

What you need to know about cross-border transactions in challenging jurisdictions

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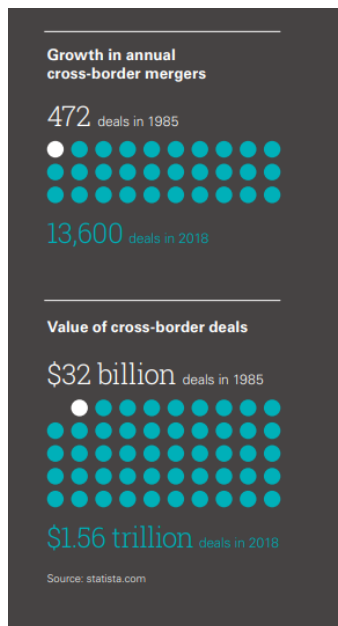
Despite shifting regulatory and geopolitical attitudes toward international trade, the public appetite for cross-border transactions is a genie that can't be put back in the bottle.

In 2018, annual cross-border M&A volume rose 23%, to \$1.2 trillion, representing 30% of global M&A volume versus 28% in 2017.¹

And with a surplus of capital searching for a home, investors are increasingly finding deals in countries beyond the usual suspects in North America and Europe, and are looking to Africa, Central Asia and other frontier markets. But some cross-border transactions present more business risk than others.

The operation of the business following closing should be baked into your overall transaction strategy.
Can the business operate in compliance with laws?

Akin Gump partners Christian Davis and Melissa Schwartz discuss why some jurisdictions pose additional challenges and how businesses can mitigate risk and position themselves for success in these markets.



Thomson Reuters: What makes a jurisdiction “challenging”?

Christian Davis: Challenging jurisdictions pose risks on both sides of the transaction that would not be present in a domestic transaction or one involving a closely allied, developed country. Those risks might involve economic sanctions or concerns about national security, technology transfers, corruption or money laundering.

Melissa Schwartz: Other countries that don't have sanctions or heightened export control risk may still be challenging places for transactions. When you're dealing with emerging market countries that don't have a lot of foreign investment or where the legal systems are still developing, your transaction may be the first of its kind. Working through that type of transaction is a different kind of challenge.

TR: What challenging markets are hot right now?

MS: We're doing a lot of compliance work relating to Venezuela. With the Maduro regime trying to cling to power while nearly 50 countries have recognized Guaidó as the rightful president, we're seeing significant sanctions being imposed by the United States and severely impacting U.S. and global clients in a range of industries.

Russia and China continue to raise complex issues for cross-border deals. For first-of-their-kind transactions, we're seeing a lot of activity in Africa and Asia.

TR: Are there particular industries that make cross-border transactions more challenging?

CD: You can have issues in any industry, but some present heightened risks, such as energy, aerospace and defense, technology and telecommunications. The financial sector is also the subject of scrutiny, particularly with respect to sanctions and anti-money laundering issues.

TR: What do you look for first in assessing a potential cross-border transaction?

MS: We start by looking to see if there's a show stopper. Who are the counterparties? What country or region are they working in? What's the industry? There are certain things that are simply prohibited, not something you can work around.

We often look at sanctions as one of the gating issues. You can't just look at the countries where the parties are located, because sanctions can flow down the corporate chain to entities that are under the control of a sanctioned party. CFIOUS is another gating issue, especially for inbound investment to the U.S.

TR: What's the next step?

MS: Depending on the risks posed by the transaction, we will look more deeply into specific areas. In a financing, we'll look at the borrower, their use of proceeds and generally how they conduct their business. If we're acquiring a company, we'll conduct diligence to understand what exposure the acquirer will have to international trade risks.

For example, we might look at whether the target company engages in trade with a sanctioned country like Iran, and the possible consequences of the sanctions on the target's business as well as for the acquirer. Assuming the risks are not show-stoppers, we then factor the risks into the price.

The interrelationship of international trade issues and existing contracts, such as insurance policies or debt agreements, is also important. For example, almost across the board, in the current market, every significant loan agreement has fairly stringent sanctions clauses.

If one company acquires another that has a preexisting sanctions violation, how does successor liability impact the acquirer's loan agreement? Could the preexisting violation lead to a problem maintaining insurance?

CD: The operation of the business following closing should be baked into your overall transaction strategy. Can the business operate in compliance with laws? Are there risks that will dilute the business purpose and make it a transaction that isn't worth doing? What is the business structure that would allow you to execute the transaction, comply with law and achieve the desired result?

As we encounter each issue, we try to figure out how to mitigate risk. If there is a relatively minor sanctions violation, we might recommend a voluntary self-disclosure to the Treasury Department. If we find significant corruption risk, we might recommend stronger safeguards, compliance and reporting.

TR: How can differences in national laws impact transaction risk?

MS: If a U.S. purchaser buys a Russian asset from a European seller, the laws governing the seller may be different than those governing the U.S. company. While certain operations of the target company might not have posed issues for the European seller, this may not be the case for the U.S. purchaser.

CD: In addition, there are a number of different foreign investment regimes popping up around the world. With multinational companies, you might go through these reviews in various jurisdictions.

The thresholds triggering those reviews are different, which can make transactions more complicated. This has been

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present with competition filings for some time, but we're now seeing it happen more in the context of foreign investment.

TR: What's the biggest mistake that companies make in challenging cross-border transactions?

MS: Failing to truly understand each other. Not because we literally speak different languages, but because when we use an expression we may mean something different than the counterparty means or a response may be couched in terms that are culturally appropriate for one party but leave the other party not understanding the response.

For instance, in a joint venture context, it's critical to make sure everyone understands which actions need the approval of both parties, which need approval of just one, and why, even if it is different from the governance traditions of one of the parties.

You can apply that same issue of a failure of communication to a variety of different areas. Think of it in the due diligence context. If I ask, "Have you ever paid a bribe?" I cannot think of a time where anyone ever said yes.

If I ask, "Did you ever have to face a situation where you had fresh produce that was stuck at customs and spoiling, and you had to find a way to get it to people on the other side who were in desperate need of food?" I probably would get a different answer.

Think about who's in the room and how you ask the question. You need to show respect for their culture while still staying true to the need for diligence.

CD: Another issue is when both parties to the transaction are not taking a broad view of the potential issues and they hold back the breadth of ongoing activities. Failing to take the big picture into account from the outset can mean you only discover some issues late in the transaction, which can cause a scramble and waste resources.



Red flags for transactions in challenging jurisdictions

Parties or controlling entities, or entities in the supply or distribution chain, are sanctioned parties or located in a geographic area subject to comprehensive sanctions

Parties involved have been subject to recent enforcement actions by or made voluntary self-disclosures to OFAC, Department of Justice or other agencies relating to sanctions, corruption or money laundering

Products or technology involved in business are subject to export controls applicable to the jurisdiction

Business sectors involved are subject to heightened regulatory requirements and/or enforcement

Business includes extensive use of “middlemen” or third-party intermediaries, consultants, increasing the corruption risks

Involvement of governmental entities as transaction parties or major customers

Absence of foreign investment protections, whether through treaty and/or local law

Lack of bilateral investment and/or tax treaties with the jurisdiction

TR: What is the best strategy for closing a deal in an untested market?

MS: Make sure the company in the untested market has experienced counsel — somebody who’s done that kind of deal in other markets numerous times and can explain issues to their clients. Otherwise, the company hears a diligence question, for instance, and may find it offensive or contrary to their practices.

The best advisor for those companies will say, “This is why they’re asking. This is why it’s important to them. This is why it’s in your interest to answer this diligence question up front in a very fulsome way.”

When working in any of these countries, it’s critical to have local counsel with experience both in the country and in the cross-border context. Compatibility between the big law firm and the local counsel is one of the keys to a successful transaction.

TR: What enforcement trends are you seeing?

MS: Overall, we’re seeing increased enforcement by government authorities, and in addition, something else worth noting is significant de-risking by financial institutions. When sanctions regimes were being instituted and ratcheted up in the United States and the EU over the past five years, there was a thought that banks and commercial actors would do everything that was legally permitted right up to the line.

But what we have seen is that banks are not willing to go there. The risk of penalties and reputational damage is just too great. Even with transactions that may be authorized or licensed but involve a sanctioned party, we’re seeing banks in

certain cases simply decline to engage. I think we’re going to continue to see that trend.

TR: Are there any important new or pending laws or regulations?

CD: Yes. First of all, there’s a CFIUS reform law called the Foreign Investment Risk Review Modernization Act (FIRRMA) that is in the process of being implemented. FIRRMA expands the scope of CFIUS jurisdiction to cover certain noncontrolling investments and real estate transactions in the United States and also imposes mandatory reporting requirements in certain transactions.

In addition, a recent executive order titled “Securing the Information and Communication Technology and Services Supply Chain” will establish new restrictions on telecommunications transactions, which we expect to at least apply to certain import transactions into the United States, though it could be broader. The U.S. government is targeting the establishment of implementing regulations by October 2019.

TR: How does the client know when to walk away from a deal?

CD: I think it’s listening to their advisers on the risks that are presented and taking a sober look at major red flags that are likely to present a significant liability that cannot be mitigated or that will prevent the business goals from being achieved.

MS: In these markets, there’s a very fine line. The only deals that get done are those where the business people are persistent believers who are willing to go the extra mile and push when most people would give up. On the other hand, business people need to have their eyes wide open.

The most successful players in these markets are the ones who are willing to walk away, but who continue to apply the pressure needed to get to closing.

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¹ Source: jpmorgan.com

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