Anti-Corruption Due Diligence in Mergers And Acquisitions

The recent increase in enforcement by United States authorities of the Foreign Corrupt Practices Act (FCPA)[1] and the July 1, 2011, effective date of the UK Bribery Act[2] heighten the importance of thorough anti-corruption due diligence in connection with proposed mergers and acquisitions. Investors acquiring companies with existing corruption problems risk investigations, criminal charges, penalties and other fines, reputational problems, loss of expected profits and market opportunities, and in some cases, a dramatic loss of value in acquired entities. This Advisory discusses these risks and provides practical tips for anti-corruption due diligence in mergers and acquisitions to minimize these risks.

Anti-Corruption Risks in Connection with Mergers And Acquisitions

The FCPA, enacted in 1977, prohibits making—or offering to make—a corrupt payment to a foreign (i.e., non-US) official for the purpose of obtaining or retaining business for or with, or directing business to, any person. It applies to a broad range of persons and businesses, including US citizens and resident aliens, businesses organized under US law or having a principal place of business in the US, and their officers, directors, employees, and agents (regardless of their citizenship). The FCPA also applies to foreign persons and organizations that take any action in furtherance of such a corrupt payment while in the United States, as well as third parties that act on behalf of any person or organization covered by the law.[3]

The United Kingdom's Bribery Act 2010 (Bribery Act), which came into force as of July 1, 2011, applies to a broad range of persons and businesses, including persons ordinarily resident in the UK and companies carrying on a business in the UK, and their activities both inside and outside of the UK. The Act prohibits persons subject to UK jurisdiction from giving someone a financial or other advantage to encourage that person

1 15 USC. §§ 78dd-1, et seq. (1977).

2 *See* 2010 UK Bribery Act, *available at*: http://www.legislation.gov.uk/ukpga/2010/23/pdfs/ukpga_20100023_en.pdf.

3 The FCPA also requires issuers on US exchanges, foreign or domestic, to comply with its anti-bribery requirements and its additional provisions on recordkeeping and internal accounting controls. Books and records of covered entities must accurately and fairly reflect transactions (including the purposes of an organization's transactions), and covered entities must devise and maintain an adequate system of internal accounting controls.

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to perform his or her functions or activities improperly or to reward that person for having already done so.[4] It includes provisions relating to corrupt payments to foreign officials (with provisions analogous in many respects to certain provisions of the FCPA), and also creates a specific offense for commercial organizations that fail to prevent bribery by people associated with such organizations.[5]

With respect to payments to foreign officials, Section 6 of the Bribery Act states that individuals cannot offer, promise, or give a financial or other advantage to a foreign public official with the intention of influencing the official in the performance of his or her official functions, where the person making the offer or promise or giving the advantage intends to obtain or retain business or an advantage in the conduct of business by doing so.[6] With respect to commercial bribery, covered under Section 1, it is illegal under the Bribery Act for a person to offer, promise, or give a financial or other advantage to another person, where the person intends the advantage to bring about the improper performance by another person of a relevant function or activity or to reward such improper performance, or where the person knows or believes that the acceptance of the advantage offered, promised, or given in itself constitutes the improper performance of a relevant function or activity.[7] Thus, the Bribery Act has provisions that, like the FCPA, cover bribery of foreign officials, but the Bribery Act also covers "commercial" bribery that does not implicate government officials.[8]

In recent years, the US government has stepped up its enforcement of the FCPA. The Criminal Division of the Department of Justice (DOJ) has substantially increased its FCPA enforcement staff, and the US Securities and Exchange Commission (SEC) has created a new, specialized enforcement unit. Over the past two years, the DOJ has "charged more than 50 individuals with FCPA-related offenses and collected nearly $2 billion in FCPA-related fines and penalties—by far the most people charged and penalties imposed in any similar period."[9]

Similarly, the United Kingdom is expected to pursue potential investigations and prosecutions of offenses under the Bribery Act with great determination. In this respect, the Guidelines issued by the UK Ministry of Justice (MOJ) note the need for thorough anti-corruption due diligence in connection with mergers and acquisitions.[10] In a June 21, 2011, speech, Richard Alderman, the Director of the UK's Serious Fraud Office (SFO), noted the need for self-reporting to the SFO by companies that discover corruption issues during mergers and acquisitions.[11]

The DOJ and SEC have long recognized successor and third-party liability in the context of the FCPA,[12] as has the

4 For a detailed analysis of the UK Bribery Act, *see* Ian Dodds-Smith, Alison Brown, Jacqueline Bore, Oliver C. A. Kerridge, and Benjamin Kieft, Arnold & Porter LLP, "Advisory: UK Government Issues Guidance on the Bribery Act," (March 2011) *available at*: http://www.arnoldporter.com/public_document.cfm?id=17392&key=10C0; Arnold & Porter (UK) LLP, "Advisory: UK Bribery Act 2010: An In-Depth Analysis," (May 2010) *available at*: http://www.arnoldporter.com/public_document.cfm?id=15833&key=23D1. The Bribery Act prohibits both bribery of officials and bribery of commercial parties in order to obtain or retain business or to obtain an advantage in the conduct of business.

5 Section 7(5) of the Bribery Act defines a "relevant commercial organisation" as a body or partnership incorporated or formed in the UK irrespective of where it carries on a business, or an incorporated body or partnership which carries on a business or part of a business in the UK irrespective of the place of incorporation or formation.

6 UK Bribery Act, Section 6.

7 UK Bribery Act, Section 1.

8 Although the FCPA does not address commercial bribery, the Travel Act prohibits using interstate or foreign facilities to carry out an activity, including bribery, that violates state law. *See* 18 U.S.C. § 1952(a), (b)(2). In recent years, the DOJ has prosecuted commercial bribery under the Travel Act for bribes paid abroad to private parties. *See*, e.g., Press Release, Dep't of Justice, Control Components Inc. Pleads Guilty to Foreign Bribery Charges and Agrees to Pay $18.2 Million Criminal Fine (July 31, 2009), *available at*: http://www.justice.gov/opa/pr/2009/July/09-crm-754.html. Thus appropriate premerger due diligence should consider possible bribery of private parties as well as government officials.

9 Speech given by DOJ Criminal Division Assistant Attorney General Lanny A. Breuer on January 26, 2011, *available at*: http://www.justice.gov/criminal/pr/speeches/2011/crm-speech-110126.html.

10 "Organisations will need to take considerable care in entering into certain business relationships, due to the particular circumstances in which the relationships come into existence… . [A] relationship that carries particularly important due diligence implications is a merger of commercial organisations or an acquisition of one by another." Ministry of Justice, The Bribery Act 2010 Guidance, 31 March 2011, Principle 4.4, at 27–28, *available at*: http://www.justice.gov.uk/downloads/guidance/making-reviewing-law/bribery-act-2010-guidance.pdf.

11 Speech given by SFO Director Richard Alderman on June 21, 2011, *available at*: http://www.sfo.gov.uk/about-us/our-views/director%27s-speeches/speeches-2011/breakfast-seminar-hosted-by-kingsley-napley--carmichael-fisher.aspx.

12 *See*, e.g., FCPA Opinion Procedure Release 2003-01 (Jan. 15, 2003), where the Justice Department evaluated an acquiring company's proposed steps to avoid successor liability to determine how the

SFO in the context of the enforcement of anti-corruption laws of the United Kingdom.[13] Those who acquire enterprises with existing anti-corruption problems can become responsible for violations of anti-corruption laws that took place prior to the acquisition.

Thus, while vigorous enforcement of the FCPA and the UK Bribery Act obviously have major consequences in themselves for companies under review for possible corruption, the problem can become more pronounced and complicated when such a company becomes the subject of a possible acquisition. In this connection, successor liability raises the specter of potential negative consequences that buyers would, of course, prefer to avoid, including investigations by the DOJ and SEC in the United States and by the SFO with other investigatory bodies (police forces) in the United Kingdom, as well as penalties or other fines, liability to third parties, and negative publicity. There is an additional danger of losing value in the acquired entity by, for example, losing key personnel, significant contracts and markets, or important relationships. In the worst case, an acquisition of an entity with prior or ongoing corruption concerns can give rise to liabilities and burdens that outweigh the benefits of the transaction.

The risks to potential acquirers can be exacerbated in the mergers and acquisitions context by a number of facts that could undermine the potential advantages to a buyer in an acquisition, including that:

- A buyer typically pays a significant premium for a company being purchased, in many cases planning to expand tactically on specific business lines or customer relationships, or with a view that certain business elements have synergies with existing lines of business. If those lines or relationships turn out to be areas with inherited corruption problems, then the buyer will be unable to obtain the expected benefits for which the premium was paid; and
- A buyer's existing business and reputation can be harmed, in some cases very significantly, directly and indirectly, by the corruption problems inherited in the acquired business.

Illustrative Cases of Anti-Corruption Problems in Mergers and Acquisitions

While there are many examples of adverse consequences of failing to discover corruption issues during due diligence in transactions large and small, an FCPA action related to eLandia International, Inc.'s US$26.8 million acquisition of Latin Node Inc. in 2007 illustrates the risks. After the deal closed, eLandia discovered that between 2004 and 2007, Latin Node made more than US$2 million in payments to third parties that used the money to pay bribes to government officials in Honduras and Yemen in exchange for favorable telecommunications deals. Upon discovering these payments, eLandia conducted a full investigation and voluntarily reported its findings to the DOJ, which filed a suit against Latin Node that resulted in a guilty plea and a US$2 million fine.

The consequences for eLandia were quite severe. In an SEC filing, the company stated that it had "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 loss of business."[14] Ultimately, eLandia had to write off its entire investment and dissolve Latin Node.

Sometimes thorough anti-corruption due diligence can lead an acquiring company to simply abandon an acquisition that might otherwise have been commercially desirable.

proposed steps addressed potential exposure of the acquiring company under the FCPA for prior acts of the target company; *see also* eLandia International, Inc. Annual Report Amendment (Form 10-K/A) (May 19, 2008), *available at*: http://www.sec.gov/Archives/edgar/data/1352819/000119312508118797/d10ka.htm.

13 *See* Joint Prosecution Guidance issued by the Director of the SFO and the Director of Public Prosecutions (March 30, 2011), *available at*: http://www.sfo.gov.uk/press-room/latest-press-releases/press-releases-2011/bribery-act-prosecution-guidance-published.aspx; Guidance On Corporate Prosecution, *available at*: http://www.sfo.gov.uk/about-us/our-policies-and-publications/guidance-on-corporate-prosecutions.aspx.

14 eLandia International, Inc. Annual Report Amendment (Form 10-K/A) (May 19, 2008), *available at*: http://www.sec.gov/Archives/edgar/data/1352819/000119312508118797/d10ka.htm.

In June 2004, Lockheed Martin Corp. abandoned its US$2.2 billion deal to acquire Titan Corp. after the San Diego-based technology company failed to resolve a federal bribery investigation into whether it had made illegal payments to officials in Saudi Arabia and Benin. The termination of the proposed transaction ended a lengthy negotiation between the two companies. According to press reporting, "Lockheed did not want to inherit legal responsibility for a violation of the Foreign Corrupt Practice Act" that had taken place prior to its acquisition of Titan.[15]

Companies considering acquisitions should also keep in mind that simply performing appropriate anti-corruption due diligence prior to closing does not end the process. Buyers must ensure that the companies they acquire continue to comply with the FCPA after a transaction closes. On April 8, 2011, Johnson & Johnson (J&J) agreed to pay a total of US$78 million in settlement agreements with the DOJ, the SEC, and the SFO in connection with payments allegedly made by J&J subsidiaries to doctors and hospital administrators in Greece, Poland, and Romania, as well as asserted kickbacks under the UN's Oil-for-Food Program in Iraq.

The allegations addressed conduct that had taken place both before and after J&J assumed control of the UK company, DePuy. J&J acquired DePuy in 1998, after DePuy had already made a series of payments to a Greek distributor that the government alleged were for the purpose of obtaining business in Greece. After the acquisition, the US government contended that J&J's Policy on Business Conduct—which prohibited bribes, required accurate books and records, and dictated controls over payments to third parties—also applied to the DePuy organization. In bringing the enforcement action, the US government argued that J&J's post-closing oversight of the DePuy operations was inadequate and that J&J did not move quickly enough to ensure that DePuy's arrangement with a Greek distributor complied with J&J's policy.[16]

Due Diligence Inquiries and Risk Management

Any government interaction creates a potential opportunity for a corrupt payment to be sought, offered, promised, or made. Acquirers should therefore first determine the extent and manner in which a target's business interacts with and relies on government officials, then make appropriate inquiries and tailor requests for information relating to government interactions. Assuming interaction with or reliance on government officials is a significant part of a target's business, acquirers should document the due diligence steps taken and include appropriate representations and warranties in transaction agreements to provide a formal mechanism for disclosure of any known problems (as well as mechanisms for addressing the issues as part of the conditions to closing the transaction and for providing post-closing remedies, to the extent available in the transaction).

The scope and nature of due diligence in corporate transactions will be driven largely by the acquiring company's assessment of risks inherent in the transaction, based on a series of threshold issues noted below. In this respect, there will be some proposed transactions where a risk-based analysis will require intensive and in-depth inquiry into multiple markets and sectors in which the target does business. In other cases, an examination of the target may lead to an examination of specific areas of focus that require detailed exploration. Due diligence will typically reveal that even companies that are not heavily regulated are likely to interact daily with government officials on matters that require them to obtain approvals for routine actions necessary for the conduct of business. These actions may include interactions with government personnel, such as customs and immigration officials, tax regulators, and product safety or registration officials.[17]

15 Renae Mearle, *Lockheed Martin Scuttles Titan Acquisition: San Diego Defense Advisor Fails to Settle Federal Bribery Investigation*, Washington Post, June 27, 2004, *available at*: http://www.washingtonpost.com/wp-dyn/articles/A8745-2004Jun26.html.

16 *See* Keith M. Korenchuk, Kirk Ogrosky, Samuel M. Witten, and Benjamin H. Wallfisch, Arnold & Porter LLP, "Advisory: J&J Agrees to Pay US$78 Million to Settle Allegations of Payments Made to European Healthcare Providers," (April 2011) *available at*: http://www.arnoldporter.com/public_document.cfm?id=17469&key=8J1.

17 Anti-corruption laws such as the FCPA and the UK Bribery Act apply to illicit payments to foreign officials regardless of rank or seniority. Thus, a corrupt offer or actual bribe to a low-level employee (such as a customs clerk) could give rise to liability in the same manner as a bribe offered to a senior minister or decision-maker.

Examples of questions that may be part of the due diligence assessment for a particular target company include:

- In what regions or countries does the target company operate? Are these areas of high risk for corruption?
- Is the target's business in a sector or industry in which corruption is endemic?
- How is the target regulated? Do the employees or agents of the target regularly conduct business with government officials?
- When and how does the target use intermediaries or third parties whose actions could subject the firm to liability?[18]
- Does the target itself have any previous history of bribes or facilitation payments? Is there any record of government investigations (including money-laundering investigations), settlements or plea agreements, or of internal investigations and audit reports?
- What types of anti-bribery and corruption compliance controls, if any, are already in place at the target company?
- What written records does the target keep with respect to its anti-bribery and corruption compliance monitoring?

In appropriate cases, the anti-corruption due diligence may include a site visit and interviews with key personnel. The interview of key personnel on compliance and anti-corruption considerations will be a valuable exercise that can yield important information about company culture and commitment to compliance, specific activities, and overall risks in the operating environment. Interviews and site visits may also help determine the nature and extent of additional follow-up.

Some acquisition targets, because of the sectors in which they operate, may present heightened concerns that require particularly extensive examination of relevant interactions. For example, a company in a heavily regulated industry (such as a company involved in pharmaceuticals, financial services, aerospace and defense, environmental, or extraction activities) will require a particularly thorough examination of its business operations, how it is regulated, how it interacts with foreign officials, and the sufficiency of its compliance program.

If due diligence uncovers a corruption problem or warning sign, further examination will be required to determine its nature and scope. Thus, in cases where there is substantial government interaction or other identification of risks, a sampling of transactions or accounting records such as vendor files and travel and entertainment expense reports should be reviewed and analyzed. In cases that appear high-risk from a corruption perspective, financial experts should be utilized to design the sampling plan, to undertake the forensic analysis, and to highlight areas or transactions which require further follow-up. Issues to consider include: Is the corruption problem an isolated incident or is there a systemic breakdown in compliance procedures? Can premerger action by the purchaser, including through the careful negotiation of closing conditions, avoid or mitigate liability for known premerger conduct by the target? What can the target do to correct any problems and begin to put in place an adequate compliance program? What should the acquiring company do preclosing to ensure that an effective compliance program is functioning once the transaction is consummated?

Recent deferred prosecution agreements negotiated by the DOJ have effectively created a template that companies subject to US regulation can follow to develop, implement, and maintain corporate compliance programs. The similarities among the required compliance program elements provide clear and much-needed guidance from the DOJ regarding what the US government has determined are the essential components of an effective FCPA compliance program.[19]

18 For a more in-depth analysis of third-party due diligence, *see* Keith M. Korenchuk, Samuel M. Witten, and Dawn Y. Yamane Hewett, Arnold & Porter LLP, "Advisory: Anti-Corruption Compliance: Avoiding Liability for the Actions of Third Parties," (April 2011) *available at*: http://www.arnoldporter.com/public_document.cfm?id=17444&key=3E0.

19 *See* Keith M. Korenchuk, Samuel M. Witten, and Dawn Y. Yamane Hewett, Arnold & Porter LLP, "Advisory: Building an Effective Anti-Corruption Compliance Program: Lessons Learned from the Recent Deferred Prosecution Agreements in Panalpina, Alcatel-Lucent, and

Similarly, the Guidelines issued on March 31, 2011, by the UK MOJ provide guidance on what compliance programs will meet UK government expectations with respect to the prevention of bribery by commercial organizations.[20]

Recommendations in Connection with Transaction Documents

Apart from conducting thorough, anti-corruption-targeted due diligence, purchasers can protect themselves in an acquisition agreement by including representations and warranties specifically relating to compliance with anti-corruption laws, such as the FCPA, the Bribery Act, and any other anti-bribery laws that may be relevant. The representations may be tailored depending on the particular target and information made available during due diligence.

As with any other representations and warranties in a purchase agreement, representations and warranties in this area generally serve three purposes in a US-style purchase agreement: (1) to force formal disclosure by the target, supplementing the buyer's due diligence (as the representations will state that the target complies with the laws and has made no corrupt payments, etc., except as set forth on a disclosure schedule); (2) to provide a basis for a condition for the buyer's obligations to close (typically the representations must be true, or true in all material respects, as of the signing date or the closing date in order for the buyer to be obligated to close, so if the target has failed to disclose an issue on a schedule or if a new issue arises that cannot be included on an updated disclosure schedule, then the buyer would not be obligated to close and could instead terminate the agreement); and (3) in transactions involving private company targets, to provide a basis for a post-closing remedy if the representation is false (generally pursuant to a specific indemnification provision).

In transactions that do not involve significant corruption risks, the protections afforded by the representations and warranties and the process they create is a reasonable and sufficient way to further due diligence and to provide some assurances in the event of an unforeseen issue arising between signing and closing or after closing. However, as noted above, there will sometimes be cases in which drastically more significant due diligence is required to assess a situation because, due to the nature of the target or the buyer or both, the negative consequences of having a significant latent corruption issue in a target can outweigh the benefits of a transaction, either by stripping out the key value the buyer hopes to obtain in the transaction or, in the worst situation of all, by destroying value of the buyer itself, reputational or otherwise.

The Possibility of a Post-Closing Grace Period and Other Consultation With Regulators

In some cases, proper due diligence efforts may be limited by other legal restrictions, and companies may need to consider alternative courses of action. In 2008, for example, Halliburton bid to acquire a UK company that operated around the world in the oil and gas industries. Due to legal requirements of the bidding process in the UK, Halliburton could not conduct the due diligence necessary to determine to its satisfaction the potential for or extent of any FCPA liability. Halliburton took advantage of the FCPA's opinion release procedure to request the DOJ's opinion on how to proceed. It requested a post-closing grace period during which the DOJ would not undertake any enforcement action while Halliburton conducted the FCPA due diligence investigation. The company presented to the DOJ a due diligence plan setting out a detailed framework and schedule for its investigation.

In response to Halliburton's request, the DOJ issued Opinion Procedure Release No. 08-02.[21] The DOJ announced that it would not take any enforcement action during a 180-day period following closing, provided that Halliburton followed its proposed post-closing plan and disclosed the results of its investigation at prescribed times. The DOJ reserved the right to prosecute enforcement actions for violations

Tyson Foods," (March 2011) *available at*: http://www.arnoldporter.com/public_document.cfm?id=17347&key=1H3.

20 *See* Ministry of Justice, The Bribery Act 2010 Guidance, 31 March 2011, *available at*: http://www.justice.gov.uk/downloads/guidance/making-reviewing-law/bribery-act-2010-guidance.pdf.

21 The Opinion Procedure Release can be obtained from the DOJ's website *available at*: http://www.justice.gov/criminal/fraud/fcpa/opinion/2008/0802.pdf.

that were not disclosed or in which Halliburton officials knowingly engaged.

Although the Opinion Release is significant because it shows that the DOJ is willing to work with companies who are facing extraordinary circumstances that prevent ordinary due diligence investigations, companies should be careful not to read too much into this one case. The DOJ explicitly noted that its decision relied on the unique circumstances of the particular bidding process and the apparently insurmountable obstacles posed by the requirements of foreign law. It also stressed that the Opinion Release applied only to the specific case at issue and had no binding application on other parties. Finally, the DOJ stated that it discouraged companies considering seeking FCPA Opinion Releases from entering into confidentiality agreements that restrict what information they can share with the government.

Like the DOJ and SEC, the UK's SFO also encourages companies to self-report any significant concerns relating to corruption that are uncovered in the context of a transaction. In his speech on June 21, 2011, Richard Alderman urged private parties to consult with government authorities where significant matters related to corruption are discovered in mergers and acquisitions, whether before or after a closing. He noted that mergers and acquisitions are a "particular area" where such governmental consultation could be appropriate.[22]

Conclusion

A buyer of a company can end up buying the target company's problems under the FCPA and the Bribery Act if such problems exist and are not resolved in advance of the consummation of the transaction. The key first step is a complete assessment of the risks inherent in a particular proposed transaction. Once those risks are understood, there will be a variety of tools for managing risks: Further due diligence to understand how anti-corruption issues are being addressed, the development of plans for an enhanced compliance program by the time of the closing, representations and warranties, and (if appropriate) advance consultation with government officials. Which tools are most effective in a given situation is highly dependent on the facts and circumstances of the transaction.

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22 In discussing the advantage of self-reporting in the context of a merger or acquisition, Alderman commented that: "What this means is that I would encourage companies that find themselves in this position to come and talk to us about it so that they can have the assurance that they need that they will be left to get on and sort out these problems in their own way in order to ensure a proper ethical culture in the target company." *See* Alderman Speech supra note 11.