

In a world dogged by corruption, buyers and sellers alike are turning to reputational due diligence firms to help uncover fraud and bribery during takeover negotiations. **Adam Durchslag** reports.

RED ALERT

Glancing over Transparency International's world map of corruption, most of the world has been painted red; it is thus corrupt according to the NGO's definition. Avoiding this scourge has become nigh impossible, given that the world is firmly interconnected but no less divided.

When it comes to M&A, an acquirer needs to know in advance any pitfalls it may be walking into when it buys a company, and what that means for it further down the road.

"Obviously an acquirer is going to take on

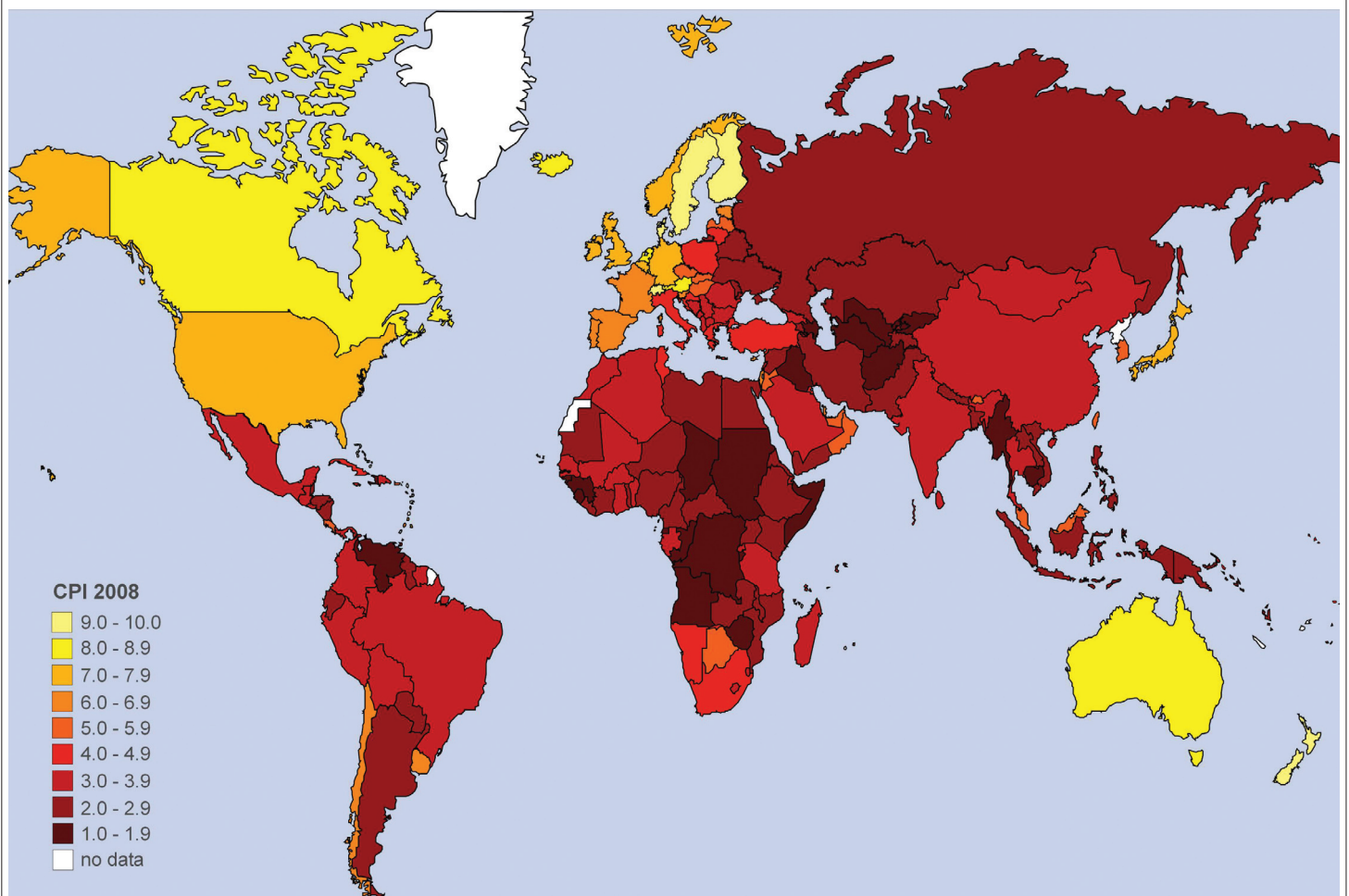
liabilities that any target may have, including possible instances of bribery or other forms of corruption in its practices," says Gordon Rainey, a senior consultant in the corporate investigations team at Control Risks.

"There have been a number of instances in which this has happened, and the acquirer has subsequently incurred substantial fines from US regulators and elsewhere," he adds.

Uncovering corruption – defined principally as bribery – early on in the negotiations, or discovering fraud – which can be anything from covering up that bribery to other forms

of money laundering and embezzlement – are key drivers behind reputational due diligence.

This is in essence about "knowing your customer". And broadly speaking, that involves vetting covertly (and occasionally, overtly) the people behind the target company and uncovering any fraudulent activities that might lurk there. Are these people who they say they are? Have they done what they have claimed? Have they done other things that they should have disclosed? Unravelling corruption, such as illegal payments made to government officials to win or retain contracts,



Source: Transparency International. The Corruption Perceptions Index measures the perceived levels of public-sector corruption in a given country. The scores range from zero (highly corrupt) to ten (highly clean).

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is merely one part of the reputational due diligence process.

Doing business with corrupt companies, regimes, or countries, does not mean that you are by nature corrupt or, indeed, are corrupted in the process. One has to be rational in such situations and accept corruption cannot be completely circumnavigated if certain business is to be won or retained, in

a world to varying degrees ruled by self-interest and amorality.

Rather than steering clear of doing business with those with a bad smell, companies should manage the risks in their conduct of their business. This is particularly in light of the recent scandals surrounding Bernard Madoff, Sir Allen Stanford and subprime mortgage securities as well as other long

running sagas involving Siemens and the Al-Yamamah arms deal.

"Reputational due diligence is certainly something that we have noticed our clients thinking about in more detail," says Heyrick Bond Gunning, managing director at Salamanca Risk Management. "They have a bit more time, and they and their investors are a little more cautious."

M&A RISKS IN CURRENT MARKETS

The existing M&A market is split between prevarication, as some companies nervously sit on the sidelines, or heightened risk taking by others, as opportunities present themselves in unfamiliar territories where investors are more likely to encounter a myriad of risks at a time when the regulatory environment is tightening.

Debt financing is no longer the easiest route to produce stellar returns. The economic environment calls for assets to be sweated which requires a truly effective management team, combined with more than a cursory understanding of the risks. Opportunities in new markets not only bring the chance of greater gains but also the exposure to unfamiliar risks such as a lack of transparency, corruption and bribery which are all too often a pre-requisite to 'oil the wheels of commerce'. Even as the US Foreign Corrupt Practices Act (FCPA) becomes the de facto anti-bribery standard worldwide, Ernst & Young's 10th Global Fraud Survey identified that over 50% of US executives — and a shocking 84% globally — know little to nothing of its key provisions.

When combined with political and country risk analysis, a range of protective tools from reputational due diligence through to occupational psychology help to identify potential problems early. This minimises wasting time on unrealistic opportunities whilst providing transparency on those that are fraught with risk. It also plugs the gap between the work that the lawyers and accountants do, by providing a 360 degrees background check on a target company and its affiliates.

Online Reputation Management is another tool, which can be effectively utilised where the public perception of a deal or company is negative. This was most effectively demonstrated during the Obama election campaign where campaign managers countered negative stories on the web through search engine optimisation. Thus, fundamental to success in emerging markets is the ability to understand the full breadth of risk around a project.

However, the present trend (70%) is for retrospective actions following deals that have gone sour, with service providers instructed to investigate the wrongdoings of directors and to help in the subsequent attempts at reputation management, asset recovery and evidence gathering. Understanding risks early and having the mitigation tools to hand can transform adversity into opportunity.

It is almost inevitable that those countries offering the greatest rewards are also highlighted as high risk on Transparency International's world map of Bribery and Corruption. The examples of Iraq and DRC exemplify the difficulties faced.

Democratic Republic of Congo – Natural Resources

The US Department of State described corruption in the DRC in 2007 as "pervasive." Transparency International's 2007 Corruption Perceptions Index identifies the DRC as one of the 10th most corrupt countries in the world. Furthermore, The World Bank has reported that the DRC's judicial system is one of the world's six

weakest in terms of enforcing commercial contracts. It is this institutional weakness that has allowed corruption to flourish.

At the lower levels, corruption targets the naïve and is evident from the moment one enters the country, whether it is US\$50 required to overcome a Yellow Fever immunisation document problem or payments required at Police checkpoints. At the other end of the scale, the abundance of natural resources in the DRC enables corruption on an enormous scale as government officials use bribery to share in resource profits. For example, it is estimated that through extensive bribery and corruption in the mining sector, exports of large quantities of DRC copper and cobalt have been undeclared and that 60 to 80 percent of the DRC's 2005-2006 customs revenue was embezzled. A payment in kind or in cash is often required at every step of the process.

It is possible to operate without using bribery but this requires patience, time, an extremely robust anti-bribery policy and above all, local knowledge.

Iraq: Reconstruction

Iraq was ranked 118th in Transparency International's 2003 Corruption Perception Index, with a CPI of 2.2, but descended to 178th in 2007 with a CPI of 1.4, making it the third most corrupt country in the world.

The demise of Saddam Hussein's regime saw the removal of any form of state control and in the ensuing vacuum the country descended into anarchy. The population sought to compensate

itself after years of repression; the initial indiscriminate looting was replaced with institutionalised corruption. Vast amounts of money poured into the reconstruction effort and billions of dollars have remained unaccounted for and lost to corrupt practices.

"In Iraq, allegations range from petty bribery to large scale embezzlement, expropriation, profiteering and nepotism." A Transparency International Report has stated that the corruption in Iraq will probably become "the biggest corruption scandal in history". A Coalition Provisional Authority report by Stuart Bowen found that US\$8.8bn from Iraqi oil revenues had been distributed by US administrators to Iraqi ministries without proper accounting procedures. Consequently, the money has virtually disappeared.

Whilst setting up DHL in Iraq, the author saw a variety of levels of corruption. This came in the form of bribes being issued to customs officials through to the almost constant stream of 'officials', who went as far as waiting at his hotel to demand payment for everything from office space and land through to services that hadn't been delivered.

Even so, there still are numerous opportunities within Iraq, but it is necessary to undertake rigorous analysis prior to committing; to perform due diligence on clients and opportunities involved; and to ensure that the necessary mitigating procedures are put in place to counter the risks uncovered.

*Heyrick Bond Gunning,
Salamanca Risk Management*

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Apart from Sir Allen's role in an alleged US\$8bn Ponzi scheme, all of these scandals originated in parts of the world that, according to Transparency International, have the least amount of corruption. But perhaps it is because Western democracies are more transparent than other parts of the world that such putrefaction has indeed been uncovered.

The Foreign Corrupt Practices Act

Philosophers have long argued whether man – and by extension, his corporations – are by nature good or bad. Kant concluded that “he is neither; for he is by nature not a moral being at all; he becomes a moral being only when his reason raises itself to the concepts of duty and of law.”

Raising oneself in this way has arguably led

to the rule of law and, sometimes to its destruction as history has shown. And it is the rule of law – especially as laid out by the US Foreign Corrupt Practices Act (FCPA) – that is doing quite a good job of trapping companies in what is known as the “FCPA dilemma”.

Proving beyond a reasonable doubt in a court of law the intent to bribe a foreign government official to obtain or retain business would otherwise be much more difficult.

“One piece of the FCPA which to the best of my knowledge is unique is its accounting provision because it catches companies out,” says Tommy Helsby, Kroll's chairman for EMEA. “The bribe has got to come from somewhere. The money needs to be accounted for within the bribing company's accounts. There's the FCPA dilemma: if I account for it

as a bribe, I am admitting a crime; if I disguise it, I am committing a crime.”

The accounting provision therefore provides the excuse the Department of Justice (DoJ) and Securities and Exchange Commission (SEC) need in order to launch a full-scale investigation of a suspect company. While the DoJ is responsible for all criminal and civil enforcement against US persons (citizens, residents, or other) and companies, as well as their foreign counterparts, the SEC deals with the civil enforcement against issuers of US-registered securities.

The authorities have indeed become very innovative in how they apply the FCPA to companies. If, for example, individuals or companies (domestic or foreign) are caught using US interstate commerce such as email

READ THE SMALL PRINT

Now is the time for all good men ... to read the small print. Out of all those deals done when the economy was hot and time was short, many are now looking somewhat pale, perhaps even decidedly sickly, and the natural and sensible inclination is to decide who and what to blame. Natural, because that's human nature; sensible, because understanding what happened and how it will help address the problems and perhaps provide some basis for relief.

Not so long ago, you could rely on the “greater fool” principle for relief: however stupid you may now be feeling for buying the company at that price, there's bound to be a greater fool out there to whom you can sell it. While that is probably still true, the greater fool no longer can find the financing to pay for it: according to Thomson Reuters, sellside financial sponsor activity is down 88% for H1 2009 versus Q1 2008. So it is increasingly likely that you are stuck with dealing with the problem yourself.

Increasingly, Kroll's clients have been coming to us suffering from varieties of buyer's remorse. Sometimes the business simply is not performing as promised (but then, who is?); sometimes it's not quite the business that had been described by the seller; and sometimes it included some very undesirable surprises—corrupt re-

lationships with clients, undisclosed contracts or disputes, management self-dealing or environmental time bombs. Here's where the small print comes in: the reps and warranties, the rescission clauses and the claw backs that you may have felt your lawyer was just drafting to bump up his billable hours suddenly all seem worthwhile.

There was the private equity company backing a roll up strategy in Europe. The original acquisition was good—proper hands-on due diligence by the fund. The problem came with one of the add-ons, where the acquisition was led by the portfolio company management—good technologists but not so experienced in acquisitions. Key contracts turned out to be in dispute and close to termination; various services were contracted out to related parties to the seller on non-competitive terms; and the longer they looked, the worse it got. We helped them get a handle on how deep the problem was, and how to wrest control of the business from the seller (he was still in situ); then to define precisely the misrepresentations (was it fraud or just excessive gilding of the lily?); and then prepare for negotiations, with appropriate threat of litigation as an alternate, to remove the seller as director of the roll up entity, cancel

the back end of the purchase price and even take back some of the front equity in the deal.

Another recent case involved a multinational, listed heavy machinery company which had bought a private company with good complementary market coverage, only to find that one key national market was entirely corrupt: all of the key client relationships were secured through bribery. There had been some indication of it in the due diligence, but the seller claimed to have cleaned up the business, put in place proper contracts and financial structures that prevented such abuse. New financial structures had indeed been put in place, but only to hide the fact that nothing at all had changed. Helping to document and specify this gave the client ammunition to make a nine figure recovery from the sellers.

One could go on, but it begins to get depressing. The important point is that when the deal sours, you don't necessarily have to put up with it. Post-transaction due diligence may seem like post event stable door shutting; but when there are still horses present, that's a good idea. Obviously, as the owner rather than the buyer (or worse, the bidder in an auction), you have far more access and control over the process. This implies some very different

approaches, requiring different skill sets. Sharp eyed forensic accountants will get more from the numbers than even the Big Four transaction team. Better yet, support them with a team experienced in data mining, a technique we use to expose patterns of fraud and abuse in very large volumes of accounting data. Interviewing key staff, customers, suppliers and even regulators—call it a “compliance audit”—will tell you things you really do need to know. It is shocking how often we hear, “I wondered when someone was going to ask me about that” or “I wanted to say something but I wasn't sure who to tell”.

The exercise may require different people as well as different skill sets. If things have gone terribly wrong, the advisors who helped put together the deal may not be the right ones to perform the post hoc review. At the very least, they will want to come out smelling of roses. At worst, they may be sharing the blame and perhaps carrying some of the financial consequences.

But spare a kind thought for the lawyer who drafted the dull but critical small print. Next time you see him, say thank you; assuming, that is, that you didn't let the seller delete those paragraphs.

Tommy Helsby, Kroll

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in furtherance of a corrupt payment to a foreign government official, the US government can prosecute them.

“When an SEC company buys another company that is not SEC-registered, then you have an immediate potential problem,” says Helsby. All of a sudden, the law can apply. Any issues that emerge in due diligence need to be disclosed to the SEC and DoJ.

Regulatory misbehaviour is a communicable disease; becoming unwittingly infected through an acquisition, because no reputational due diligence has been carried out, can end up being very painful indeed. It can also be very expensive, leading to a possible jail sentence for the offending employees, a substantial fine, or both.

“Regulatory authorities are becoming much more aggressive because they believe the tide is flowing their way,” states Helsby.

Conventions, laws and regulatory obligations, are all driving the need for companies to carry out reputational due diligence. The US is not the only jurisdiction seen to be clamping down on corruption. Other OECD nations are doing the same, having signed up and implemented the OECD Anti-Bribery Convention. A draft bribery bill is also currently going through the committee stages of the UK Parliament to simplify and make more efficient the country’s cacophony of existing anti-bribery legislation.

As for fraud, M&A advisers must, for example, be aware of the EU Third Directive on Money Laundering. “From an adviser point of view, obviously money laundering is becoming all-encompassing. Obviously, that

is something everyone takes extremely seriously these days,” says David Silver, an MD at the mid-market investment bank Baird.

Due diligence benefits

Discovering illegal activities early through these processes can: help the buyer to negotiate a better price; strengthen considerably the target’s defence if reverse reputational due diligence has found any mud that can be slung at the hostile acquirer; and enable the company, which has been the subject of corruption, to inform the SEC and DoJ about it, in the hope that some agreement with the authorities can be reached. Such measures as paying a large fine, improving internal audits, hiring more internal compliance officers, and sacking the chief executive and chairman, usually suffice.

That’s what leading German manufacturer Siemens did, so it could continue doing business in the US. It reduced its culpability by conducting a thorough internal investigation and turning the results over to the US authorities.

At the end of the day, it got off lightly for breaching the FCPA despite an US\$800m fine for having admitted to bribing government officials worldwide with US\$1.4bn. “Siemens is viewed as having negotiated a favourable settlement because it can continue to do business with the US government,” Helsby says.

Admittedly, the Siemens case is not about pure M&A, but it gives a taste of the FCPA’s overwhelming tentacles. Similarly, Sun Microsystems has followed Siemens’ example, and has initiated its own independent investigation into potential breaches of the

FCPA, for fear of losing substantial US government contracts. It says it is fully co-operating with the DoJ and the SEC on the matter.

Sun Microsystems

It would appear that reputational due diligence uncovered possible corruption at Sun Microsystems prior to it agreeing the US\$7.4bn takeover by Oracle. Sun had indeed given assurances in the merger agreement that it had fully complied with the FCPA – but those assurances would have been qualified by a confidential “exceptions list” between Oracle and Sun found in the “disclosure schedule”. If that had not been the case, Oracle could have pulled the deal by now, making Sun pay it a US\$260m break-up fee.

As it turns out, Oracle has admitted that it was aware of the corruption issue before agreeing the deal. If not a deal breaker per se, the revelation enabled Oracle no doubt to get a better price for Sun.

“The last thing you want is a potential buyer to find out something you weren’t aware of to cause problems,” says Silver. “Generally, we haven’t had deals that have collapsed as a consequence of this sort of due diligence, but buyers are very interested in this area.”

With the financial crisis and the ensuing scandals so far uncovered, potential acquirers will want to be much more diligent in what they are buying. A note of caution, however: there is no guarantee that a reputational due diligence probe will reveal all instances of corruption and fraud in a target company. But, it seems that the earlier that such a process starts, the better.

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