

The Deal

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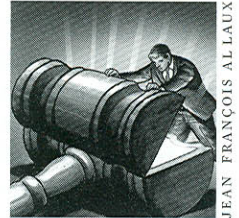
ADVISERS

JUDGMENT CALL

Global gumshoeing

Thorough due diligence is much more difficult—and even more necessary—in cross-border transactions

by Arthur H. Rosenbloom and James B. Mintz



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Explosive headlines in the business media make a simple handshake difficult when it comes to new business transactions. Would better due-diligence analysis have discerned the bombs ticking inside companies such as Enron, Adelphia, Global Crossing, WorldCom? It certainly

would have helped.

In fact, the success of most new deals depends on predeal “bomb-sniffing” skills. The ability to ferret out questionable accounting, phantom revenue, self-dealing and other activities has never been more timely. But as difficult as due diligence can be in domestic transactions, when acquirers traverse political borders, understanding a company and designing deal terms often pose an even greater challenge.

Cross-border due-diligence issues are simple to identify but hard to resolve. Among them, many from our direct experience are:

- **Time:** Trying to organize a three-continent conference call at a convenient time for all for a deal in Australia.
- **Distance:** Longer but less frequent due diligence trips.

• **Language:** Translations that can't convey exactly the right nuances, especially when bluffing or attempting humor.

• **Legal:** Civil law being somewhat different from common law and totally different from no law at all.

• **Tax:** Deciphering which kinds of transactions are immediately taxable and which are tax-deferred and differences in the degree of tax compliance.

• **Accounting:** Differences in accounting for goodwill, pension costs, etc., that may be encountered and create real difference in valuations.

• **Regulatory:** Regimes encouraging foreign investment versus those that do not, resulting in major differences in transactional feasibility.

• **Currency:** Currency fluctuations that make it difficult

to determine how much a deal actually costs.

• **Cultural:** Time-sensitive deals such as those that will not work in France in August or in Israel when a key executive is on reserve duty.

Because of these and other factors, the number and nature of flawed cross-border deals reported in news stories is long and serious. Of these, perhaps the most dramatic are those touched with elements of criminality.

In 1998, American investors seeking to buy portfolios of bad loans from Japanese banks ran into Japanese crime syndicates called yakuza. Starting in the 1980s, these syndicates invested in Japan's then wildly speculative real estate market. Faced with brass knuckles and worse from criminals who did not take kindly to competitors, savvy U.S. investors hired high-powered investigators and law firms to go through portfolios loan by loan. To add insult to injury, in one portfolio investigators found 40% of the borrowers had ties to organized crime and 25% had criminal records.

In February, after several rounds of convertible bond sales,

it was announced that the president of Sumikura Industrial Co. had been charged with paying off gangsters. Sumikura later filed for liquidation.

But those seeking to offer or receive cross-border financing or engage in cross-border mergers are far from powerless. New technology allows access to the international public record on companies and individuals. That includes regulatory filings, criminal convictions, civil litigation, bankruptcy filings, news articles and reports by non-governmental agencies.

Any computer plugged into a phone line can access this cornucopia of data. Backgrounds of key executives, business practices of the target and concerns about intellectual property can also be addressed by appropriate on-the-spot due diligence by local investigators.

Of course, cross-border due diligence also is needed in the investigation of non-criminal activities. Among these in outbound deals (non-U.S. target, U.S. investor) are host country regulations of foreign investment through investment controls, share transfer restrictions, local content laws, foreign exchange

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regulations, price controls and tariffs and duties.

Local legal and business advisers are a must in the due diligence of these areas. By pinpointing potential deal-killing issues early on, clients can reap savings in time, money and energy far greater than the professionals' fees.

Emerging markets pose additional risks, including exposure to confiscation, political instability resulting in laws that can change in the middle of a deal and ambivalence about foreign investment. Multiple sets of accounting records covering the same period—one for the tax collector, one for the shareholders and one for management—are by no means uncommon.

The absence of the rule of law in many places results in problems in enforcing creditors' and others' rights. In addition, contradictory laws and bribery and corruption are often present. Buyer beware: Conventional U.S. merger formats such as the statutory merger may be unknown abroad, or fraught with adverse consequences to the target or its shareholders.

Some practical advice: Make part of due diligence getting to know the local decision-makers and use preliminary due diligence to evaluate the other side's willingness to work cooperatively with you. In addition, use due diligence to identify government officials who can explain legislation or

administrative decrees to eliminate ambiguities.

As to time barriers, consider the Israeli company with a substantial presence in Silicon Valley that chose U.S. counsel in Boston partly because the time difference between it and counsel was only seven hours rather than 10 in California.

In the final analysis, the client will determine the outcome of the cross-border risk-reward calculation. One of the authors recalls a recent incident in which a hotel magnate described his company's proposal to buy and build new hotels in a remote section of the world, about as far removed from the rule of law as one can get.

"How is it that you're prepared to take the investment risk in such a situation?" he was asked. The client responded, "For a six-month payback, I can accept a lot of risk."

Conduct up-front due diligence early to ferret out problems and provide workable solutions to issues that can ruin the best of deals. ■

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