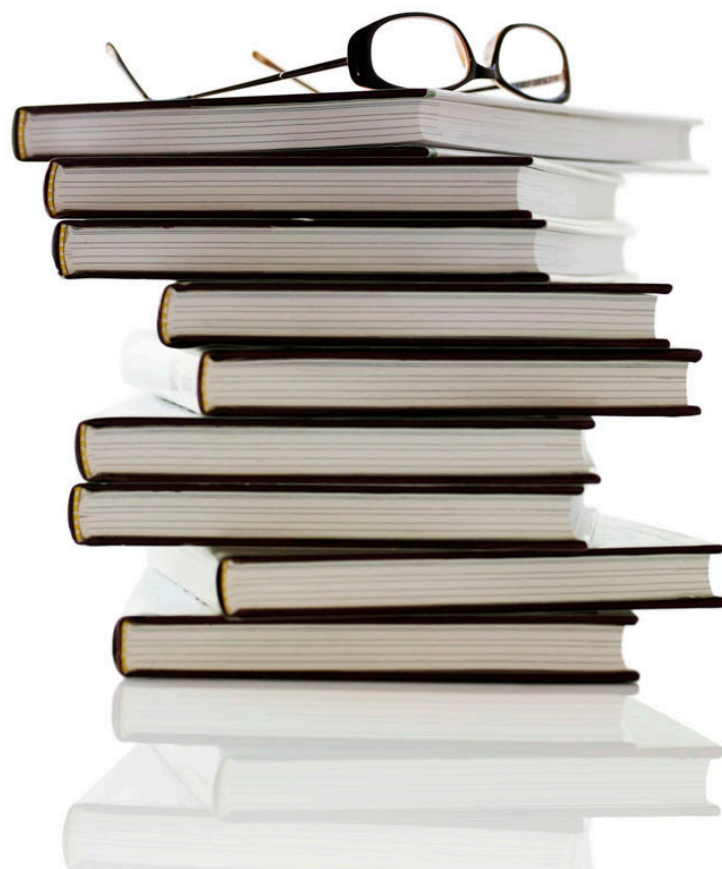


# FCPA due diligence in M&A



Given increasing awareness and enforcement of anti-bribery laws worldwide, companies would be wise to expand their financial and legal M&A due diligence to include efforts aimed at uncovering possible corrupt practices.

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## Thousands of mergers and acquisitions (M&As) are completed every year — some 8,700 U.S. and U.S. cross-border transactions were completed in 2008 and nearly 88,000 since 2000, according to Mergerstat.

Although companies engaging in M&A activity are familiar with the legal and financial due diligence that precedes a deal, there has been a recent focus in the United States and abroad, on compliance with anticorruption laws. As such, companies contemplating M&A transactions generally want to avoid acquiring potential corruption liability along with their new business.

### The growing risk

According to attorney Mark Friedman, litigation partner in the New York and London offices of Debevoise & Plimpton LLP, worldwide intolerance of corruption is growing and is typically a significant concern when contemplating an M&A deal. “For many years, the U.S. was essentially alone in its anti-corruption efforts — the only country in the world to prohibit foreign bribery,” Friedman notes. “Through the efforts of the United States, many other industrialized nations in the 1990s joined the Organization for Economic Cooperation and Development (OECD) Convention against bribery, which requires countries to implement legislation in their home countries that also prohibits their nationals from paying foreign bribes. While the implementing legislation may look different from country to country, we now have more than 30 countries in the world with effectively similar legislation.”

In the United States, the key legislation is the Foreign Corrupt Practices Act of 1977 (FCPA), which is enforced by the Department of

Justice (DOJ) and the Securities and Exchange Commission (SEC). FCPA enforcement actions have increased in recent years. From January 2006 to the end of 2008, the SEC brought 38 FCPA anti-bribery enforcement actions — more than were brought in all prior years combined since the FCPA became law in 1977. Further, in 2008 fines and disgorgements were far greater than in any other year. The largest combined SEC and DOJ violation penalty paid by a company to date — \$800 million — was levied in December 2008 as part of a \$1.6 billion settlement of U.S. and German bribery investigations. The largest penalty paid by a U.S. company — \$579 million — was levied in February 2009.

### A far-reaching statute

The FCPA prohibits bribery of “foreign officials” and requires companies to maintain accurate books and records and a system of internal controls designed to prevent and detect suspect payments.

Another consideration is the extensive breadth of what may give rise to an FCPA violation. The FCPA has been interpreted to include not only bribes to win business, but also actions such as making a payment to reduce tax liability or paying freight forwarders or customs brokers to avoid importation duties. The statute applies not only to actual payments, but also to offers or promises to pay, whether undertaken directly by a person or entity or indirectly through subsidiaries of the company or through outside agents and third parties.

If your company, or a subsidiary of your company, pays a third party to work for it and that party violates the FCPA, your company may be liable, even without direct participation or knowledge of the illegal acts.

As Ed Rial, leader of the FCPA Consulting Group at Deloitte Financial Advisory Services LLP confirms, a hands-off attitude is no protection. “There is no actual knowledge requirement,” says Rial. “If someone makes a payment through a third party and consciously disregards the likelihood of that third party making an improper payment, that is considered a knowledge substitute, referred to colloquially as ‘sticking your head in the sand.’”

The books and records provision also extends the FCPA's breadth considerably, meaning violations of the FCPA do not necessarily have to involve corruption. For example, any expenditure that is either improperly recorded or mischaracterized could potentially violate the books and records provision of the FCPA. In fact, the SEC has brought many cases under the books and records provision and far fewer under the anti-bribery provision.

Friedman concurs, noting, "The books and records provision is a way the U.S. government can jump over certain jurisdictional hurdles to reach private bribery, for example, which isn't outlawed by the FCPA's anti-bribery provisions. But to pay a bribe to a private customer could nevertheless be a violation of books and records and the internal controls provisions. These provisions are very general and can apply to those kind of 'head in the sand' situations where you're paying out agents and nobody can tell you what the agents are actually doing or any legitimate service they are providing."

### Mitigating the risk in M&A

Combining global business expansion with growing intolerance of corrupt practices and broad interpretation of what constitutes corruption has created a climate that makes it prudent for companies exposed to this risk to have a robust FCPA compliance program. Companies contemplating an M&A transaction face additional risks because illegal practices, weaknesses in controls, or books and records inaccuracies at the target could become the responsibility of the acquiring company or the emerging entity.

What level of M&A due diligence might be considered? Step one might include a risk-based assessment of the target company's business to understand the nature of the business and to identify potential risks and red flags.

As part of the risk-based assessment, one might typically consider:

- In what countries does the target company operate, and how do they rank on Transparency International's Corruption Perceptions Index?

- How susceptible is the business model to potential corrupt activities? (For example, consider whether the target company is highly regulated or if the company traditionally sells to or deals with foreign governments.)
- What is the nature and extent of the compliance programs already in place at the target company?
- Has the target company (or its principals, directors, or key managers) been publicly sanctioned or come under suspicion for corruption?
- Have background checks and other forms of due diligence been performed on key members of management, customers, agents, etc. to identify potential government links?
- To what extent does the target company rely on third parties to conduct business? Consider the amounts of retainers, commissions, and expenses paid to third parties in connection with sales.
- Has the target company distributed a compliance policy to all employees and agents? Has the policy been assessed as to whether it is regularly enforced and records maintained?
- To what extent does the target company maintain written agreements for all international agents regarding FCPA and anti-corruption clauses?
- To what extent have the target company's competitors been subject to FCPA investigations?
- It might also be appropriate to perform risk-based testing to help assess whether there are suspect transactions.

### FCPA concerns in joint ventures

Companies entering into joint ventures also have to consider the implications of the FCPA. Although much depends on the company's stake in the venture, even minority stakeholders would be wise to exercise caution, as they may be held liable for the conduct of the venture. It would be prudent for U.S. companies to do what they can to promote good governance, accurate record-keeping, and anti-bribery provisions in the joint

venture to help achieve compliance with the FCPA. This may include having audit rights, anti-corruption representations, and commitments to abide by anti-corruption laws built into the agreements. It is desirable to have a record of having proposed that the venture adopt such standards, even if your company is unsuccessful in prevailing upon its co-venturers.

Any discomfort with the level of FCPA compliance — for example, refusal to put a compliance program in place or to conduct due diligence on third-party agents — may be grounds to consider getting out of the venture, a difficult business decision that in some cases may be the best option. In China in particular, many joint ventures are being undertaken with state-owned enterprises, raising potential FCPA issues about how the ventures are funded, the flow of funds, who is controlling those funds, and the potential liability of any U.S. participants.

#### DOJ guidance

Another potential recourse for acquiring companies stems from a pivotal 2008 DOJ Opinion Release. A potential acquiring company, Halliburton, was allowed a 180-day, post-closing grace period in which to conduct FCPA due diligence that would usually be done prior to closing. Halliburton sought this relief because it was unable to gain access to information relevant to the target's FCPA risk due to local company tender rules. Halliburton was absolved of responsibility for any pre-acquisition or post-closing conduct of the target corporation that was uncovered and disclosed to the DOJ during the grace period.

This DOJ Opinion Release could open the door for other companies to request similar accommodations in cases where information is hard to come by and where requiring such information prior to the acquisition could place the requesting party at a competitive disadvantage. Although the ruling has no precedential value, it appears to offer more flexibility, under the right circumstances, as to how to conduct due diligence when there may be time constraints or restrictions on the availability of necessary information.

"It certainly provides what appears to be greater flexibility," Rial notes. "There are a number of instances where companies cannot get access to information sufficient to conduct a thorough anti-corruption due diligence. This ruling offers an alternative approach to conducting due diligence when there may be time constraints or restrictions on information availability."

Among the many conditions outlined, the DOJ Opinion Release specified that the acquiring company must voluntarily disclose any instances of corrupt activity uncovered post-closing. Friedman notes that the government generally encourages and rewards cooperation and voluntary disclosure, and that where corruption has likely occurred, it is often advantageous to self-report. "If you do raise the issue and are able to show that it [is] limited to historic conduct... the company is normally okay. There may be a fine associated with it, but the penalties should not be dire in those cases."

#### What may come next?

Just as U.S. FCPA enforcement has increased over the last decade, many believe that foreign enforcement will also rise. There has been a strengthening of international participation and cooperation in corruption mitigation. From a litigation perspective, there will be more formal and informal sharing of information among prosecutors in different countries. In the political setting, we have also seen a greater focus on bribery issues.

In addition, Friedman explains, "The OECD itself has a working group that meets regularly to monitor enforcement and perhaps act as a sort of shaming device in cases where countries have been laggards in the field."

Given these factors, it seems likely that the current heightened attention to corruption and vigorous FCPA enforcement will continue to be a focus for regulators. Companies are wise to be vigilant not only about their own practices, but also the practices of companies they consider acquiring.

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