



Compliance due diligence in
M&A transactions is becoming
increasingly institutionalised

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A. Foreword

Whether it is corruption, cartel infringements, money laundering, data breaches, product liability, or violations of international sanctions: acquiring a company can occasionally present substantial liability risks for the acquirer. Such risks not only have the potential to render a deal unprofitable, but they can also permanently impair the acquiring company. For example, many will recall the judgment of the General Court of the European Union (EGC) from July 2018 (T-419/14). According to that judgment, a private equity investor can be jointly and severally liable with a portfolio company for the latter's cartel infringements even if the former's interest in the portfolio company is far less than 50%.

With compliance due diligence (CDD) purchasers can reduce these risks. But what significance do market participants attach to CDD today and how far has its institutionalisation progressed in M&A transactions? What concerns are there on the seller's side and what instruments are used to conduct the review? To provide answers to these and other questions, we polled the executives and managers responsible for M&A and compliance at blue-chip companies and investors in the German market.

We hope you enjoy reading our survey.

Katja Langenbucher

Goethe-Universität Frankfurt am Main

Andreas Hoger

Hengeler Mueller

Constantin Lauterwein

Hengeler Mueller

B. Essential insights

Increasing relevance	Executives and managers responsible for M&A and compliance attach great and ever increasing significance to CDD in the context of corporate transactions.
No methodological innovation	The use of technology, which is well-established in internal investigations (e-discovery, artificial intelligence), is rarely deployed in CDD.
Open sellers	CDD is generally accepted on the seller's side. Sellers see issues regarding the protection of business secrets, the risk of delaying transactions and costs.
US focus; additional momentum through planned corporate criminal liability	US investigations are the primary spur for companies to conduct a CDD review. Liability risks in the EU are considered to be lower. The significance of CDD is expected to increase further in Germany because of the intended tightening of corporate criminal liability.
Competition law, corruption, money laundering and sanctions/embargoes	The classic compliance issues dominate while data protection and product compliance are gaining in significance. Environmental protection and human rights are also relevant.
Extensive consequences	Discovered risks are regularly addressed in a transaction, e.g. by specific indemnifications and the introduction of additional compliance measures. Transactions are seldom aborted because of a compliance issue.

C. Report

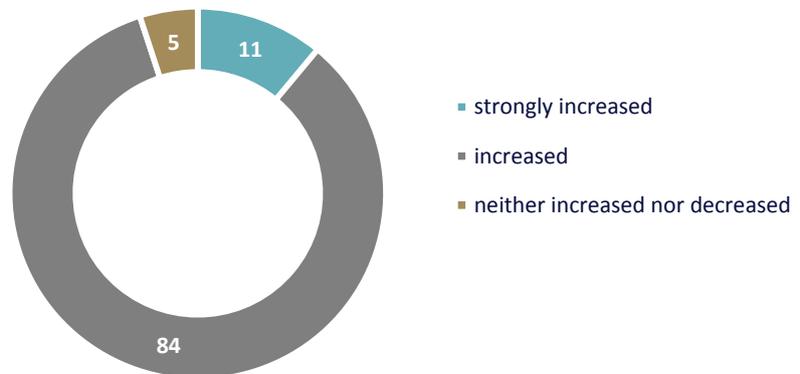
1. The risks are recognised

Market participants acknowledge the liability risks. Indeed, they have come to attach immense importance to them and, simultaneously, to CDD for the acquirer in M&A transactions.

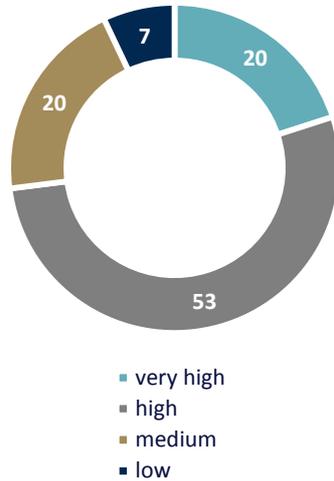
84% of respondents confirm that compliance-related liability risks have increased in importance for acquirers over the last few years, while another 11% of them say that there has been a significant increase.

In parallel, the significance of CDD in M&A processes has also grown according to 85% of respondents.

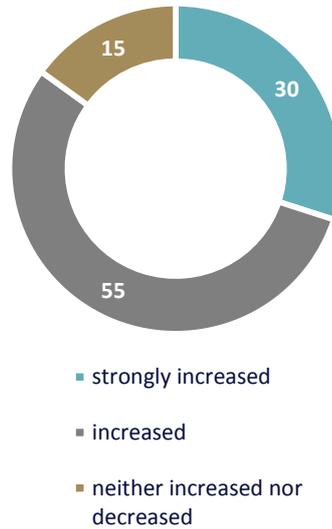
Perception of buy side liability risks resulting from legal violations of target companies



The relevance of CDD in M&A transactions



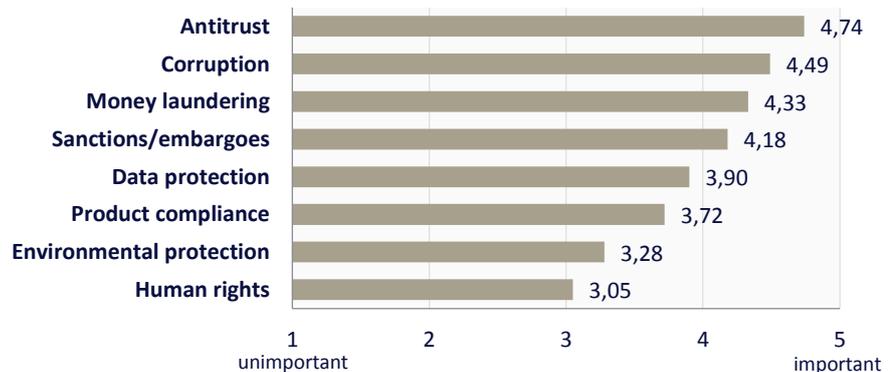
Increasing relevance of CDD in recent years



2. Typical compliance areas are in the centre

The main CDD topics relate to classic areas of compliance such as competition law, corruption, money laundering and sanctions/embargoes. But data protection and product compliance are also of significant importance. In addition, environmental protection and human rights are seen as relevant concerns.

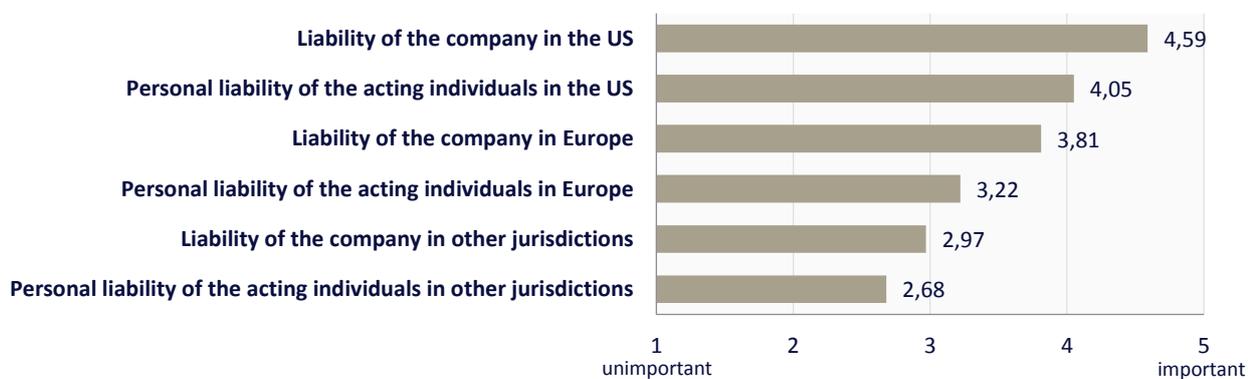
Most important issues covered by CDD



3. Respect for US law enforcement: a driver of risk

Across various markets, US law enforcement commands particular respect among respondents. Any liability of a company, or even the assertion of claims against specific individuals acting in the US, is considered to be the biggest risk factor. This is perhaps best explained by the US having a deep understanding of its own sphere of influence.

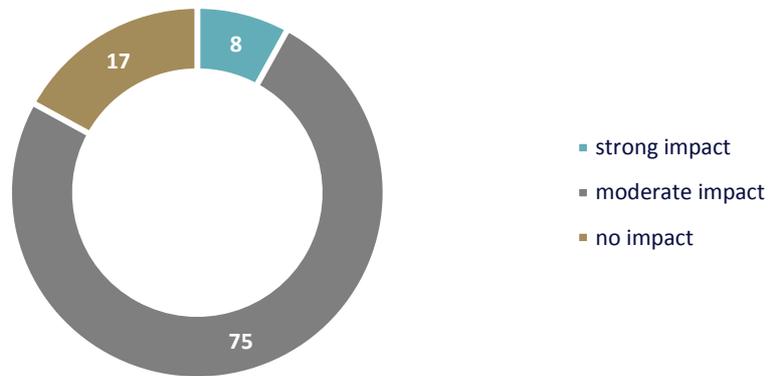
Most significant liability risks for acquirers in connection with legal infringements by the target company



The recent guidance document published by the US Department of Justice (DoJ) outlining what it requires from compliance management systems could fuel the increasing institutionalisation of CDD. The document gives a relatively specific and comprehensive idea of what factors the DoJ considers when evaluating a compliance programme. It is also highly relevant to Department decision-makers and prosecutors when considering, for instance, whether to initiate (criminal) proceedings, assess a criminal fine, or appoint a monitor. A central issue in the evaluation of a compliance management system is the extent to which companies address their own risk profiles by means of specific policies and procedures. Besides employee training programmes and possible anonymous reporting of suspicions, the document explicitly mentions conducting adequate CDD in M&A processes. In light of the DoJ's often extensive jurisdiction, which from the US perspective can reach far beyond its own borders, and considering the signal this gives to European and German law enforcement agencies, CDD as an element of "best US practice" will likely continue to develop as a norm in M&A business.

However, an increasingly standardised CDD conducted by acquirers in M&A processes is also driven by expanding regulatory requirements in Germany and in Europe overall. For example, three quarters of the respondents assume that the intended tightening of corporate criminal liability in Germany (entailing intended measures such as increasing the maximum fine to ten per cent of annual revenues) will further contribute to CDD becoming an established part of the M&A process.

The impact of the proposed change to German law on corporate fines on the standard implementation of CDD

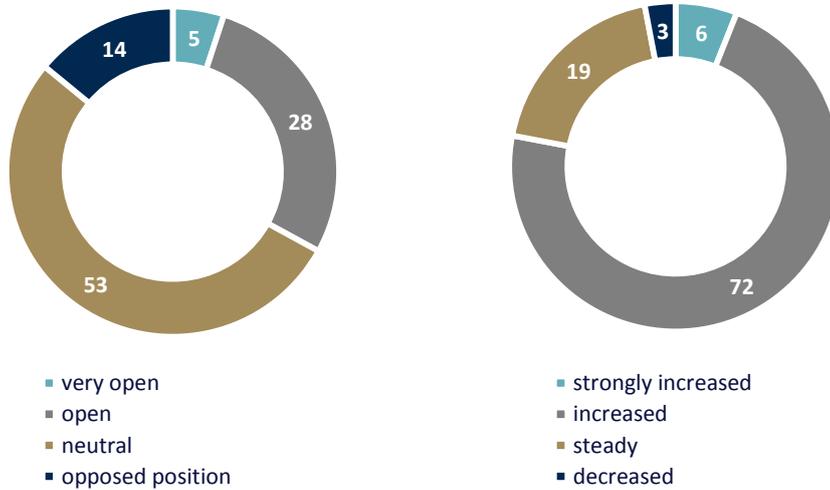


4. Sellers tend to be open

Sellers do not generally stand in the way of acquirers when addressing their growing need for due diligence. They invariably regard the trend towards CDD in neutral terms: only one in ten of those surveyed note any disapproval, while more than three quarters see a growing acceptance.

Aspects such as confidentiality or the protection of business secrets are considered to be critical issues by acquirers, but these are not preventing the growing spread of CDD. The same applies to costs and expenditure for acquirers.

**Sell side acceptance for the CDD (left)
and development of the sell side acceptance for the CDD in recent years (right)**



5. Diverse motivations for a review

The factors determining whether and how a CDD review is conducted are diverse. Knowledge of previous compliance violations or doing business in high-risk countries nearly always leads to particular CDD measures being undertaken in an M&A transaction. Business dealings in the US, activities in regulated industries and the number of clients from the public sector are also very relevant.

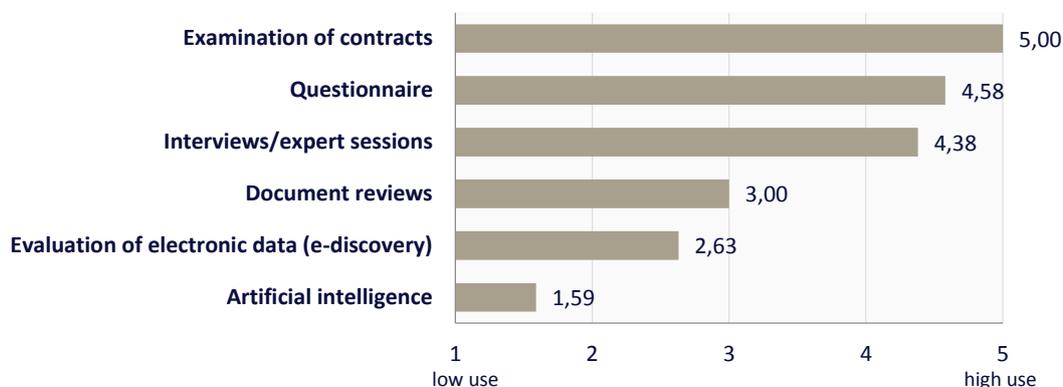
Factors which affect the implementation of compliance due diligence



6. Traditional methods set

As progressive as developments are towards the increased institutionalisation of CDD, methods used in reviewing them remain conventional. Companies continue to use questionnaires most often, followed by interviews or expert sessions. The analysis of electronic data (e-discovery), or even the use of tools such as artificial intelligence, occurs far less frequently. However, it is certainly conceivable that technological tools which have become standard in internal investigations, and are already used occasionally in other areas of M&A due diligence, will also be used to assist CDD in the future.

Compliance due diligence instruments used

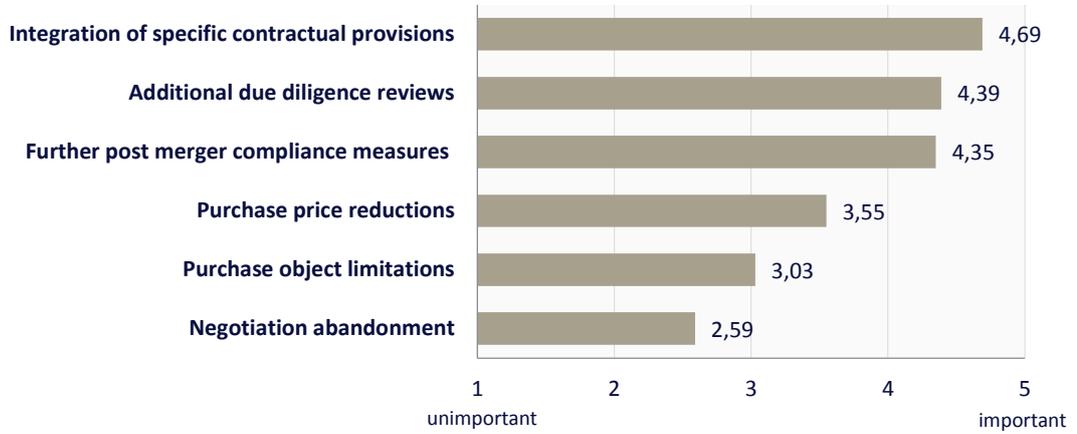


7. Consequences of CDD findings

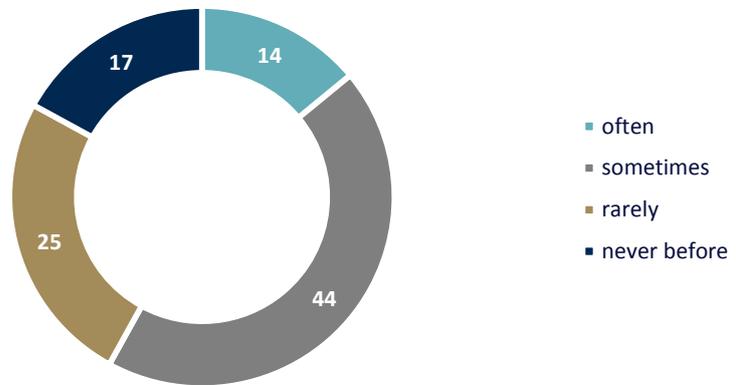
How do acquirers use the findings from a CDD review? They often respond to the discovery of compliance risks with specific contractual provisions (e.g. indemnities and warranties). Regardless of specifically identified risks, compliance warranties have become the norm in private acquisitions. Public takeovers are also increasingly conditional upon no substantial compliance incidents occurring by the time the acceptance period for the offer expires (compliance MAC out). But identified risks can result in additional due diligence reviews being conducted, or further compliance measures being taken after an M&A transaction is completed – e.g. as part of the integration. Although infrequent, the purchase price is occasionally reduced, the purchase object is limited or negotiations are even abandoned.

Without a CDD review during the M&A process, the purchaser forgoes having these possible options for reducing risk and liability. At best, they can only take action in the aftermath of a transaction. This would be an obvious constraint for the purchaser, especially since the vast majority of respondents have experienced cases where, in retrospect, a satisfactory CDD would have been beneficial. Another reason why the importance of CDD could continue to increase.

Implications of revealed risks by CDD for M&A deals



Situations based on experience where compliance due diligence would have been beneficial



D. The bottom line

The survey findings demonstrate that a CDD review is now part of acquirers' standard repertoire in M&A transactions. The most important question for companies and investors in this context is no longer "whether", but rather how wide the scope of the review should be and what means should be used in conducting it. In this context, there is considerable latitude, which can also have a significant impact on the costs incurred and the time required. Acquirers should use this latitude and take measures based on the risks instead of adopting one-size-fits-all solutions.

AML compliance can provide guidance with respect to risk analysis. The German Anti-Money Laundering Act identifies factors and possible indicators of a potentially higher or lower risk in respect of customers, products, services, transactions and distribution channels, as well as geographic risks. The individual factors are specific to money laundering, but the risk categories can also serve as the basis for other areas – such as product compliance and environmental protection.

E. Survey methodology

Executives and managers responsible for M&A and compliance from 330 blue-chip companies in the German market were polled for the online survey, which was conducted in May 2019. In total, 40 companies participated anonymously.

F. About the authors



langenbucher@jur.uni-frankfurt.de

Katja Langenbucher holds a full professorship for Private Law, Corporate and Financial Law in Goethe-University's House of Finance and is an affiliated professor at SciencesPo, Paris.



andreas.hoger@hengeler.com

Andreas Hoger is partner at Hengeler Mueller in Frankfurt. He specialises in M&A and corporate law, with a particular focus on cross-border and private equity transactions. He advises a broad range of private and public corporates, private equity and venture capital funds as well as other financial investors.



constantin.lauterwein@hengeler.com

Constantin Lauterwein is counsel at Hengeler Mueller in Berlin. He advises and represents companies, executives and board members in all areas of white-collar criminal law, administrative offences and corporate compliance.

**Hengeler Mueller
Partnerschaft von Rechtsanwälten mbB**

GERMANY

Behrenstrasse 42
10117 Berlin
T +49 30 20374 0
F +49 30 20374 333

Benrather Strasse 18-20
40213 Düsseldorf
T +49 211 8304 0
F +49 211 8304 170

Bockenheimer Landstrasse 24
60323 Frankfurt
T +49 69 17095 0
F +49 69 17095 099

Leopoldstrasse 8-10
80802 Munich
T +49 89 383388 0
F +49 89 383388 333

BELGIUM

Square de Meeûs 40
1000 Brussels
T +32 2 7885 500
F +32 2 7885 599

UNITED KINGDOM

30 Cannon Street
London EC4M 6XH
T +44 20 7429 0660
F +44 20 7429 0666

CHINA

Unit 3201, Wheelock Square
No. 1717 Nanjing West Road
Shanghai 200040
T +86 21 52030800
F +86 21 52030810

www.hengeler.com