Corruption Risk in Mergers & Acquisitions with International Partners
Italian companies are getting more and more international, the barriers and borders of the domestic market are getting weaker and weaker, and supply and demand meet in a worldwide market. Although internationalization represents a big opportunity for Italian companies, it comes with a certain degree of risk.

Over 70% of international markets bear high levels of corruption risk. In order to withstand this risk, international and cross-border organizations, together with local regulators, have implemented a growing number of anti-corruption regulations in the last decades, and pursued an aggressive fight against corruptors all over the world. The enforcement of these regulations is carried out through civil and criminal proceedings, which may cause heavy financial penalties for the companies involved.

This document presents a summary of empiric observations collected by reviewing the trends in mergers and acquisitions (“M&A”) of Italian companies with foreign partners in the period 2012 – 2013, analyzes the consequences arising from international corruption risk and describes possible measures to mitigate such risk in M&A transactions. Preliminary anti-corruption due diligence before the closing of M&A transactions with foreign partners represents the best opportunity to assess the level of corruption risk within the target company and, consequently, redefine the correct purchase price based on the information collected.

Introduction

Between January 2012 and June 2013, Italian companies closed several M&A transactions, which involved various industries and geographic markets. There was a significant push to the internationalization of Italian companies towards both mature and emerging foreign markets. In particular, 40% of transactions carried out by Italian companies in the period January 2012 - June 2013 involved business partners located abroad, either as investors (15%) or targets (25%).

Companies located in the United States were the preferred partners, for both inbound M&A transactions, between foreign investors and Italian targets, and outbound M&A transactions, between Italian investors and foreign targets. Among the foreign investments of Italian companies, there are transactions with business partners in emerging markets, such as Brazil, China, India and Russia, which are notoriously associated to high growth rates as well as high corruption levels.

For Italian companies, interactions with international partners from the aforementioned countries imply, on one side, the exposure to the risk of potentially corrupted behaviors by the business partner, on the other side, the need to be compliant with regulations aimed at fighting international corruption, which may be different and potentially harsher than domestic ones. With this regard, one of the stricter international anti-corruption regulations is the US Foreign Corrupt Practices Act (“FCPA”), which is also applicable to potential foreign corruptors, and governs M&A transactions, by requiring investors to assess corruption risks before the closing of a deal, by means of specific anti-corruption due diligence procedures.

Preliminary anti-corruption due diligence procedures before the closing of M&A transactions with foreign partners should include accounting reviews, verifications on third parties and analyses on the existing anti-corruption policies. Evidence collected through due diligence is instrumental in the correct definition of the purchase price of the target entity; in fact a company, which heavily relies on corruption for its success, has inherent weaknesses that necessarily affect its value. It is also necessary to consider the potential sanctions which may affect the company, should this corruptive behavior be discovered by surveillance organizations.

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1 The percentage is calculated based on the Corruption Perception Index (“CPI”), published by Transparency International, which represents an estimate of the corruption level perceived in various countries, by taking into account only the countries with a below 50 CPI.
2 PwC 2011 Global Economic Crime Survey 2011
3 The high level of corruption is evaluated based on Corruption Perception Index levels below 50, associated to countries such as Brazil, India, China and Russia.
Corruption and regulatory risk for M&A transactions between Italian and foreign entities
From 1 January 2012 and 30 June 2013, M&A on international markets involving Italian companies, both as investors and as targets, amount to approximately 40% of total transactions.

In particular, 25% of international M&A transactions are transactions carried out by foreign companies with Italian targets (inbound M&A), and the remaining 15% are Italian investments on international markets (outbound M&A).

Investing in M&A and choosing an international partner to be merged in its structure may enable to reach foreign demand segments and strengthen its brand outside domestic borders.

However, although the internalization process represents a big opportunity, it is not risk-free.

In their effort to expand abroad and interact with foreign investors and targets, Italian companies face a double risk:

- Corruption risk, upon investing in high-risk countries;
- Regulatory risk, due to possible sanctions or legal (both civil and criminal) proceedings enforced in compliance with harsher anti-corruption regulations.

In this environment, and in compliance with international anti-corruption regulations, investors are required to assess the corruption risk associated to the acquisition of a target company by performing adequate anti-corruption due diligence.
M&A transactions between Italian investors and foreign targets (Outbound M&A)

With reference to transactions carried out by Italian investors on international markets, 30% of targets were located within the Euro zone, 13% in the United States, 11% in the United Kingdom and over 10% in BRICS countries. The United States are the top country to which Italian company directed their investments, with over 10 transactions in the period January 2012 – June 2013.

Top 10 foreign target countries

- USA: 13%
- UK: 11%
- France: 11%
- Germany: 11%
- Brazil: 6%
- Spain: 5%
- Turkey: 5%
- India: 4%
- Sweden: 3%
- China: 3%

*Brazil, Russia, India, China and South Africa.*
M&As performed by Italian companies abroad include transactions to countries identified as at high corruption risk by statistics in fact, the Top 10 target countries includes Brazil, Turkey and China, which have a Corruption Perception Index (CPI) below 50: 43 for Brazil, 49 for Turkey, and 39 for China.

<table>
<thead>
<tr>
<th>Country of incorporation</th>
<th>% of M&amp;A transactions on total</th>
<th>Corruption Perception Index (CPI)</th>
<th>Ranking Transparency International</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
<td>13%</td>
<td>73</td>
<td>19th place</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>11%</td>
<td>74</td>
<td>17th place</td>
</tr>
<tr>
<td>France</td>
<td>11%</td>
<td>71</td>
<td>22nd place</td>
</tr>
<tr>
<td>Germany</td>
<td>11%</td>
<td>79</td>
<td>13th place</td>
</tr>
<tr>
<td>Brazil</td>
<td>6%</td>
<td>43</td>
<td>69th place</td>
</tr>
<tr>
<td>Spain</td>
<td>5%</td>
<td>65</td>
<td>30th place</td>
</tr>
<tr>
<td>Turkey</td>
<td>5%</td>
<td>49</td>
<td>54th place</td>
</tr>
<tr>
<td>India</td>
<td>4%</td>
<td>36</td>
<td>94th place</td>
</tr>
<tr>
<td>Sweden</td>
<td>3%</td>
<td>88</td>
<td>4th place</td>
</tr>
<tr>
<td>China</td>
<td>3%</td>
<td>39</td>
<td>80th place</td>
</tr>
<tr>
<td><strong>Top 10 total</strong></td>
<td><strong>72%</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: PwC analysis on ThompsonOne data

The highest concentration of transactions with high corruption risk countries is in the medical & pharma industry: in fact, transactions carried out by Italian entities in this industry represented, in the reference period, 17% of the volume of M&A transactions in high corruption risk countries. It is well-known that this industry is characterized by a high level of regulation and monitoring by public authorities, and a high level of interaction with public authorities and entities, and in general, with public officials. These factors contribute to increasing the risk of corruptive behaviors, especially in those countries where such behaviors are deeply rooted.

**International anti-corruption regulations and regulatory risk**

Given the growing sensitivity shown by international institutions in fighting corruption risks, specific regulations with extra-territorial effects, such as the FCPA, have become harsher and harsher over time. The most recent amendments to these regulations also govern corruption risk in international M&A transactions, by imposing specific obligations for the investors.

The FCPA is one of the harshest anti-corruption regulations, passed in the seventies and aimed at fighting corruption not only in the US territory but also wherever US entities, their subsidiaries...
and companies listed on US markets operate all over the world. According to the FCPA, legal entities and individuals can be prosecuted, both in civil and criminal courts, should they bribe or attempt to bribe foreign public officials with the purpose of obtaining unlawful advantages. A corruptive behavior adopted in Italy by an Italian company which is part of an American group is liable to be prosecuted by the pertaining US authorities (Department of Justice “DOJ” and Security Exchange Commission “SEC”) according to FCPA provisions.

From 2008 to date, over 200 civil and criminal proceedings initiated by US authorities, the DOJ and SEC, in compliance with the FCPA, have involved legal entities and individuals in over 40 different countries. The sanctions against liable companies are estimated in over USD 5 billion (an average of approximately USD 19.5 million per sanction).

We present aside two cases involving Italian entities under the scope of the FCPA (since they are listed in a US market), which received sanctions from the SEC and the DOJ, for violation of the FCPA, due to corrupting behaviors during joint-venture transactions.

The recent regulations issued in November 2012, about international M&As, by the SEC and the DOJ impose to the investors to which the FCPA applies, the obligation to assess the corruption risk of every potential investment opportunity in high-risk countries.

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Resource Guide to the U.S. Foreign Corrupt Practices Act”, issued in November 2012 by the SEC Enforcement Division” and the DOJ "Criminal Division"

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Source: Trace International
In particular, the investor is required to perform a risk assessment before closing a deal through specific anti-corruption due diligence procedures. In compliance with the two regulators, preliminary due diligence allows to evaluate more accurately the target and adopt the proper procedures to mitigate corruption risks.

The importance of anti-corruption due diligence within the FCPA is confirmed by the fact that when investors have voluntarily reported corruption behaviors at the target discovered during anti-corruption due diligence procedures and implemented adequate remediation plans, both the DOJ and the SEC have shown no intention to prosecute them.

In compliance with the most recent FCPA provisions, every Italian entity under the scope of application of the FCPA is recommended to perform specific anti-corruption due diligence procedures for every potential investment with foreign target companies incorporated in high-risk countries.
Transactions between Italian entities and foreign investors (Inbound M&A)

With reference to M&A transactions between Italian companies and foreign investors, approximately 80% was carried out by companies incorporated in the following countries: United States, Germany, United Kingdom, France, Switzerland, Luxembourg, Spain, Japan, Turkey and Russia.

Source: PwC analysis on ThompsonOne data
US and German companies have shown the highest interest in Italian target companies, and represent 30% of the inbound M&As closed in the reference period (15% of which by US investors alone). This data is relevant with reference to anti-corruption, because, as stated above, the US is the country that has emphasized, more than others, an aggressive fight against international corruption through the FCPA.

Although the Italian market is attractive for investments and M&As by foreign investors, a strong perception remains within the international community (institutions, regulatory boards and investors) that the Italian business environment is associated to low levels of transparency and significant levels of corruption.

According to the 2011 PwC Global Economic Crime Survey, corruption in Italy is increasing at growth rates close to 60% per annum.

Besides, according to the Transparency International rankings, Italy is at the seventy-second place (of 176) for transparency and corruption, measured on the Corruption Perception Index (“CPI”), which was 42 (of 100) in 2012.

The Transparency in Reporting on Anti-corruption (“TRAC”) Report published by Transparency International, which reviews both the quality and quantity of information made available by leading companies worldwide about their anti-corruption and anti-fraud policies, ranked the Italian companies at the seventh place (of 17), and gave Italy an “intermediate – sufficient” outlook.

The growing sensitivity regarding corruption shown by international institutions (first of all, US regulators) has progressively influenced the attitude of the investors from those countries, which are interested in investing in markets perceived as high-risk, such as the Italian one.

For this reason, the corruption risk assessment connected to the acquisition of a potential target has become more frequent while performing due diligence before closing an M&A. In particular, foreign investors are getting more interested in assessing the corruption risk associated to a potential Italian target by verifying: (i) the level of corruption in the industrial environment of the company; (ii) the anti-corruption regulations in the country where the target is incorporated; (iii) the existing anti-corruption compliance program at the target, aimed at preventing and mitigating the risk of potential corruptive behaviors, and (iv) the level of spreading of the anti-corruption program among employees and third parties (including suppliers, subcontractors, external advisors, if any).

In this environment, it is essential for Italian companies to implement appropriate anti-corruption compliance procedures, in order to increase their appeal towards potential foreign investors.

... Over the years, many foreign investors have shunned Italy because of the country’s widespread corruption ...

“Italy in two minds about foreign investors”,

www.reuters.com
7 Ottobre 2013
National regulations and regulatory risk

The potential corruption risk in acquiring a target during M&A transactions between Italian companies and foreign investors is also evaluated based on local anti-corruption regulations. In particular, at this stage, a foreign investor which has identified an Italian target is interested in verifying the provisions of Legislative Decree 231/2001 and the related compliance policies adopted by the target.

Legislative Decree 231/2001 and subsequent amendments regulate administrative liability of legal entities. In particular, according to the Decree, the implementation of an adequate Organization, Management and Control Model (“Organizational Model”) to prevent certain offences could be a safeguarding condition to avoid administrative liability for a legal entity. Together with the adoption of the Organizational Model according to Decree 231/2001, companies are required to implement other policies to prevent offenses, such as: the implementation of an internal control system and its continuous enforcement, training of company personnel and the appointment of a Surveillance Board. With this respect, in the preliminary stages of an international M&A, a target could be required, during anti-corruption due diligence procedures, to report on the anti-corruption risk prevention and mitigation procedures in compliance with the Decree.
Anti-corruption due diligence to assess the risk associated with M&As
The purpose of anti-corruption due diligence within M&A transactions is to assess the corruption risk associated with the target by means of specific procedures, including: (i) identification of illicit payments, if any, connected to corruptive behaviors aimed at obtaining illegal advantages; (ii) review of anti-corruption regulations in the country of the target; (iii) review of the anti-corruption compliance program for the prevention and mitigation of potential corruptive behaviors and (iv) analysis of the dissemination of the anti-corruption program among employees and third parties (including suppliers, sub-contractors, external advisors, if any).

The execution of anti-corruption due diligence procedures during the M&A of a new target allows the investor to:

- Identify unlawful behaviors, if any, at the target in violation of anti-corruption regulations;
- Identify specific activities, contracts, agreements, bids obtained through corruptive behaviors;
- Identify and assess thoroughly the existing internal control system at the target in connection with corruption risks (i.e. understand and evaluate, for example, which procedures are implemented by the target with regards to bookkeeping, information flows to and from management, existing authorization profiles, etc.);
- Assess and evaluate the compliance plan adopted by the target, and implement in advance, if necessary, specific remediation and corrective procedures.
- The anti-corruption due diligence plan comprises several verification procedures, including, for example: (i) background search, i.e. collection of information from the press or public databases on the target, its top management, main clients, agents and suppliers; (ii) transaction analysis, i.e. review of existing contracts with public entities or other subjects who act as intermediaries with public entities; (iii) interviews with management; (iv) review of any existing compliance plan at the target, with regards to corruption risk and training policies for employees on this subject.

These activities allow to mitigate the corruption risk associated with the acquisition of a new partner and correctly evaluate its purchase price. In fact, corruption risk may affect the value of a target company in several ways; the following are just some examples:

- Future expected costs due to the implementation of a compliance and anti-corruption model at the target, aimed at mitigating future corruptive behaviors;
- Future expected sanctions for corruptive behaviors, if any, identified through anti-corruption due diligence procedures;
- Quantification of any additional charges for possible investigations required by relevant authorities;
- Quantification of any additional cost for assistance which the management of the target may require in case of inspections by surveillance authorities or investigations.

Consequently, a preliminary anti-corruption due diligence plan within M&A transactions allows to identify not only the risk connected to corruptive behaviors at the target company, but also those resulting from possible sanctions and legal proceedings. The preliminary identification of such risks allows to evaluate more accurately the purchase price and estimate future costs, associated to the implementation of additional corruption risk prevention and mitigation measures.
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