

Why is anti-corruption due diligence relevant in mergers and acquisitions?

Highlights:

- Trends indicate increased enforcement and relevance of anti-corruption due diligence in M&A
- A risk based approach is required, with the timing, nature and extent of the due diligence dependent on the circumstances of each M&A

Anti-corruption compliance trends

The trends are clear, anti-corruption compliance is becoming increasingly more important to companies. From the perspective of mergers and acquisitions (M&A) it is no different - the acquisition of targets engaged in corruption can significantly impact deal value. The risk of inheriting a target company's ineffective anti-corruption compliance practice is highlighted by the possible answers to the following questions:

- How sustainable is the target company's business in the absence of corrupt activities?
- How much will it cost to remediate the weaknesses in the target company's internal controls?
- What is the impact of regulatory action (penalties and fines) and civil claims from both a financial and reputational perspective?

The possible answers to the above questions should be assessed from an M&A perspective in the light of certain recent regulatory, economic and overall business trends. The trends indicate increased enforcement of anti-corruption laws with cooperation between regulators from different territories, resulting in increased fines and penalties. This increased enforcement trend, not only by US regulators, but by European regulators (e.g. Germany), is expected to continue for the foreseeable future. Other trends to consider are: greater exposure to corruption risks by globalised businesses operating in, and expanding into, emerging markets; and, the increased likelihood of breaches of anti-corruption laws given greater pressure to meet targets, or even to stay in business, in the current economic down-turn.

A further development that companies should take into consideration is the Bribery Bill that is currently before parliament in the UK. The scope of the Bill is broad in that it is applicable to UK individuals and companies, as well as companies conducting business within the UK. Of particular note is that companies incorporated outside of the UK that "carry on all or part of business" in the UK can be found guilty of the offence of failing to prevent bribery in the absence of what is referred to in the Bill as "adequate procedures".

A risk based approach

With these trends and developments in mind, it is important for companies to consider a risk based approach in determining the necessity to conduct anti-corruption due diligence during the M&A process. One of the first factors to consider is whether the target is listed in the US or is operating in the UK and what is the extent of such operations. Other factors include the territory and industry within which the target operates, the extent of its government business, the use of intermediaries to conduct business and the robustness of the target's compliance framework.

It should be noted that no single factor may result in an assessment that a target has high corruption risk exposure, but one should rather assess the factors as a whole to determine the actual risk of corruption and the related impact such risk could have on deal value.

An example where anti-corruption compliance issues played a role in an M&A transaction was in Elandia International Inc's acquisition of Latin Node Inc in 2007. As a result of irregularities discovered during Elandia's post-acquisition financial integration review, Elandia conducted an extensive internal investigation resulting in Latin Node pleading guilty in April 2009 to criminal charges in connection with approximately \$2.25 million paid in bribes to officials of two state-owned telecommunications companies in Honduras and Yemen for the award of new contracts and the negotiation of favourable terms on existing contracts, and paying a penalty of US\$2 million¹.

The impact to Elandia was however much higher in that they "determined that the \$26.8 million purchase price was approximately \$20.6 million in excess of the fair value of the net assets acquired from Latin Node mostly due to the cost of the FCPA investigation, the resulting fines and penalties to which it may be subject, the termination of Latin Node's senior management, and the resultant loss of business²".

1. Elandia Form 10-Q filed on 14 August 2009 with the SEC

2. Elandia Form 10-Q/A filed on 5 September 2008 with the SEC

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Another example is KBR Inc and Halliburton agreeing to pay US\$177 million in disgorgement of profit in February 2009 to settle SEC charges. Kellogg Brown & Root, a subsidiary of KBR further agreed to pay US\$402 million to settle parallel criminal charges brought by the DoJ. It was alleged that Halliburton's internal controls failed to detect or prevent the bribery that started before Halliburton's acquisition of Kellogg Brown & Root, which continued afterwards³.

When and how to conduct anti-corruption due diligence

The timing, nature and extent of anti-corruption due diligence will be dependent on the circumstances of each transaction and can be influenced by the level of access given to the target's personnel and books and records.

Regulators have a growing expectation that acquirers assess a target's anti-corruption compliance practices while conducting due diligence, particularly US regulators. This is illustrated by an opinion release issued by the DoJ based on questions posed by Halliburton during a more recent acquisition process than the acquisition referenced above⁴. In this instance, Halliburton was unable to perform full anti-corruption due diligence as a result of legal restrictions relating to the bidding process for a public UK company.

In the opinion release the DoJ indicated that it did not intend to take enforcement action against Halliburton for any potential past corruption violations by the target provided that Halliburton undertake the following should it be successful in acquiring the target:

- Conducting a comprehensive, risk based anti-corruption due-diligence using external counsel, third-party consultants including forensic accountants as well as internal resources.

- Taking of specific action relating to agents and third parties including termination of contracts and remedial action where anti-corruption compliance issues were identified and entering of new contracts with the appropriate anti-corruption terms where no anti-corruption issues existed or were resolved.
- Imposing Code of Business Conduct and anti-corruption policies and procedures on the target, including effective communication thereof and providing training to employees and officers of the target.
- Disclosing any corruption and related internal controls and accounting issues to the DoJ.

Interestingly, in guidance that the UK Serious Fraud Office (SFO) issued in July 2009, provision is also made for "an opinion procedure" whereby companies can approach the SFO for guidance when they discover overseas corruption during the process of acquiring another entity⁵.

Conclusion

The above noted trends indicate the importance of anti-corruption compliance for companies, not only in their existing operations, but also when involved in M&A transactions. Acquiring a target with anti-bribery compliance issues can significantly impact deal value, reputation and the like. To safeguard against these risks, companies should carefully consider the merits of conducting anti-bribery due diligence of M&A targets, applying a risk based approach to determine the suitability, timing, nature and extent of such due diligence.

To have a deeper conversation about how this subject may affect your business, please contact:

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3. US Department of Justice press release – 11 February 2009

4. US Department of Justice Opinion Procedure Release 08-02

5. SFO communication "Approach of the Serious Fraud Office to dealing with overseas corruption" dated 21 July 2009