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Staying Ahead of Corruption Liabilities

Companies pursuing cross-border deals need a detailed FCPA due diligence process to address potential pitfalls.

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The discovery of bribery of a foreign government official after closing an acquisition is one of the fastest ways to lose company value, given that the regulatory and legal fines, penalties and remediation costs can be significant. Even without regulatory action, fraud and illegal acts pose a barrier to operational efficiency for a strategic or financial buyer. For an investor, the post-acquisition discovery of a fraudulently enhanced revenue stream will not only erode company profitability but will also impact exit realization and the internal rate of return.

As corporations continue to acquire new businesses, expand globally and enter new emerging markets, they must be cognizant of the increased exposure to the US Foreign Corrupt Practices Act (FCPA) and other international anti-corruption laws and regulations. Recently, the US Department of Justice (DOJ) issued an opinion concerning potential FCPA implications surrounding a proposed acquisition. The areas highlighted in this opinion demonstrate the need for companies making global acquisitions to have a robust FCPA and anti-corruption due diligence process including an assessment of the relevant risk factors. A detailed FCPA due diligence process can address potential pitfalls seen in high risk market transactions.

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A significant number of FCPA enforcement actions in 2007 arose in the context of a merger or acquisition. Yet nearly 30% of companies that acquired a new business in the last two years never or infrequently considered bribery or corruption risks in the context of a potential acquisition, according to Ernst & Young's 10th Global Fraud Survey, "Corruption or Compliance: Weighing the Costs." Only one-third of survey respondents claimed to have some level of knowledge about the FCPA and fully 58% of senior in-house counsel were not familiar with the FCPA.

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While more than 45% of respondents claim to routinely conduct anti-corruption due diligence, the continued flow of FCPA enforcement actions suggests that representations and warranties relating to bribery and corruption are only one step in protecting the acquiring company and its executives from successor liabilities, such as fines, penalties and imposition of a monitor. Furthermore, the purchase price may have been inflated if predicated on revenues obtained due to questionable payments.

In many countries, the line between state-owned and private entities is unclear, making it difficult to determine whether payments to government officials are occurring. Third-party agents or consultants may facilitate payments of bribes to government officials, or may indirectly be government employees themselves. Illegal practices may continue after a company is acquired, putting the acquiring company at risk of major fines for the pre- and post-acquisition activities of a target company.

Experience shows that dealmakers can mitigate the risk of FCPA noncompliance, even within the limitations of the due diligence period. In a

June 2008 opinion commonly known as "the Halliburton opinion," the Department of Justice took a position allowing Halliburton to proceed with the submission of a bid for a target where due to the UK tender offer rules, FCPA-related due diligence would not be performed until after the acquisition closed. The opinion hinged on Halliburton's commitment to successfully implement the comprehensive FCPA and anti-corruption program that the company had proposed, to disclose and promptly resolve any violations discovered post-close, and to meet the DOJ's other rigorous conditions.

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While this DOJ opinion applies only to Halliburton and its full impact remains to be seen, it reflects the high standards the DOJ expects acquirers to meet for FCPA compliance and underscores the importance of having an FCPA due diligence strategy.

The first step in FCPA-specific due diligence should be a risk assessment, implemented during the initial phase of the overall due diligence process and revisited as new information emerges. Such a risk assessment helps to identify areas of potential exposure, areas requiring performance of specific procedures and red flags. Examples of the components of a risk assessment include: identification of relevant anti-corruption laws and the industries in which the target operates, geographic considerations, level of interaction with government entities, internal audit findings, use of third party intermediaries, commission structures, travel and entertainment, gifts, competitor information and use of non-controlled entities.

In addition, the risk assessment sets the agenda for FCPA-related pre- and post-closing procedures, which should include a detailed analysis of, among other items, accounts that generate cash payments — such as travel and entertainment, charitable donations or consulting fees — and could potentially be used to pay bribes. Because the due diligence team may have limited information, the pre-close procedures can help an acquirer develop an effective detailed post-closing plan.

A post-closing FCPA and anti-corruption plan should also include integration of the compliance programs of the purchaser as part of the integration process. In Halliburton's request to the DOJ, the plan included special training for employees in high-risk areas such as sales, management and accounting.

Highly effective FCPA anti-corruption due diligence processes can help the acquirer to identify broad risk areas, allow them to assess their tolerance for such identified risk and build appropriate remedial action into a post-close integration plan. The plan should include a detailed follow-through on any unresolved issues identified prior to acquisition.

The risks and issues identified pre-closing should be incorporated when determining the real value of the target. Should corruption issues emerge post-closing, timely and thorough vetting of the potential risks in the due diligence process can strengthen the argument for leniency in any enforcement proceeding.

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