Addressing corruption risk in M&A transactions

The international balancing act

At a glance

Get up to speed on how to mitigate risk in US outbound M&A activity and recent changes in the global fight against corruption.

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Introduction

The current global economic environment has posed various challenges for US investors, including private equity firms, domestic corporations, and multi-nationals. However, we expect deal activity to intensify as companies look for new ways to grow and meet their strategic objectives. In particular, the pace of US deal activity may increase as companies seek to find value and expand through mergers and acquisitions with international targets.

Addressing corruption risk in M&A transactions:

The international balancing act

As companies grow, they find themselves operating in a global environment, whether from an operational, sales, or investment perspective. Barriers to business and market penetration are disappearing as domestic and international borders blur. Although this creates opportunities for US investors, it also presents even greater challenges. Consider that more than 70%[1] of the world is deemed to have high corruption risk—and that companies venturing abroad are likely to be operating in unfamiliar cultures and locales.

In response, many governments are taking a proactive, aggressive, and vocal approach to combatting corruption, and making public statements about enhanced enforcement and legislation. Ultimately, these countries understand that corruption steals scarce resources from those that need it most, undermines the public interest, and creates an uneven playing field for global businesses.

We will provide insights into the corruption risk for US outbound M&A activity and changes in global anti-corruption enforcement. To learn what companies can do to mitigate corruption and regulatory risk, understand potential remedial measures post-closing, and better assess deal value, simply turn the page.

1 The percentage is calculated based on the Transparency International Corruption Perception Index ("CPI") 2012, taking into account those countries with CPI below 50

An overview

Are you aware of corruption risk associated with outbound M&A activity?

US investors continue to seek high-growth opportunities abroad. However, approximately 25%[2] has occurred in countries that pose significant corruption risk according to Transparency International 2012 Corruption Perceptions Index (CPI). The majority of this activity has taken place in Brazil, India, and China—three of the world's fastest growing economies, which also have a high risk of corruption based on the CPI.

This risk is exacerbated when outbound deal activity involves an industry with a high degree of government oversight and involvement, where bribes to public officials may be used to obtain, retain, or facilitate business transactions.

What anti-corruption regulatory developments are we seeing globally?

Keeping pace with the changing landscape of global anti-corruption enforcement is often a complex and difficult task. The US Department of Justice (DOJ) and US Securities and Exchange Commission (SEC) continue to lead the charge against corruption through use of the Foreign Corrupt Practices Act (FCPA). The agencies have brought approximately 250[3] FCPA enforcement actions against companies and individuals since 2008, resulting in over $5 billion in penalties, fines, and disgorgement. Of these actions, 10% and more than $1 billion were associated with joint ventures (JV) and M&A activity in 40-plus countries.

In a bid to attract foreign investors, many of these countries have recently begun to address local corruption risk by enforcing or amending existing laws and introducing new laws and measures. These laws are intended to increase government transparency and criminalize bribery and corruption, not only domestically, but also abroad. As such, in an effort to avoid running afoul of relevant laws, regulations and customs, business leaders should strive to understand the current regulatory environment and laws that govern conduct in their home country as well as those in which the target entity is located and does business.

How can you mitigate corruption risk and better assess deal value?

Corruption risk associated with outbound activity should be targeted and mitigated through specific and deliberate measures, including proactive pre-acquisition due diligence steps and post-acquisition integration measures. Specifically, pre-acquisition due diligence assists investors in estimating the target's 'true' value. For example, contracts obtained through bribes may be legally unenforceable; business obtained improperly may be lost when bribe payments are stopped; there may be liability for prior illegal conduct; and the prior corrupt acts may in turn harm the investor's reputation and future business prospects.

Similarly, post-acquisition integration establishes compliance program measures, expectations, and definitive obligations of target management to mitigate the risk of any ongoing or future corrupt activity and related transactions. Additionally, as more investors and companies realize the importance of an anti-corruption compliance program, establishing proactive measures to identify and manage related risks can enhance a company's value and attractiveness to future potential business partners or purchasers.

2 Thomson Reuters 2012 Data, including M&A deals announced and executed by US investors internationally in the domestic and well as international market

3 PwC analysis based on publicly available documents including various filing documents in support of the SEC and DOJ actions

A deeper dive

Are you aware of corruption risk associated with outbound M&A activity?

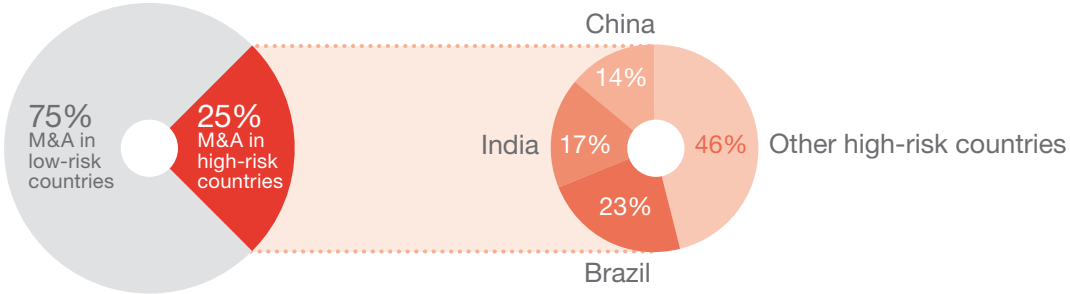
While recent M&A activity levels have fluctuated[4], US investors continue to maintain a stable position as one of the world's largest investors in terms of the number of deals announced and executed in the domestic and international markets. A significant portion of these deals involve countries with a high risk of corruption, exposing US investors to increased regulatory risk, as bribes are often expected in such locations and treated by local companies as a cost of doing business.

This risk is further heightened because outbound activity is often focused on industries with intense regulatory oversight and frequent government interaction, where foreign government officials could be customers, suppliers, inspectors, or agents.

Outbound activity: What countries?

Outbound M&A activity knows no borders. US investors are becoming increasingly aggressive and diverse with respect to the geographies in which they invest, venturing into deals throughout the Americas, Africa, Asia, Europe, and the Middle East. US investors have recently announced or executed deals with targets located in over 100 countries, of which 25%[5] involved targets located in countries with a high risk of corruption. *Refer to Table 1.*

Table 1: % of deals announced and executed in 2012 by US investors in high-risk and low-risk target countries



Source: PwC Analysis, based on Thomson Reuters data of 2012 M&A deals announced and executed by US investors

4 Reference Period: January through December 2012

5 PwC analysis based on Thomson Reuters data, 2012 M&A deals announced and executed by US investors

Three of the top 10 target countries had a CPI below 50 ("Top Three Emerging Markets"), indicating a location where there is a high risk of corruption according to the Transparency International CPI:

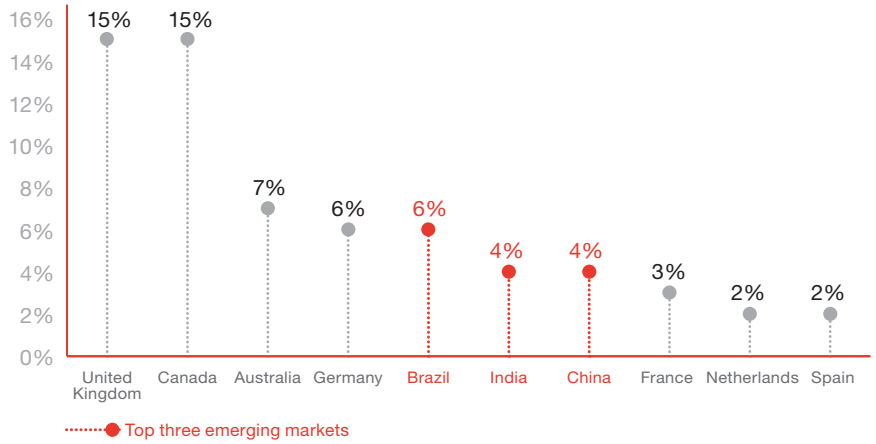
Still, these countries are poised to contribute up to half of global economic growth in 2013,[6] so global businesses should not avoid these locations, but address corruption risk associated with M&A activity head-on. *Refer to Tables 2 and 3.*

Many foreign investors tend to be attracted to high-risk countries, seeing opportunities such as:

- Favorable labor profile that has spurred recent growth and sophistication in manufacturing;
- Development of new technology and other innovations; and
- Growth of the new middle class, which is gaining in terms of population and wealth.

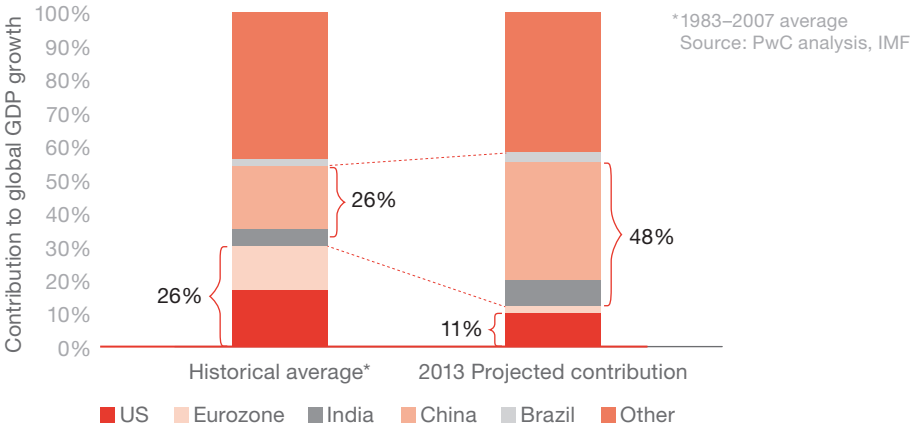
Such opportunities, however, are not risk free. While US investors seek high-value deals abroad, they also face significant corruption risk associated with the countries in which these targets operate. Often, high-risk countries present a 'pay to play' system in which bribes to public officials are required to obtain or retain business.

Table 2: Top 10 target countries based on number of deals announced and executed in 2012 by US investors



Source: PwC Analysis, based on Thomson Reuters data of 2012 M&A deals announced and executed by US investors

Table 3: Top Three Emerging Markets account for nearly half of the world GDP growth in 2013



Source: PwC Global Economy Watch—January 2013

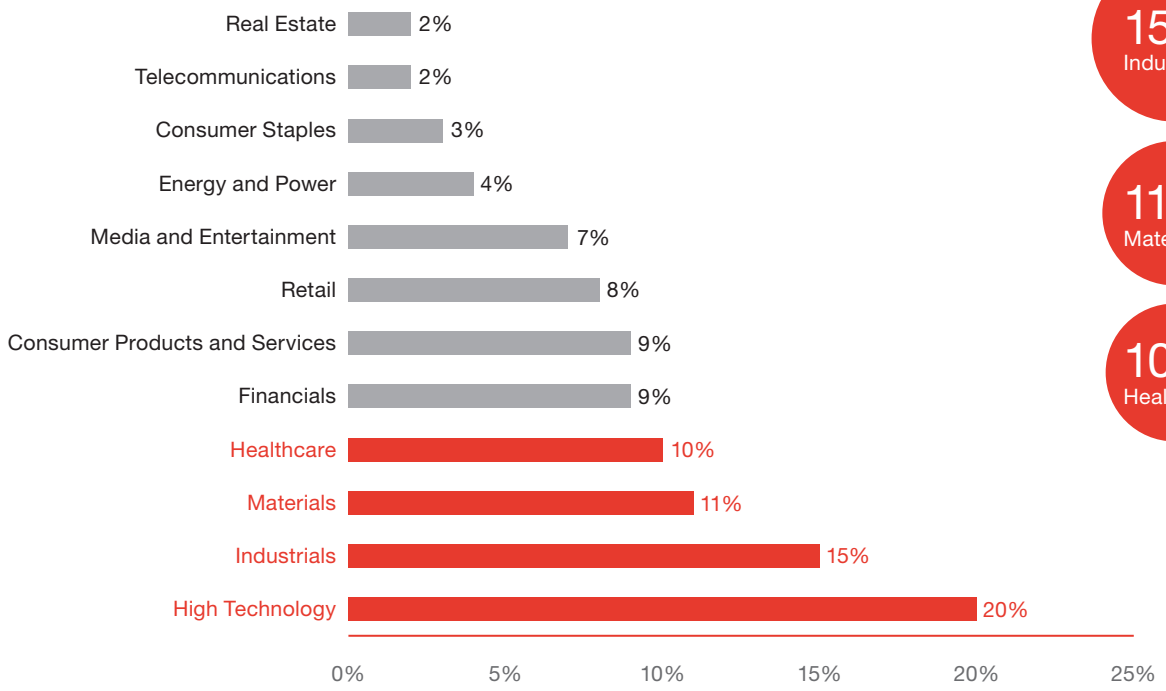
6 PwC Global economy watch—January 2013

Additionally, payments are often required in the context of general business operations, including the ability to:

- Obtain or retain operating licenses and permits;
- Receive favorable inspections of products and operations; and
- Import or export capital equipment, supplies, and products.

The government touch points are numerous and often overlooked or underestimated when assessing a target entity's potential risks.

Table 4: Percent of deals announced and executed in 2012 by US investors in Brazil, China, India by industry



Source: PwC Analysis, based on Thomson Reuters data of 2012 M&A deals announced and executed by US investors

Outbound activity: What industries?

As US investors seek to enter new markets and access the growing middle class, they are often focused on industries that can meet the growing demand of that population. Based on deals announced and executed by US investors, **four industries** have represented over 50%[7] of M&A activity in the Top Three Emerging Markets:

7 PwC analysis based on Thomson Reuters data, 2012 M&A deals announced and executed by US investors

These industries are exposed to a high degree of corruption risk due to frequent government interaction and regulatory oversight in many jurisdictions. Specifically, these industries encounter government officials at every turn. This may include such activities as obtaining port and mining concessions, sales to state-owned hospitals and doctors, inspection of operating and manufacturing facilities, registration and approval of new products, reduction of customs payments and fines, or settlement of tax assessments. Here's a further look at important corruption risk factors, with a focus on sales, purchase, and operating processes:

- *Sales* to government-related customers, including:
  - Nationalized healthcare systems;
  - Governmental ministries, departments, and agencies; and
  - State-owned enterprises.
- *Purchases* of:
  - Raw materials;
  - Finished goods; and
  - Services from government-related suppliers.
- *Operational* activities requiring frequent government oversight, including:
  - Research and development activities;
  - Clinical trials and governmental approval;
  - Registration, licenses, and permits; and
  - Import and export customs processes.

Companies should be aware of the corruption risk that can be faced in these and other industries and develop appropriate risk-mitigation procedures and enhanced controls. Business leaders should be knowledgeable and aware of which industries can present greater corruption risk and increased vulnerability due to the level of government interaction.

To effectively capitalize on opportunities in these industries, companies should remain aware of potential risks and establish defenses against them. Many companies tend to underestimate the risk of improper practices in certain industries, thereby potentially exposing themselves to continued bribery and corruption after acquisition of a target entity.

What anti-corruption regulatory developments are we seeing globally?

In addition to financial and other typical deal risks, foreign investment raises regulatory risk for investors. The most prominent anti-corruption regulation that should be considered when conducting cross-border M&A activity continues to be the FCPA.[8] The US remains the global leader in anti-corruption enforcement, representing approximately 60%[9] of foreign bribery cases.

Other countries are joining the fray by starting to implement additional measures and taking a stronger stance against corruption. For example, Brazil, China, and India have developed, introduced, or enacted more aggressive anti-corruption regulations over the last five years. Such regulations address conduct by both the bribe payers and recipients, whether domestic or abroad. Recently, China has begun to target foreign firms utilizing these new measures.

Careful investors will want to consider and evaluate a variety of regulations when assessing a potential target, including its own domestic regulations and those of any of the target's countries of incorporation, operations, and sales. This can help build understanding of the breadth and depth of international anti-corruption frameworks, enable monitoring of the extent to which emerging policies are being implemented and enforced, and assess the potential impact on their business model and related strategies.

8 Additional prominent anti-corruption regulations also include the UK Bribery act which came into force on July 1, 2011 and governs offenses of paying and receiving bribes and bribing foreign public officials as well as offence of a commercial organization failing to prevent a bribe being paid on its behalf

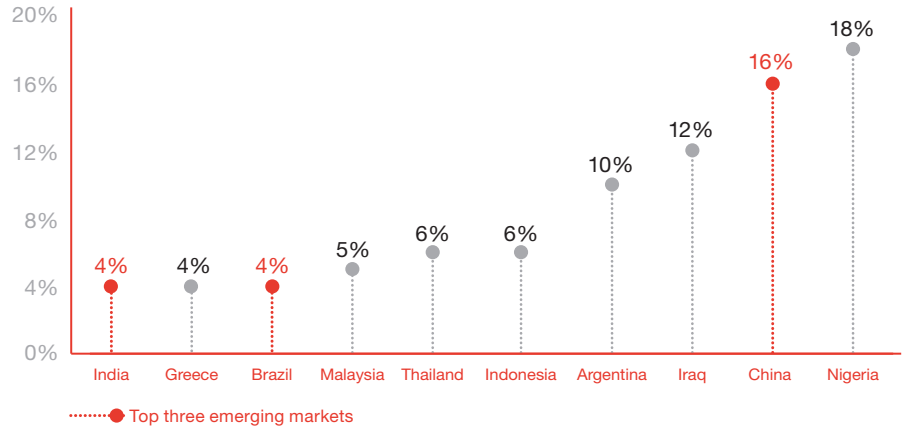
9 The percentage is calculated based on the OECD enforcement data included in the "Working Group on Bribery: 2012 Data on Enforcement of the Anti-Bribery Convention"

Domestic anti-corruption enforcement: What's new in the US?

The DOJ and SEC jointly enforce the FCPA, which prohibits bribery of foreign government officials and applies to anyone or any company that has a connection to the US.[10] Specifically, it prohibits offering or promising to pay, paying, or authorizing the payment of money or anything of value to a foreign official, with the goal of influencing the foreign official's actions or decisions (in an official capacity) or to secure an improper advantage to obtain or retain business.

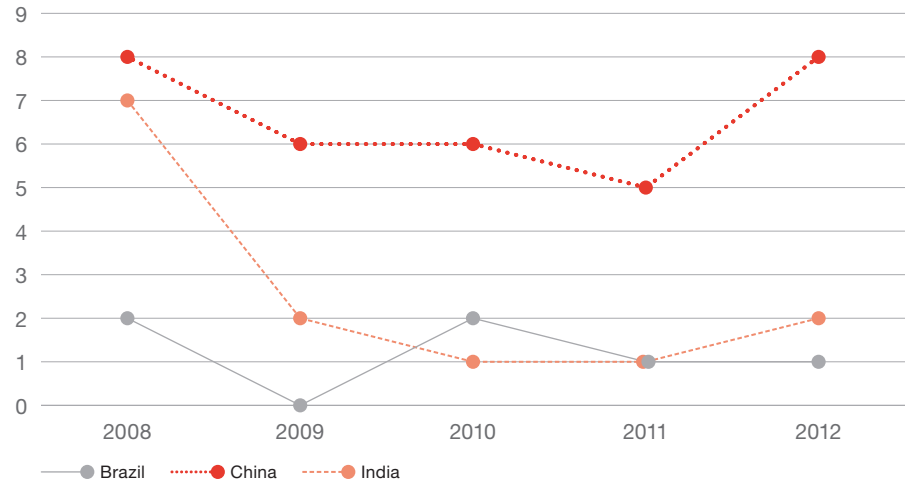
US regulators are encouraging other countries to implement similar anti-corruption standards and take immediate action to enforce existing laws and regulations. Between 2008 and 2012, there have been approximately 250[11] enforcement actions brought by the DOJ and SEC related to conduct in 48 countries (of which 43% and 57% are against individuals and companies respectively). These actions have resulted in over $5 billion in fines, penalties, and disgorgement. Further, nearly 25% of these actions have involved conduct in the Top Three Emerging Markets. *Refer to Tables 5 and 6.*

Table 5: Top 10 target countries by number of FCPA actions between 2008 to 2012



Source: PwC Analysis, based on publicly available filing documents in support of the SEC and DOJ actions[12]

Table 6: Number of FCPA actions per year in the Top Three Emerging Markets



Source: PwC Analysis, based on publicly available filing documents in support of the SEC and DOJ actions

10 The FCPA applies to all US companies and citizens, foreign companies listed on any US stock exchange or required to file reports under the US Security Exchange Act, individuals acting on behalf of such companies or individuals, and entities that commit an offense in the US

11 PwC analysis, based on publicly available documents to include various filing documents in support of the SEC and DOJ actions

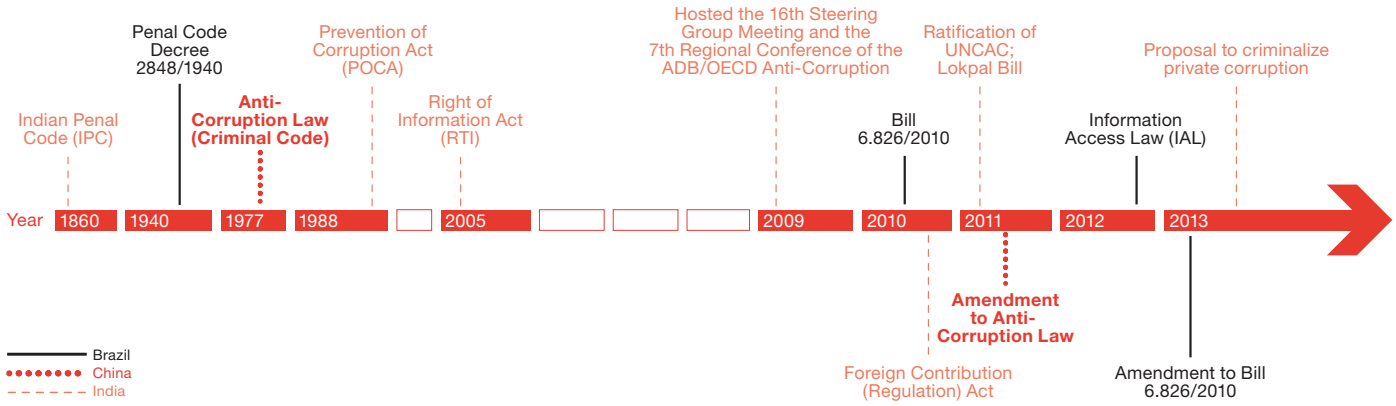
12 The remaining 53% of enforcement actions involved "other" countries with individual percentages between 1% and 4%: Venezuela, Vietnam, Honduras, Russian Federation, Montenegro, Ecuador, Egypt, South Korea, Macedonia, Croatia, Poland, Saudi Arabia, Bolivia, Serbia, Turkey, Turkmenistan, Uzbekistan, Hungary, Ivory Coast, Taiwan, Bosnia and Herzegovina, Congo, Latvia, and Libya

Anti-Corruption regulations: What's new in the Top Three Emerging Markets?

In an effort to better align with the global anti-corruption movement, decrease corruption risk, and attract foreign investors, Brazil, China, and India have begun to implement additional measures and take a strong stance when addressing domestic or foreign corruption.

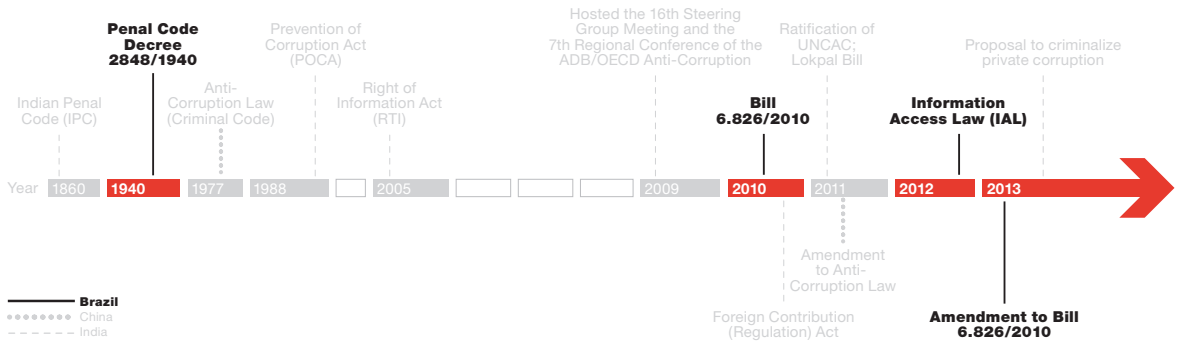
China and Brazil, for example, have enacted legislation that prohibits domestic and foreign bribery as well as bribery by domestic companies and citizens. India has enhanced existing regulations concerning the acceptance of 'anything of value' by public servants, and also implemented legislation restricting foreign contributions to political parties. *Refer to Table 7.*

Table 7: Anti-corruption regulations implemented by Brazil, China, and India



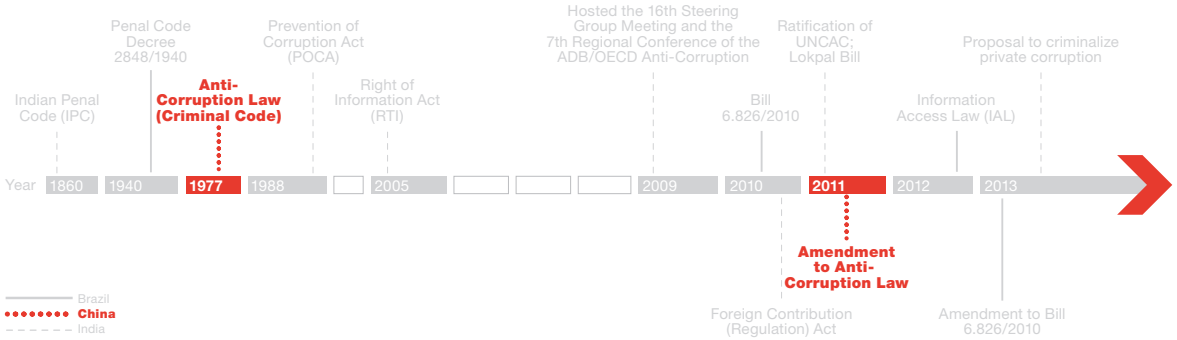
The following pages show an overview of important provisions of major anti-corruption regulations that have been introduced in these emerging markets. *Refer to Tables 7-1 to 7-3*.

Table 7–1: Anti-corruption regulations implemented by Brazil



- On October 25, 2011, the Brazilian Senate passed the Access to Information Law (PLC 41/2010), which was introduced on November 18, 2011 to provide greater access to government information, thereby improving transparency related to the use and allocation of public funds.
- On July 4, 2013, the Brazilian Senate passed the Legislative Bill No. 6826/2010. The anti-corruption bill is intended to overhaul the country's laws targeting bribery and other forms of corruption. Corporate entities, including non-Brazilian companies with an office, branch, or representation in Brazil, are now subject to civil liability in Brazil for corrupt acts. In particular, the law makes companies liable for the acts of their directors, officers, employees, and agents. The new law applies to bribery of Brazilian officials and of foreign public officials. As such, it impacts Brazilian companies doing business in foreign countries and the Brazilian subsidiaries of foreign companies doing business in Brazil.
- Penalties include administrative fines of up to 20% of the gross revenue in the previous fiscal year of the responsible legal entity. However, these fines can't be lower than the advantage obtained from related corrupt activity. If authorities are unable to calculate the gross revenue, the legislation provides an alternate fine between $3,000 and $30 million. Judicial penalties can include disgorgement of benefits obtained, suspension of company activities, and even the dissolution of the legal entity.

Table 7–2: Anti-corruption regulations implemented by China



- In May 2011, China amended the PRC Criminal Code to prohibit bribery of domestic and foreign government officials and international public organizations, where the bribe payer's objective is to secure an 'improper gain.' Criminal liability under this amendment extends not only to Chinese companies or individuals who live abroad, but also to non-Chinese companies that have joint ventures or representative offices in China.

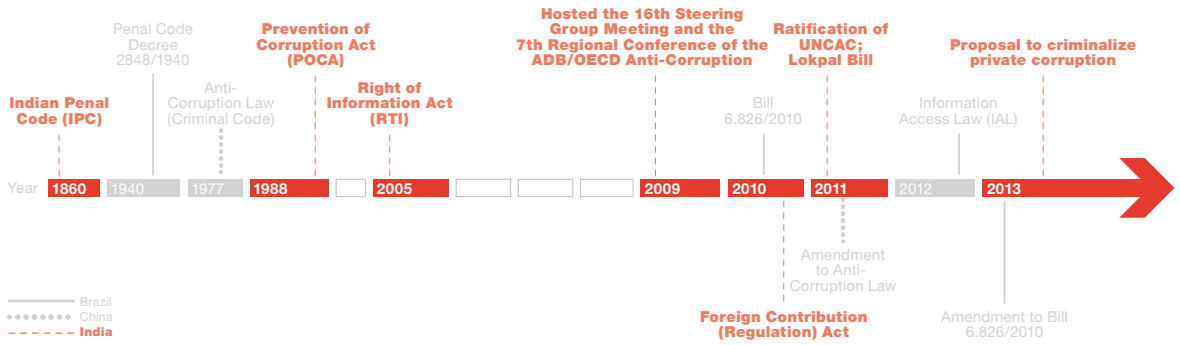
  Because improper gain encompasses illegal profits and illegitimate profits, any competitive advantages obtained in violation of the principles of 'justice and fairness' are deemed improper gains as well. This could, for example, cover situations where one uses confidential information provided by a PRC official to realize a gain in the stock market, when benefits for the bribe payer are in breach of PRC regulations, or when a government official is asked to break PRC regulations to provide assistance in obtaining such improper gains.

- Under this amendment, the sanctions for major criminal offenses related to bribery and corruption vary depending on the nature of the offense and its severity, but generally involve criminal detention up to life imprisonment, as well as confiscation of property or liability for a criminal fine. The law does not specify the minimum or maximum amount of the fine for bribery cases; in practice it's left to the discretion of the judges and can vary from case to case.

- On December 26, 2012, guidance interpreting existing criminal bribery laws was issued. This guidance, which carries the force of law in China, became effective on January 1, 2013. The guidance sets monetary thresholds for a bribe to a state functionary that will generate a criminal investigation (RMB 10,000, or approximately USD 1,600), and also the monetary thresholds and other factors that will trigger categorization as a 'serious case' or a 'very serious case,' among other designations.

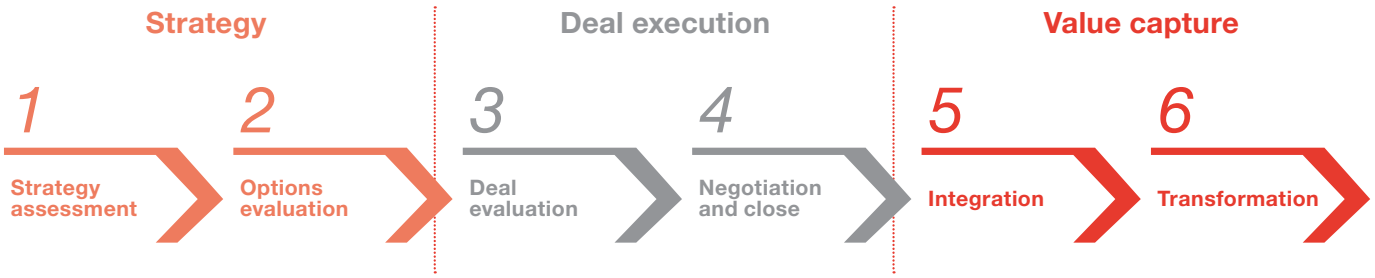
- In March 2013, Lang Sheng, deputy head of the China NPC's (National People Congress) law committee, said that additional anti-corruption legislation would be one of the focal points of the congress's work in the coming years.

Table 7–3: Anti-corruption regulations implemented by India



- India's anti-corruption regulations include a number of laws, many of which were introduced decades ago. They've been enhanced over the last five years. Specifically, the Prevention of Corruption Act prohibits a public servant from accepting anything of value for no consideration or for consideration they know to be inadequate, from any person who is likely to be concerned with any business before a public servant. Punishments include imprisonment between six months and five years; specific amounts for fines are not listed in the law.
- The Foreign Contribution Regulation Act (FCRA 2010), effective May 1, 2011, prohibits political candidates; legislators, political parties, and their office-bearers; and political organizations from receiving contributions as donations, deliveries, or transfers of any article, currency (Indian or foreign), or security. The Act also sets out permitted, restricted, and prohibited actions with respect to acceptance and use of foreign contributions or hospitality by certain individuals, associations, and entities.
- Currently, Indian anti-corruption regulation governs the conduct of the recipients of bribes but not that of the bribe payers; however such conduct may still be prosecuted under the FCPA.

Table 8: Deal continuum



How can you mitigate corruption risk and better assess deal value?

Acquisitions in developing countries bring opportunities and rewards, such as access to new markets. But they also bring a substantial amount of risk that can't be avoided completely. This risk can, however, be targeted and mitigated.

Business leaders can fight corruption and regulatory risk through specific and proactive measures across the deal continuum, from strategy to deal execution to value capture. *Refer to Table 8*. International anti-corruption regulations, including the FCPA and the UK Bribery Act, can be instructive in determining how to face corruption risk prior to and after the execution of a deal. Performing pre-acquisition due diligence and post-acquisition integration and remediation have become a high-priority for organizations that want to up their chances of achieving the desired results of M&A activity while maintaining business continuity.

Specifically, anti-corruption due diligence can help investors to:

- Identify previous instances of potential misconduct;
- Identify contracts and business that may have been obtained through illegal acts;
- Review and evaluate internal controls, books and records, and financial reporting policies and procedures; and
- Enhance the existing compliance program to prevent, detect, and deter potential future violations of law.

Pre-acquisition due-diligence: Why is it worth it?

Investors that fail to perform adequate anti-corruption due diligence prior to a merger or acquisition may face regulatory and business risks, according to the Guide to the FCPA, published November 2012 by the Criminal Division of the DOJ and the Enforcement Division of the SEC. Regulators continue to warn private equity and institutional investors to take responsibility for conducting adequate due diligence.

Regulatory agencies in various countries make similar observations, indicating that inadequate or non-existent anti-corruption due diligence of the target business enables bribery to continue. This presents significant reputation and profitability risk to investors, among other challenges. Companies that conduct effective due diligence, including the assessment of potential corruption risk, prior to executing a deal, can better evaluate the target's 'true value' and negotiate an acquisition price that takes into account historical and current business practices and the possible presence of corrupt activity. Specifically, anti-corruption due diligence can help investors assess the financial risk associated with corruption and the impact it may have on the value of the target based on various factors:

- Loss of revenues that were generated from or associated with bribery or corruption;
- Potential impact on the business model, including changes to customers, suppliers, and use of certain third parties;
- Significant expenses associated with conducting internal investigations in connection with regulatory inquiries;
- Costs associated with the implementation of an anti-corruption program to align it with regulatory expectations and internal compliance program objectives; and
- Costs associated with management time spent on a potential investigation as well as any associated criminal charges against management who may have been involved in the improper conduct.

Based on guidance issued by regulatory agencies and as a result of enforcement actions brought against companies, anti-corruption due diligence should be performed using a risk-based approach that incorporates multiple procedures, including among others:

- Media research and public records searches with respect to the target and key management personnel as well as high-risk third parties, including distributors and sales agents;
- Analysis of financial data, customer and supplier contracts, and other third party agreements as well as detailed transaction testing;
- Interviews with selected members of target management, including compliance, finance, and internal audit personnel, general counsel, and executives in charge of sales and operations;
- Assessment of the anti-corruption compliance program, internal controls, books and records, and financial reporting policies and procedures; and
- Analysis of the target's anti-corruption training program.

Business leaders should understand and address the following areas in developing a risk-based approach and assessing the underlying corruption risk associated with M&A activity:

- *Business locations*—physical operations versus sales destinations;
- *Government interactions*—sales, purchases, and operations;
- *Customer and supplier base*—private versus public;
- *Structure*—management, ownership and joint venture partners;
- *Third parties*—agents, consultants, distributors, and brokers;
- *Violations*—settled and current;
- *Compliance program*—existing and planned; and
- *Management team*—tone at the top and behavioral environment.

If pre-acquisition due diligence reveals potential corruption issues, then pre-closing remedial measures should be put in place. These may include, among others:

- Obtaining anti-corruption representation and warranties within the sales purchase agreement;
- Requiring the target to terminate or suspend agreements or business relationships with employees or third parties responsible for the improper conduct;
- Assessing potential disclosure of identified conduct; and
- Requiring that the target's third parties sign anti-corruption certificates, complete anti-corruption training in their local language, and sign new contracts that incorporate anti-corruption warranties, representations and audit rights.

Post-acquisition integration plan: What's expected?

If it's not possible to conduct pre-acquisition due diligence, companies should still conduct thorough post-acquisition anti-corruption due diligence, as described in the DOJ's Opinion Procedure Release (No. 08-02) and noted in the FCPA Guide.

Table 9 provides an illustrative example of the post-acquisition due diligence timeline described in Release 08-02.

Table 9: DOJ opinion procedure Release 08–02 timeline

10 Days	90 Days	120 Days	180 Days	360 Days
Comprehensive risk-based anti-corruption due diligence work plan	High-risk anti-corruption due diligence conducted	Medium-risk anti-corruption due diligence conducted	Low-risk anti-corruption due diligence conducted	anti-corruption due diligence/ remediation completed

In addition to conducting pre- and post-acquisition anti-corruption due diligence, investors should align their operations with regulatory expectations that they will develop and execute a post-acquisition integration plan that promptly incorporates the target into their internal control environment, including the overall compliance program. Post-acquisition integration should include:

- Integrating the target into the investor's internal compliance and training programs;
- Communicating the investor's compliance and financial policies and procedures to the target's employees and agents;
- Implementing a set of internal controls capable of preventing, detecting, or mitigating potentially corrupt practices; and
- Assigning a senior-level executive to be responsible for establishing compliance policies and procedures and conducting compliance training to address identified risk areas.

It's important that investors identify, address, and mitigate risk through the design and implementation of an integration plan, including the enhanced policies and procedures that the target is expected to adopt. A post-acquisition integration plan is essential, especially when investing in high-risk countries, where business partners and target companies may lack the compliance sophistication and maturity needed to adequately address key areas of risk.

The bottom line

Cross-border opportunities can be alluring. But they also can be daunting. As the saying goes, fools rush in. That said, with thorough due diligence pre- and post-acquisition, you can better position your entity to derive the value you seek from the deal you're contemplating. It's a basic equation: ***Prepare first. Position yourself to prosper for the long term.***

Contributors:

Editors

Matt Shelhorse
Forensic Services Partner

Steven Skalak
Forensic Services Partner

Paul Ellis
Deals Partner

Co-authors and research

Michael Skrief
Forensic Services Director

Roberta Rima
Forensic Services Senior Associate

Design

Nory Hilaire

www.pwc.com

To have a deeper conversation about how this subject may affect your business, please contact:

Manny A. Alas
Forensic Services Partner
Co-FCPA Leader
(646) 471 3242
manny.a.alas@us.pwc.com

Martyn Curragh
Deals Principal
US Practice Leader
(646) 471 2622
martyn.curragh@us.pwc.com

Paul Ellis
Deals Partner
(646) 471 5300
paul.m.ellis@us.pwc.com

Patricia Etzold
Forensic Services Partner
(646) 471 3691
patricia.a.etzold@us.pwc.com

Matt Shelhorse
Forensic Services Partner
(646) 471 5749
matthew.j.shelhorse@us.pwc.com

Steven Skalak
Forensic Services Partner
(646) 471 5950
steven.skalak@us.pwc.com

Michael Skrief
Forensic Services Director
(646) 471 8049
michael.a.skrief@us.pwc.com