Taking Sherlock Shopping - International Due Diligence

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Due Diligence ~ What is it and why is it due?

You may wonder what exactly is "due diligence," and why and when it is conducted. "Due diligence" is the investigation that a business, its lawyers and accountants will conduct into another business. Perhaps the target business is one the investigating company wishes to acquire, perhaps the parties propose a joint venture, or they wish to engage in a significant financing, distribution or other ongoing relationship. The investigating company wants to verify that the business terms the parties are negotiating are in fact supported by realities. It also wants to determine that the target of the investigation has the legal capacity to perform their agreed upon promises and to draw out any legal risks that may affect the pricing and viability of the transaction. Finally, the investigating company wants to investigate the financial condition of the target to ascertain its wherewithal to perform as called for in the relevant agreements.

Accordingly, the general goals of due diligence are:

- evaluating whether the price to be paid in a transaction is in fact fair;
- determining the strengths of the target company;
- identifying the weaknesses of the target company;
- concluding whether there are significant problem areas or "deal breakers;" and
- assessing whether the contemplated transaction is likely to meet the originally defined objectives.

Due diligence as performed by lawyers is often perceived as serving an almost exclusively legal purpose: i.e., assisting lawyers in drafting legal agreements that the business people hope they will never actually have to reference. Whether the legal due diligence process in fact informs the business decisions in the transaction is open to debate. However, in international transactions, due diligence as performed by lawyers is clearly significant in assisting business people who are unfamiliar with the local jurisdiction draw out factual information that will assist them in assessing the viability of their aims. The due diligence process can be arduous and seem never ending (see attached diagram of the process). The aim is to conclude a mutually beneficial transaction, without major surprises arising after closing.

CHECKLIST FOR INTERNATIONAL DUE DILIGENCE PROCESS

1. PRELIMINARY DUE DILIGENCE (to be undertaken by the Company)

a) Evaluate market potential

b) Obtain information about target company

i) Public vs. private (how to access public information)

ii) Lines of business

iii) Locations of businesses

iv) Financial status

v) Attitude toward timeliness: high/low

vi) Target company's lawyer(s)

vii) Bankers

viii) Accountants

ix) Types of contracts typically used by customer

c) Determine political/market stability

d) Research cultural attitudes toward business transactions

i) Cultural basics

ii) Industry basics

e) Company visit to foreign country

i) Have clear understanding of schedules/expectations of meetings with opposite party

ii) Obtain advice from local counsel prior to disclosing proprietary information to customer

iii) Execute confidentiality agreement with customer prior to meetings

iv) Insurance coverage (see attached sample "Foreign Travel Insurance Questionnaire")

f) Assemble due diligence team/Establish point person for long-term aspects of relationship

2. LEGAL ISSUE DUE DILIGENCE (in collaboration with legal counsel)

a) Brainstorm with counsel to identify business and legal issues for consideration in the negotiation, due diligence and contract drafting processes.

b) Establish relationship with local counsel and determine appropriate reporting relationships.

c) Create transaction timetable

d) Acquire knowledge of governmental procedures and acquaintance with officials

e) Identify type of relationship with customer

i) Licensee

ii) Franchisee

iii) Distributor

iv) Agent

v) Joint venture

vi) Acquisitions

vii) Third-party service providers

viii) Subcontractor arrangements

ix) Other

f) Identify laws of the applicable foreign jurisdiction

i) Intellectual property regulations

ii) Termination provisions

iii) Environmental regulations

iv) Import/export laws

v) Tax laws

vi) Permits/license requirement

vii) Assess enforceability of contracts

g) Identify applicable multi-national treaties and ensure that U.S. has signed them

h) Identify anti-trust risks

i) Ensure compliance with foreign corrupt practices act

3. CONTRACT ISSUES

a) Dispute resolution

i) Governing law

ii) Venue

1) United States – New York, Chicago, Seattle

2) Europe – London, Paris, Switzerland

3) Asia – Singapore or European Venue

4) Middle East – Cairo

iii) Arbitration provision

1) Governing rules

2) AAA rules

3) U.N. Convention on the International Sale of Goods (CISG)

4) International Chamber of Commerce (ICC)

5) United National 1958 Convention on the Recognition and Enforcement of Arbitral Award

iv) Enforceability of judgments

b) Warranties – regarding what matters would you like the target company to warrant?

c) Indemnities – from what risks do you want indemnification, e.g. from environmental issues, possible product liability claims?

d) Insurance provisions

e) Intellectual property protection

i) Patents

ii) Trademarks

iii) Domain names

iv) Trade secrets

f) Exchange rate controls

g) Foreign exchange reporting requirements

h) Invoice and payment provisions

i) Pricing

j) Contract term

k) Exclusive vs. non-exclusive

l) Termination/default

m) Reference government approvals required

n) Force majeure

o) Shipment terms

p) Taxes

q) Notice provision

r) Severability

s) Entire agreement

t) Assignment

u) Governing law language

Red Flags ~ or Not?

Whether your company is engaged in a financing, joint venture, licensing arrangement or distribution scheme, below are some points to consider as you approach the transaction:

In evaluating the target company's financial condition, make sure you understand any significant differences in financial accounting standards. There is no true global "GAAP" (generally accepted accounting principles). The closest approximation is the International Accounting Standards, which are sponsored by the London-based International Accounting Standards Committee. Each country's own accounting standards organization decides what standard will apply, and there can be significant deviations in practices between jurisdictions. For example, International Accounting Standards require that contingent losses are accrued and disclosed as appropriate. By contrast, the PRC's Accounting Standards for Business Enterprises do not specify any standard regarding when contingent losses must be accrued and disclosed.

Recommendation: *At the outset of the transaction, consult a certified public accounting firm that practices in the jurisdiction to get a "primer" on differences in standards that you should consider in valuing and assessing the transaction at issue.*

In conducting a transaction involving a US counterpart, one would expect the company to have legal documentation supporting all significant transactions and relationships of the company. The failure of a US company to obtain written support for its significant relationships would raise red flags as to their reliability, thoroughness and understanding of business standards in this market. However, in certain jurisdictions the absence of complete, written documentation evidencing significant transactions would not necessarily present a danger signal. For example, a Taiwan client that is about to list their securities for sale in the Taiwan over-the-counter market provided certain local employees "options" (rights to acquire stock in the company at the original price per share, which was much lower than the current value of the stock). The Taiwan company did not adopt a stock option plan, enter into option agreements, or buy-sell agreements to define the rights of the employee-stockholders. Rather, the majority shareholder simply assigned shares to the employees. This company is well run and senior management is reliable, so the absence of documentation in this instance is not evidence of nefarious dealings.

Recommendation: *Work with local resources (e.g., bankers, accountants, lawyers) to determine whether an issue that would be red flag in the home country is in fact a sign of a problem in the target company's jurisdiction.*

Consistent with the above point that in certain jurisdictions even fairly large companies will not engage in thorough documentation of their legal transactions, those companies will also probably lack an established relationship with a law firm. This does not necessarily indicate they are not well established. However, whether or not the company enjoys established banking relationships may be a better barometer of their standing. If a company purports to have engaged for business for some period of time, to have significant business dealings, and to make a profit, it stands to reason that it should have money and need a place to put it. Accordingly, the absence of regular banking relationships may be an indicator that the company's positive assertions are untrue.

Recommendation: *Ask to meet with the target company's bankers (perhaps under the auspices of gaining a better understanding of the market or exploring financing options for your company in that jurisdiction). Use the meeting to gauge the closeness of the relationship between the company and its banker and to assess the banker's familiarity with the customer's business (which may be an indicator that they in fact have the regular business relations the previously described to you).*