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Top 10 Political Red Flags In M&A

By **Zachary Parks** (February 22, 2019, 4:12 PM EST)

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Investment firms and corporations should not overlook political law compliance during the regulatory due diligence that precedes a merger or acquisition. In this hyper-charged political environment, the last thing an acquirer can afford is to unknowingly inherit a political scandal resulting from the purchase of a portfolio or target company. To help investment firms and others, this article outlines the top 10 political law compliance pitfalls that should be weighed during the diligence process. Careful political law diligence is especially important when the target is a government contractor, has an in-house government affairs department, has federal or state lobbyists on retainer, operates a political action committee or has politically active executives.

1. Is There a Lingering "Pay-to-Play" Problem That Could Jeopardize a Major Contract?

In many states and localities, if a target company has contracts with state or local government agencies, the company may be subject to "pay-to-play" laws. These laws often effectively prohibit the company's executives and employees from making certain political contributions to candidates who could be in a position to influence the award of the government contract. Pursuant to those laws, a single personal political contribution by an employee — motivated purely for ideological reasons — can force the company to forfeit the government contract, disgorge receipts and pay civil penalties. For companies with large government contracts, these penalties can be catastrophic. Further, political contributions by portfolio companies and their executives can, in some circumstances, cause the investment firm that owns the portfolio company to inadvertently violate the "pay-to-play" laws that apply to it.

These "pay-to-play" laws are easy to violate, carry enormous penalties and are not hard for regulators, competitors and the press to detect. Accordingly, an acquirer should know whether it is inheriting a "pay-to-play" problem prior to closing the deal. The diligence process should therefore include a review of existing political contribution pre-approval policies, online campaign finance databases, internal political contribution records, and the names of current and prospective government clients and customers.

2. Is the Company Appropriately Registered Under Applicable Lobbying Laws Where Required?

Federal and state lobbying registration and reporting rules vary widely. In some jurisdictions, even a single phone call or email to a government official regarding a procurement or policy issue can trigger registration requirements. The failure to register can result in fines that often increase daily and adverse publicity.

Before completing a purchase, an acquirer should identify each jurisdiction in which the target is registered as a lobbying entity or retains or employs lobbyists. The acquirer should review filed reports in those jurisdictions for accuracy and completeness. Back-up documentation for lobbying reports should also be reviewed to confirm the accuracy of the reports. Red flags include the same "cut and paste" lobbying filings month after month, frequent report amendments, a history of penalties, the failure to respond to inquiries from regulators, or retaining lobbying firms or employees who have been caught up in their own government ethics investigations.

3. Is There a Political Contribution Reimbursement or "Name of Another" Problem?

Acquirers should watch out for the following land mine when reviewing a potential target: the target's track record of reimbursed political contributions or conduit contributions. At the federal level and in many states, it is a violation of criminal law for companies to reimburse employee political contributions or to route political contributions through intermediary conduit entities. These laws are aggressively enforced and have resulted in major penalties. In California, for example, an alleged conduit contribution scheme resulted in a $1 million civil fine. And there have been several recent high-profile examples of criminal penalties assessed against those involved in campaign contribution reimbursements. As a result, during due diligence, the acquirer should inquire regarding any history of such arrangements.

4. Has the Company Violated Campaign Finance Laws?

The federal government and each state have adopted a complicated patchwork of laws regulating corporate involvement in elections. These laws are not intuitive and it is relatively easy for well-intentioned employees to inadvertently violate them. In order to avoid walking headlong into a campaign finance scandal, an acquirer should be on the lookout for certain campaign finance red flags. These include the absence of policies adopted by the target governing the use of corporate resources in elections, a history of excessive or illegal corporate contributions or a record of foreign national involvement in the company's U.S. election activities. The due diligence should also include a review of the target's political action committees. An acquirer should confirm that the political action committee reports are accurate and timely filed, that the PAC bank account reconciles to the reports, that the PAC solicitations are not unlawfully coercive and that the PAC is not soliciting contributions from individuals who are outside of its "restricted class." Red flags here include an unusually high percentage of employees who are PAC contributors (which could suggest coercive solicitations), PAC reports identifying donors with occupations that may fall outside of the restricted class (e.g., administrative assistants or assembly line workers), and the failure to conduct a recent legal or financial audit.

The diligence process is also a good opportunity for the acquirer to prepare for steps that should take place at or near closing, such as merging or affiliating the target's PAC with the acquirer PAC or terminating the target's PAC.

5. Do Corporate Executives Impermissibly Use Corporate Resources to Support Their Personal Political Activities?

Acquirers should be on the lookout for companies with politically-active executives. It is not uncommon for politically-active executives to ask the company's government affairs staff or their support staff to help them in hosting a candidate fundraiser or conveying a contribution check to a candidate. This kind of activity can result in illegal corporate contributions to the benefiting candidate. In addition, politically-active executives may expect the company to engage aggressively in politics, resulting in a corporate culture that encourages heavy-handed PAC solicitations or the improper tying of campaign contributions to corporate lobbying activities.

6. Has the Company Provided any Illegal Gifts to Government Officials?

The federal government and most states limit gifts corporations may give to government employees and officials. Some so-called "no cup of coffee" states even bar de minimis gifts. Any allegations of prior gift rule violations should be carefully reviewed during the diligence process. A history of violations or the failure to adopt a policy that requires legal review of proposed gifts to government officials can be a significant concern.

7. Are Company Officials Violating "Revolving Door" Rules?

If a target company is hiring individuals from government, those government officials may be subject to post-government employment rules that restrict their activities for their new employer. The duration of these restrictions ranges from one year to life and some of these restrictions prohibit these former government employees from providing "behind the scenes" advice about the company's lobbying activities. Companies often overlook these restrictions and hire former government employees to perform certain roles, only to later learn that the individual is legally barred from working on projects the company envisioned when the individual was hired. Because many of these revolving door laws derive from criminal laws, acquirers should determine whether the target company complies with them.

8. Is There a Looming FARA Problem?

In recent years, the Foreign Agents Registration Act, a 1930s era criminal statute, has experienced a dramatic increase in attention from the U.S. Department of Justice and the press. The statute is broadly-worded, vague, has little interpretative guidance and is increasingly enforced. In general, FARA requires persons who engage in the United States in political activities or certain other activities as an agent of a foreign principal — including a foreign individual, company or organization — to register and file burdensome reports with the Department of Justice. Accordingly, if an acquirer is conducting diligence with respect to a target company with foreign ownership or substantial foreign operations, the diligence should assess the FARA risk, particularly if there are indicia that the target's work benefits a foreign government. Any existing FARA registrations and reports should be carefully reviewed. If the target company is a consulting firm, lobbying firm, public affairs firm or public relations firm, or a media company, the client lists should be examined for potential FARA risks.

9. Is the Company A CPA-Zicklin Index "Basement Dweller"?

Since 2011, a group called the Center for Political Accountability has encouraged public companies to voluntarily disclose more information about their political spending by posting this information to their websites. Based on this website information, the Center for Political Accountability scores public companies on their levels of political spending transparency. Companies with low scores have been the targets for shareholder proposals, litigation and negative press. In particular, the annual "CPA-Zicklin Index" calls out low-scoring companies by name as "basement dwellers." Prior to purchasing a public company, an acquirer should therefore review the target's CPA-Zicklin score in order to assess the likelihood that the target might face criticism from the press, reform groups and others.

10. Does the Company Have Appropriate Political Law Compliance Policies in Place and Has It Conducted a Recent Political Law Compliance Audit?

Companies that interact with government officials should adopt policies and standard operating procedures governing political law compliance. Common policies include those covering corporate and personal political activities, lobbying, giving gifts to government officials and hiring government officials. The absence of any such policies — or the lack of awareness of existing policies — increases the risk the acquirer will inherit a pre-existing violation of political law, leading to legal and reputational consequences.

Companies should also conduct periodic political law compliance audits — once every election cycle is a good rule of thumb. The absence of a compliance audit, or the failure to implement the recommendations of previous audits, may raise questions about the target's oversight of political activities.

Conclusion

Political law diligence is an essential component when conducting diligence on a target company that interacts with federal, state or local governments. Because undetected political law issues can result in major legal and reputational problems for both the target company and the acquirer, acquirers should know the political law risks they are inheriting before closing. By paying attention to political law concerns during diligence, the acquirer can, if necessary, adjust purchase terms to account for these risks and take steps to resolve molehill-size compliance problems before they become mountains.

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