

Professional Perspective

M&A Implications of International Conflict

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M&A Implications of International Conflict

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The war in Ukraine highlights the potential consequences of international conflict and worldwide market impacts. This article provides a short guide for considering M&A and private capital investment in the case of such events, including due diligence of risk surrounding sanctions, money laundering, corruption, and cybersecurity.

The Extent of Sanctions

International conflict can trigger new sanctions or stricter enforcement of existing sanctions. Both have been happening as a result of the Russian invasion of Ukraine.

Violations of sanctions or related export restrictions, many of which are strict liability offenses, can result in large fines and even criminal prosecution. In the M&A context, many acquiring companies fail to appreciate the extent to which they can face successor or other liability for any violations committed by the entity they acquire.

Sanctions blocking the access of the Russian central bank to its foreign reserves, in conjunction with those against other Russian financial institutions, have had profoundly negative effects on the Russian economy.

The precipitous decline in the Russian economy has adversely affected Western enterprises that have investment and trade relations with Russia. However, its impact on Western economies as a whole, as opposed to particular enterprises, is not expected to be severe.

In contrast, Western economies and consumers could suffer significantly from sanctions against Russian exports upon which those economies depend, including Russian oil, natural gas, or agricultural exports.

Another major focus of sanctions is Russian banks and Russia-related financial transactions, notably the issuance of new debt and equity by major Russian state-owned enterprises, payments processing by Russian banks, and the markets for Russian sovereign debt. Furthermore, the sanctions include stringent export restrictions on items subject to the Export Administration Regulations (EAR). The sanctions against Crimea and the separatist regions of Donetsk (DNR) and Luhansk (LNR) have been comprehensive. Virtually all activities with those regions were blocked.

Due Diligence of Sanctions Risk

In their due diligence investigations of target companies, potential buyers should pay special attention to risks relating to sanctions or export controls. If the risks are improperly evaluated, or arise, the value of an acquisition can be destroyed.

The potential buyer should start by identifying links, direct and indirect, between the target company and Russia, Belarus, Crimea, and the separatist regions of Ukraine. The links may not be obvious, including because schemes to evade sanctions seek to go undetected.

For example, the target company may be part of a supply chain involved with the separatist regions, Russia or Belarus, which involvement may be indirect through persons illegally providing material support to sanctioned persons. In particular, technology companies frequently use software developers in Russia.

Russian companies and oligarchs have been able to obfuscate their ownership interests in various companies to avoid sanctions. Companies trying to ascertain whether a target has connections to sanctioned Russian entities or individuals can encounter a maze of shell companies that make ascertaining the actual ownership difficult or even impossible.

If there is a U.S. nexus, any links between the target company and Crimea or the Donetsk and Luhansk separatist regions will likely be forbidden by the sanctions. Links with Russia and Belarus will not necessarily be prohibited, so they will often need to be checked against the global lists of sanctioned individuals and enterprises, including those maintained by OFAC, the EU, and the U.K.

Even if links to Russia and Belarus do not fall within the ambit of the sanctions, they may be susceptible to a risk of future sanction. For example, the list of sanctioned individuals has been expanding. Because the sanctions are a moving target, as well as a specialist legal subject, potential buyers are well-advised to have their sanctions due diligence done by law firms with expertise in U.S., U.K. and European sanctions, even if they use their regular legal counsel for other aspects of an M&A deal.

Outside of the legal realm, unsanctioned links to Russia and the Belarus may still be problematic, because of the major economic difficulties resulting from the sanctions. Many U.S., U.K., and EU financial institutions and other companies will refuse to process financial transactions relating to Russia or Belarus, even if technically permissible under the relevant regulations. These difficulties, combined with moral outrage over the Russian invasion, have prompted numerous companies to curtail business relating to Russia.

In conjunction with their due diligence investigations relating to sanctions, potential buyers should include in their acquisition agreements specific representations as to compliance with sanctions, export controls, anti-money laundering laws, and anti-corruption laws. Based in part on their due diligence investigations, potential buyers will need to decide to what extent they will accept any risks in these areas. These risks may be partly allocated to them through quantitative and qualitative limitations on their rights to indemnification for breach of representations.

Anticipating the focus of potential buyers on these risks, sellers should evaluate them in advance of any sales process and prophylactically address issues to the extent appropriate or desirable. A proactive approach to risk management will usually help a seller achieve greater buyer interest and a higher price.

Whereas a potential buyer may be unwilling to accept much, if any, allocation to it of these risks when they relate to the current circumstances of the seller, the seller may be unwilling to bear these risks when they arise from future developments, such as changes in regulation or the state of the war in Ukraine. These material adverse effects would typically be excluded from the MAE provision allowing the buyer to abandon the transaction when certain negative events occur after the signing, but before the closing, for it.

In contrast, the war in Ukraine may serve as grounds for suppliers to walk away from their contracts with the seller if performance is excused by force majeure provisions in them or common law doctrines applicable to them—impossibility, impracticability, or frustration of purpose. This risk will typically be addressed in acquisition agreements by standard representations relating to material contracts.

Due Diligence of Money Laundering & Corruption Risk

Evasion of financial sanctions will often give rise to related money laundering activities. For this reason, where the potential buyer or seller is a private equity fund, the due diligence investigation should extend to the sources of its funds as well as an understanding of the ultimate natural person beneficiaries of the underlying transactions.

Such due diligence exercises should involve a full exploration up corporate chains to understand the persons that own or control entities, such as limited liability companies and trusts. EU-based private equity funds should already be undertaking due diligence investigations of this sort in connection with their obligations to comply with anti-money laundering laws. U.S.-based private equity funds are not subject to the same AML due diligence legal requirements as their EU counterparts, though an AML due diligence representation in the acquisition agreement can compensate for this deficiency.

Not infrequently, money laundering is the consequential result of corruption as corrupt public officials seek to hide the origins of bribes and other ill-gotten wealth. In the past, corruption in Russia was apparently not a significant concern for the West, since expatriation of large sums of money by Russian elites for purchases of real estate and luxury items was largely tolerated, if not accepted.

Recently however, a new perspective appears to be emerging that corruption in Russia has had ill effects in the West as well as Russia. In particular, the U.S. and U.K. responded to the invasion of Ukraine by targeting the overseas assets of Russian “oligarchs” on the basis that many oligarchs have effectively served as facilitators of the Putin regime.

The Foreign Corrupt Practices Act and the OECD Convention Against Bribery have been more actively and broadly applied as the U.S. and other countries have become more concerned about the negative effects of foreign corruption. The crack-down on Russia could very well be the impetus for even stricter enforcement of anti-corruption and anti-money laundering

laws. If so, it likely will extend beyond parties located in Russia or Belarus, since U.S. and U.K. governmental authorities are likely to cast their net wide in pursuit of infractions and to prosecute those they happen to catch in it.

Cryptocurrency transactions have been tied to the risk of money laundering in general and evasion of financial sanctions by Russia in particular. Despite the enthusiasm for cryptocurrency as an alternative to state fiat currency, the lack of transparency that typifies most cryptocurrency transactions is of particular concern in the context of the Russia sanctions.

The U.S. [has identified](#) cryptocurrency transactions with Russian parties as a potential red flag that should receive additional scrutiny in the context of AML compliance procedures. The trend towards greater regulation of cryptocurrency, which had already begun before the invasion of Ukraine, will likely be reinforced as a result of it.

Due Diligence of Cybersecurity Risk

Apparently motivated purely by financial gain, Russian hackers were a major source of ransomware attacks prior to the Ukraine invasion. President Joe Biden and Western intelligence agencies have warned of an even higher risk of cyberattacks emanating from Russia, in retaliation for the sanctions against Russia.

Whether the Russian government would conduct such attacks directly or through state-supported hackers, or flagrantly turn a blind eye to private hackers based in Russia, remains to be seen. However, it is often the case that companies subject to ransomware attacks are instructed by their attackers to make payments in cryptocurrency in order to regain access to their stolen data. An increase in cryptocurrency payments by parties that have historically transacted in fiat currencies may be an indication of a ransomware payment or a transaction designed to evade sanctions. For these reasons, such transactions should be carefully reviewed before they are accepted.

More broadly, given the heightened concerns about cyberattacks, potential buyers should pay special attention to the need for cybersecurity due diligence in their deals and related representations in acquisition agreements. In the case of transactions involving public companies, potential buyers should be mindful of their disclosure obligations relating to cybersecurity, including the [proposed rules](#) in this area recently issued by the Securities and Exchange Commission.

Altered Markets for M&A

M&A practitioners need to take into consideration changes in the business environment relating to the invasion of Ukraine. Following are some salient developments to watch closely.

- **Energy:** The cost of oil and gas has increased dramatically and will likely remain comparatively high. As a result, there seems to be increased interest in M&A in the North American oil and gas sector. In Europe, the development of renewable energy as a substitute has been accelerated, which will likely generate opportunities for M&A and private capital investment. Additionally, a desire to reduce dependence on gas may promote increased activity in the electric vehicles industry, already an area of huge growth potential.
- **Inflation:** The rise in energy prices is fueling inflation, which was already a problem before the invasion of Ukraine. In response, the U.S. Federal Reserve has increased interest rates and has signaled an interest in future increases. Consequently, debt financing of M&A deals is becoming more expensive.
- **Tech:** Because of their effect on discount rates, rising interest rates are one of the causes of the decline in valuations of technology companies. Many think a correction in these valuations was overdue, but believe in digital transformation and other long-term technology trends. Lower valuations in the technology sector may be a buying opportunity.
- **Defense:** Defense spending is going up. Because of China's support so far for the Russian invasion and, by implication, the expansionary use of force in violation of countries' sovereignty, this is likely to be a trend in Asia, as well as Europe.
- **China:** China's support for Russia could go too far, provoking rapid and extensive economic decoupling of the West from China. Many businesses could be hurt by such a miscalculation by China.
- **India:** India is reportedly exploring ways to evade sanctions against Russia and to exploit business opportunities arising from them. Western countries could take measures in response that adversely affect Western companies doing business in and with India.

Conclusion

The Ukraine invasion and related developments are, like the pandemic, a tragedy with terrible human cost. Nevertheless, they may, like the pandemic, increase economic and transactional activity as governments and market participants react to avoid damage and fill market vacancies.

Some of this activity is likely to take the form of M&A, because M&A is one of the most rapid ways for enterprises to mitigate or take advantage of market dislocations, including in relation to the developments highlighted above. Successful efforts to do so will need to meet the due diligence challenges, and make advisable enhancements, in certain areas, including specifically sanctions, export controls, anti-money laundering, anti-corruption, and cybersecurity.