

Pre- And Post-Closing Due Diligence Is Vital After DOJ Memo

By Holly Drumheller Butler and Kristin Burtzlaff (October 21, 2022)

New guidance from the U.S. Department of Justice may affect how companies conduct acquisition due diligence and integration.

In company acquisitions, legal, business and operation due diligence typically examine the target company's business activities to identify and mitigate risks arising from the company's historic business practices, among other things.

This often includes evaluating a target company's current and historical governance structure; contractual arrangements with customers and vendors; existing debt and financing relationships; employment, compensation and benefits matters; pending or potential lawsuits; and compliance with legal and regulatory requirements.

Recent DOJ guidance may cause acquirers to reexamine existing practices, as it reinforces the importance of both preclosing and post-closing compliance due diligence.

On Sept. 15, DOJ Deputy Attorney General Lisa Monaco announced several new guidelines^[1] for prosecutors to employ in their prosecutorial decisions for corporate offenders. The same day, the department issued a memorandum^[2] outlining the new policies in further detail.

Both the announcement and subsequent memorandum make clear that the department has reinvigorated its focus on corporate recidivism.

Among the litany of enforcement policies announced, two may have immediate and practical implications for how companies conduct acquisition due diligence.

First, the department emphasized its consideration of prior company misconduct — including the full criminal, civil and regulatory record stemming from domestic and foreign activities of the company. This consideration of prior misconduct suggests that the DOJ will evaluate the prior record of acquired companies.

Second, the department directed prosecutors to assess the adequacy and effectiveness of the company's compliance program at the time of the offense and at the time of the charging decision.

This focus on an evolving compliance review highlights that the DOJ may take the position that due diligence does not end when the deal is closed but extends into post-acquisition.

As Monaco stated in her announcement:

[W]e do not want to discourage acquisitions that result in reformed and improved compliance structures. We will not treat as recidivists companies with a proven track record of compliance that acquire companies with a history of compliance problems, so long as those problems are promptly and properly addressed post-acquisition.



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The department's guidance should assure diligent acquirers that they will not be treated as recidivists where, post-acquisition, the acquirer implements improved compliance structures.

But the DOJ guidance forewarns that a head-in-the-sand due diligence approach will not be well received in any subsequent investigation. Rather, such an approach increases post-closing risks to the acquirer, as the department appears to suggest that it will assert that an acquirer will assume the risks of becoming associated with the prior business activities of the target company at closing, but without the benefit of understanding the full scope of those prior activities.

Further, the acquirer will have no game plan to take corrective action and mitigate risks on a go-forward basis, instead relying on indemnification provisions in the purchase agreement that may not fully mitigate the risks associated with such activities.

An acquirer that identifies risks from a target company's business activities during the due diligence process should prioritize development and implementation of a corrective action and risk mitigation plan with respect to such activities promptly following closing to reduce the risk that the acquirer may be encumbered by the prior bad acts of the target company.

Target companies should expect that acquirers may negotiate more heavily for specific indemnification provisions addressing risky business activities undertaken by the target company that are discovered during the due diligence process to cover the potential for increased risks to acquirers as a result of the department's guidance.

Following the DOJ's guidance, appropriate consideration should be given to due diligence of:

- Prior criminal, civil and regulatory investigations, domestic and foreign, including any penalties or resolutions with the target company and key management. The department generally disfavors multiple deferred prosecution or nonprosecution agreements, especially where the issue involves the same or similar types of misconduct, the same personnel or the same entities. Therefore, preacquisition due diligence should look for prior incidences of misconduct, and post-acquisition due diligence should reduce the likelihood that the problematic conduct either has reoccurred or is reoccurring;
- Compliance programs — the playbook: code of conduct, policies, risk assessment, training and reporting. To the extent possible, this may include an understanding of who was charged with compliance oversight, relevant reporting structures and budget allocations, and an evaluation of compliance tone, as well as any open issues; and
- The target company's compliance with applicable legal and regulatory requirements, particularly in heavily regulated industries such as government contracting and health care.

Perhaps the greatest takeaway is that post-acquisition, an acquirer should have a renewed focus on compliance review and risk assessment in the post-closing integration of the target company into its existing business structure.

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[1] <https://www.justice.gov/opa/speech/deputy-attorney-general-lisa-o-monaco-delivers-remarks-corporate-criminal-enforcement>.

[2] <https://www.justice.gov/opa/speech/file/1535301/download>.