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What is driving due diligence? The importance of anti-bribery due diligence in M&A transactions

Anti-bribery due diligence in merger and acquisition transactions ("**M&A transactions**") has been relatively commonplace in transactions involving buyers subject to the US Foreign Corrupt Practices Act 1977 ("**FCPA**") for some time. With the UK's new Bribery Act 2010 ("**UKBA**") now in force, and with the intensified focus on corruption by authorities across the globe, the demand for anti-bribery preventative measures has become much broader. Buyers (and underwriters), even those not within US jurisdiction, are increasingly concerned about target companies' historic compliance breaches and the measures and controls in place to prevent such breaches prior to acquisition. As enforcement spreads, the business community has recognised that the lack of a robust anti-bribery compliance programme will affect their bottom line directly, including the value realised from corporate acquisitions and disposals.

Why has the UKBA prompted greater diligence by buyers?

Put simply, the answer to this question is that the UKBA has broader application than any other anti-bribery law legislated around the world to date and diligence in the acquisition process may help with providing the proverbial “get out of jail free” card down the track (at least those jails in the UK).

The UKBA, passed in 2010, provides that a commercial organisation (a company or partnership) is guilty of a crime if a person associated with it (which the legislation refers to as an "**Associated Person**") bribes someone, anywhere in the world, with the intention of obtaining or retaining business or a business advantage for the commercial organisation. This offence is commonly known as the "**Corporate Offence**". The Corporate Offence has wide application as it is not only applicable to UK commercial organisations but also to any organisation, wherever incorporated, that carries on a part of its business in the UK.

"Associated Person" is defined broadly under the UKBA as an individual or corporate entity that "performs services" for, or on behalf of, the organisation, including its own subsidiaries. The term “performs services” is not defined in the legislation but it is intended to embrace the whole range of persons connected to an organisation who might be capable of committing bribery on its behalf. Group companies will often do business and otherwise interact with each other, so a new acquisition to a group is also a new bribery risk to the group.

The Corporate Offence is essentially a "strict liability" or "no fault" offence, so there is no need for prosecutors to prove that the organisation had any involvement in, or knowledge of, its Associated Person's bribery. The only defence to prosecution is that the organisation had "adequate procedures" (anti-bribery policies, systems and controls) in place to prevent such bribery.

"Adequate procedures" include, amongst other things, carrying out due diligence on potential Associated Persons taking a proportionate risk-based approach.

Consequently, anti-bribery due diligence in acquisitions has become necessary to both assess whether the target will pose a liability risk to the acquirer and to help build an "adequate procedures" defence should the target have post-acquisition bribery issues.

How does the need for pre-acquisition due diligence arise under the FCPA?

A buyer subject to the FCPA is exposed to risk from its target's conduct under three theories: successor liability, parent-subsidiary liability, and books and records liability. This was spelled out in "*A Resource Guide to the US Foreign Corrupt Practices Act*"[1] (the "**FCPA Guide**"), published in 2012 by US enforcement authorities. In all three scenarios, no actual participation in the subsidiary's bribery is required for the parent to be prosecuted. These risks, combined with the fact that half of US corruption-related prosecutions arise in the context of M&A transactions, have buyers and their lawyers demanding answers from their acquisition targets[2].

What is successor liability?

Essentially, an acquiring company is held responsible for the pre-acquisition sins of the target. The FCPA Guide explains that as "a general legal matter, when a company merges with or acquires another company, the successor company assumes the predecessor company's liabilities….[s]uccessor liability applies to all kinds of civil and criminal liabilities and FCPA violations are no exception."[3]

To date, there have been a number of prosecutions brought by the US Department of Justice on the basis of successor liability but the parties generally settle without a full adjudication of the issues so there is little clarity around the true extent of successor liability. The FCPA Guide does however acknowledge that successor liability "does not create liability where none existed before" so that a FCPA-subject buyer's acquisition of a foreign company that was not previously subject to the FCPA's jurisdiction would not retroactively create FCPA liability for the target's pre-acquisition bribes. Nevertheless, the threat of liability for a target's pre-acquisition FCPA violations -- even where the target continues to be a separate legal entity -- is ample incentive for buyers to ask detailed questions before the transaction proceeds.

Parent-subsidiary liability?

The FCPA Guide also states that a parent may be legally responsible for the bribery of its subsidiary where an agency relationship exists, even if the parent does not participate in such conduct. The agencies have adopted the view that where such a relationship does exist, "a subsidiary's actions and knowledge are imputed to its parent."[4]

Books and records liability?

The FCPA's books and accounting provisions require issuers (US companies and non-US companies listed on a US exchange or required to file annual or other periodic reports pursuant to s.15(d) of the Exchange Act) to keep accurate books and records and reasonable accounting controls. The FCPA Guide notes that an "issuer's books and records include those of its consolidated subsidiaries and affiliates" and therefore an "[i]ssuer's responsibility thus extends to ensuring that subsidiaries or affiliates under its control, including foreign subsidiaries and joint ventures, comply with the accounting provisions." For a violation of the books and record provisions, prosecutors do not need to prove intent -- a parent is at risk of prosecution for simply consolidating its subsidiary's false accounts with its own. US prosecutors have regularly used the books and accounting provisions to hold a parent responsible for the bribery of its subsidiary where the subsidiary's accounting entry for a bribe was mischaracterised as some kind of legitimate payment.

An added FCPA reason for anti-bribery diligence

While the FCPA does not provide a statutory defence of "adequate procedures" to any of its offences like the UKBA does with respect to the Corporate Offence, the FCPA Guide makes it clear that extensive pre-acquisition anti-bribery due diligence coupled with remediation and the quick integration of the target into the parent's own robust compliance anti-bribery compliance controls may result in a declination of prosecution for the acquirer.

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1 November, 2012

2 In recent years, 50% of US corruption-related transactions were connected to M&A transactions: Transparency International UK

3 FCPA Guide, page 28.

4 FCPA Guide, page 27.

Aside from avoiding liability, what are the economic reasons for due diligence?

Apart from helping to avoid liability for the acquirer itself, anti-bribery due diligence helps an acquirer to better value the target and to decide whether the transaction is worthwhile.

If the target has a history of bribery, it may eventually be prosecuted (under local laws and/or that of "long-arm" jurisdictions like that of the US and the UK). This could mean large fines and penalties, huge costs of investigation and defence, likely diversion of management attention, and a corresponding impact on the target's creditworthiness and access to financing. For a listed company, it could mean a drop in its share price. If the target's business model is dependent on bribery, its revenues may decline if it adopts compliant business practices or if important revenue-producing contracts are terminated because they were induced through bribery and are therefore voidable. The target's conduct may also affect the acquirer's (and its group's) reputation.

The value of good compliance?

A target with robust anti-bribery compliance controls and procedures will quite simply be an easier, cleaner sell. If bribery red flags and a poor compliance culture does not scare a purchaser off for the reasons mentioned above, then a purchaser (at least a well-advised one) will look to cover the risk in other ways – a reduced purchase price, onerous open-ended warranties and indemnities, and money held in escrow to cover costs in the event of a prosecution connected to the target's bribery being obvious examples.

Contacts

If you would like to know more about the subjects covered in this publication or our services, please contact:

Wendy Wysong
Partner

T: +852 2826 3460 (Hong Kong)
+1 202 912 5030 (Washington)
E: wendy.wysong
@cliffordchance.com

Michelle Mizutani
Counsel

T: +(81 3) 5561 6646
E: michelle.mizutani
@cliffordchance.com

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Clifford Chance, Akasaka Tameike Tower, 7th Floor, 2-17-7 Akasaka, Minato-ku, Tokyo 107-0052, Japan
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