securities law violations with members of its internal deal team against the possibility that such individuals could, themselves, become whistleblowers either before or after the acquisition is closed.

Likewise, a cautious seller or target may be concerned that (a) an acquirer's employees or representatives will attempt to obtain a whistleblower award under Dodd-Frank by submitting to the SEC information they have learned about the target's possible securities law violations, or (b) an acquirer's due diligence investigation may induce the target's employees to become whistleblowers. Consequently, a seller or target may try to limit a prospective acquirer's access to relevant information. This tendency may be exacerbated by Rules that prohibit impeding any person from communicating with the SEC about possible securities law violations, including (generally) by enforcing or threatening to enforce confidentiality agreements.

Potential acquirers and targets routinely enter into confidentiality agreements when they initiate acquisition discussions to protect targets' (and often acquirers') confidential information. Under the Rules, if an acquirer's employee or representative discovers evidence that a target may have violated the securities laws, neither the acquirer nor the target may enforce the parties' confidentiality agreement to prohibit the employee or representative from becoming a whistleblower. Consequently, targets may withhold information from acquirers or delay the disclosure to acquirers of information that could reveal possible securities law violations. Thus, ironically, Dodd-Frank, which was promulgated to encourage the reporting of securities law violations, may have the unintended consequence of inducing targets to conceal such violations or impede their discovery.

Second, during the course of due diligence into securities law violations, the parties should consider whether they will be able to preserve their attorney-client privilege and work-product protections, and, if so, take appropriate steps to preserve such protections. Sometimes, this can be achieved by involving attorneys instead of accountants or others to review certain documents and communications, or by having the parties sign common interest or similar agreements. Whether privilege can be protected in this context usually requires a review of applicable law (which often varies considerably jurisdiction to jurisdiction) and a fact-specific analysis.

Acquirers should be aware, however, that the Rules permit lawyers to become whistleblowers when permitted by the SEC’s or applicable states’ attorney conduct rules. In particular, under the Rules, a lawyer may disclose privileged information to prevent an issuer from committing a material violation of the securities laws that is likely to cause substantial injury to the financial interests or property of the issuer or investors, or, under certain circumstances, to rectify the consequences of a material violation of securities laws.

The Bottom Line

In many instances, properly structured acquisition due diligence can reduce an acquirer's acquisition risk by identifying potentially significant penalties related to a target's securities law violations. No amount of due diligence can provide an acquirer with complete assurance that a target has not violated the securities laws, however. This is especially true because securities law violations, particularly those related to corrupt payments to foreign officials, often involve behavior that has been intentionally and carefully concealed and consequently is difficult to detect.

It remains to be seen whether, in practice, acquirers will insist on conducting considerably greater and more exacting due diligence to identify securities law violation risks than they have in the past, and whether sellers and targets will routinely attempt to limit access to their books, records, customers, distributors and personnel out of concern that such inquiries could induce whistleblower submissions to the SEC or cause prospective acquirers to reduce the consideration they otherwise would have paid. What is certain, however, is that acquisition risk has increased with the passage of Dodd-Frank.