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## LOGESOVÁ & PUMR

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*– Enhancing Pre-Transaction Due Diligence*

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# Due Diligence

## Enhancing Pre-Transaction Due Diligence in CEE/SEE : Three Areas Where a Conventional Balance Sheet Review Falls Short

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# Introduction

Anticorruption and compliance due diligence is still being conducted only in a limited number of cases as a part of pre or post-acquisition due diligence in Central Eastern Europe and South Eastern Europe (CEE/SEE). Limited or inaccurate due diligence prior to an acquisition can significantly weaken the (negotiation) position of clients and sometimes very seriously impact the business of the acquired company. Due diligence that fails to account for compliance risks or does not approach risks holistically often leads to considerable post-acquisition losses, sometimes even necessitating a complete write-off of the target company. The following article aims to point out some of the current key considerations and risks stemming from the expanding regulatory frameworks throughout in CEE/SEE.

## REDEFINING RISKS: DYNAMIC EVOLUTION IN REGULATORY FRAMEWORKS AND ENFORCEMENT

When assessing transaction risks, usually three main categories of risks are being targeted: business, regulatory and reputational. For a long time, these risks were generally considered independently of one another during due diligence processes. However, as the world becomes more interconnected on the one hand, yet more regulated and less globalized on the other, we are seeing various specific risks increasingly intersect and overlap. Furthermore, the category of regulatory risk is now more likely to encompass risks that were purely seen as business or reputational risks in the past, or even entirely new risks. These include for example corporate criminal liability, sanctions, money laundering, undisclosed ultimate beneficial owners (“UBO”), conflicts of interest, bribery, bid-rigging, money laundering, tax, GDPR compliance and HR related risks like harassment or mobbing. Recent years have brought an avalanche in regulatory oversight, not only on the national level but also – and more importantly – on the multi-national level, with coordination among key jurisdictions such as the USA and the EU.

This situation has resulted in a challenging scenario for both traditional, long-established businesses and startups. The former are scrambling to implement a whole array of new regulations into their large-scale processes across different jurisdictions, many of which they may never get round to implementing. Meanwhile, early-stage companies tend to pay less attention to regulatory compliance. Both types of business might then bury certain risks within the fabric of their company, often hidden deep below the surface.

It has been relatively common for acquisition due diligence not to catch red flags, even when the target's business practice clearly qualified as a complex bribery scheme under the law of the target's home country. The number of such cases has been on the rise for some time, particularly because the definition of bribery in many European countries is quite broad and covers both public and private bribery (passive and active). In the region, it is quite common for employees or board members to have a reporting obligation if they come across a suspicion of bribery post-acquisition. Consequently, the employees or board members cannot just sweep it under the rug; they have a personal, legal duty in many circumstances to report immediately to the authorities.

The key issue with regulatory risk, including bribery, is that it can significantly worsen the investor's position or even lead to a write-off of the investment. Unlike reputational or business risk, regulatory risk tends to attach itself to the company and its assets and in some cases can make the acquiring company "toxic". In another recent case, we saw how corporate criminal liability transferred to the acquiring company through an acquisition of "significant assets."

This convergence of business and reputational risk with regulatory risk illustrates the need to change mindsets when conducting pre-transactional due diligence. Red-flag issues that go unnoticed or are mismanaged before a transaction can expose investors to criminal or civil litigation both on a corporate and individual level.

## CORPORATE CRIMINAL LIABILITY AFFECTS TARGET COMPANY AND ITS ASSETS

In Czech Republic and many other CEE/SEE countries, a company is responsible for almost all crimes listed in Criminal Codes, which can be committed by a wide spectrum of personnel, including managers, employees, board members, and shadow directors. Criminal liability is incurred not only if the crime is carried out in the company's interest but also as part of its commercial activities. This means that the company can also become the offender if they are damaged by the act. For example, we had a client recently that was defrauded in a double invoicing scheme, which led the client's company to be charged with tax fraud for deducting non-incurred costs. The company's liability can be based solely on the actions and intent of the individual perpetrator, and it remains separate and concurrent with the individual's criminal liability. The individual need not even be identified. A concern is that sometimes employees or the company unknowingly engage in illegal activities, either because this is what they learned to be "business-as-usual" or even because the company was a victim of a fraud.

Moreover, the Czech case law concluded that criminal liability may extend not only to the legal entity but also to its key assets. This in practice means that if the criminally liable company sells its key assets to another company, both can face criminal charges and sanctions. Therefore, criminal liability can effectively make the assets of a company "toxic", where liabilities attached to acquired assets can emerge up to several years after their acquisition and can not only block the acquiring company from disposing of the acquired company or its assets but may also result in sanctions being imposed on the company who acquired the tainted assets. The sanctions in Czech Republic often include ban on commercial activities or a prohibition on fulfilling or participating in public tenders. This means that the mitigating efforts of restructuring the target company or selling its assets may not prove fruitful, and that the company acquiring tainted assets may also face devastating sanctions of ban on part of its commercial. This risk underscores the importance of conducting a comprehensive review of the target company's history and operations to uncover any criminal activities or liabilities.

## TYPICAL DUE DILIGENCE IN THE CEE/SEE REGION

In the M&A environment in CEE/SEE, there is a noticeable inclination towards pursuing cost-effective and predominantly financial due diligence processes ("a desktop review," consisting of remote review of documents that have been agreed, selected and prepared beforehand). This approach is of course often driven by budgetary constraints and a traditional perspective of due diligence in which the primary goal is to evaluate the financial health and viability of the target company. This due diligence typically involves reviewing financial statements, assessing assets and liabilities, analyzing historical financial performance, and conducting legal review of key contracts and obligations.

These documents, such as audit and financial reports, primarily offer a historical view of a company's financial performance. They are excellent for understanding past profitability, revenue trends and financial stability. However, they do not capture non-financial factors. Contracts and current litigations cannot typically be relied upon to assess the robustness of the legal and compliance processes currently in place at a target company. Issues such as a company's culture and any conflicts of interest involving its key personnel are usually overlooked.

There is also an overreliance on self-reported information and professional memorandums, opinions, or advice. Gathering relevant information is undoubtedly a difficult task, especially in a less-than-friendly takeover. However, this self-reported information might not always present a complete or entirely accurate picture, especially in areas where subjective judgment or undisclosed information (like internal conflicts or ethical practices) play a role. Additionally, much of the information gleaned from audits and reports is based on data provided by the target company itself or produced for its benefit by its trusted advisors. While these can provide valuable insight and advice, they are not always correct and are never binding for law enforcement or tax authorities. Occasionally, we have seen how incorrect advice can lead to significant damage to materialize many years in the future.

The most frequent lesson learned from our practice is that a traditional "desktop review" is unable to identify certain compliance risks because the company looks great on paper. These areas included corporate criminal liability, tax and specific regulatory risks (money laundering, sanctions, various reporting areas such as DAC6 or ESG). In the CEE/SEE region, a significant challenge within the M&A sector is the limited awareness and understanding of the importance of compliance due diligence. Based on a tailored risk assessment, compliance due diligence involves a thorough assessment of how well the target company and its key personnel adhere to relevant laws, regulations and industry standards.

Compliance due diligence is feared because it is inherently a very broad topic. However, it is not necessarily an expensive and demanding exercise and, in many cases, can be done by the buyer itself. The issue, predominantly, is that it is not part of regular practice and is not well known. Simple compliance due diligence of a target company consists of two parts. The first is the initial risk assessment, which is crucial for understanding the target company's specific risk profile: the company's business environment; industrial sector; the extent of its international operations, products and services offered; business processes; IT infrastructure; and sales channel. The second part consists of a review of high (and medium) risk areas, alongside the due diligence. Depending on the risks, this involves background checks of selected business partners and suppliers, transactions, key personnel or stakeholders, as well as their interviews.

### How to handle compliance diligence reporting

In most cases, compliance due diligence does not identify serious risks or issues. It points out any deficiencies or red flags, which in turn increases the negotiation leverage of the buyer. When critical issues are detected, the easiest approach might be to walk away from the transaction altogether. However, there will be other cases where this is not possible, or the transaction is too important to the buyer. In these cases, additional indemnities or warranties are highly recommended. In other cases, companies often consider self-disclosure.

In CEE/SEE region, companies also need to be aware of the duty to report, which is a legal obligation to immediately report (or prevent altogether) a catalogue of crimes to the enforcement authorities. Non-reporting is a crime. Most often, the duty to report a crime falls on the individuals, for example company's employees or advisors. Therefore, if there is a risk that reporting duty can be triggered during the compliance due diligence either pre or post-acquisition, the person should immediately stop reviewing the data or a report and an independent attorney should be engaged to review the issue (attorneys are generally exempt from the reporting duty).

As for remediating the misconduct, in the USA, for example, the Department of Justice announced a Mergers & Acquisitions Safe Harbor policy on 4 October 2023, to promote voluntary disclosure of criminal misconduct in acquired companies. Eligible companies must report any misconduct within six months of closing an M&A deal and remediate the misconduct completely within one year. In the CEE/SEE region, on the other hand, existing legal frameworks often present a challenge as they hinder cooperation between prosecuting authorities and companies that are willing to collaborate or self-disclose. Usually, the law provides no automatic benefit for self-disclosure or cooperation, nor does it incentivize companies to self-report and cooperate with prosecuting authorities.

In this sense, companies cannot be certain that they will obtain any benefit should they decide to cooperate, share information, or report misconduct. For example, in Czech Republic, the only viable option for companies is a Guilt and Sanctions Agreement made between the offender and the public prosecutor. The offender must admit that the facts as presented by the prosecution are correct and agree to sanctions. However, the defendant has no legal instrument to influence the bargaining process, thus the public prosecutor has the upper hand. In practice, public prosecutors do not offer many benefits and are unwilling to offer many concessions. The biggest upside of this instrument is that if the company can negotiate to be sentenced with a monetary fine only, it can avoid having a criminal record because by paying the fine, the company is regarded as if it had not been convicted.

## CONCLUSION

The significant shift towards new and extended regulations in previously unregulated areas requires a change in due diligence mindsets. Compliance due diligence is critical for detecting situations that look great on the paper but pose significant risks to the buyer that a desktop review cannot detect. In the CEE/SEE region, those mostly include the transfer of criminal, tax, or regulatory liability through “tainted assets” to the buyer(s). Despite the importance of compliance due diligence, there remains a lack of awareness regarding its value and utility. Nevertheless, a brief background search can be instrumental in uncovering issues that might otherwise lead to big losses or cause an investment/exit strategy to fail because of the non-transferable tainted assets. The implementation of whistleblowing directives in the EU has resulted in a rise in whistleblower activity. Unfortunately, however, whistleblowers may be of little help to a buyer, as very often whistleblowers report issues only after a transaction has been concluded.

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