

## THE STRATEGIC BENEFITS OF INTEGRITY DUE DILIGENCE

*In this first in a series of **Squire Sanders Deal Points**, London and Moscow office partner, **Christopher Rose**, discusses with **Alex Davies** of **Baker Tilly** the strategic benefits of Integrity Due Diligence and why these exercises are on the rise in transactions in emerging markets.*

**Christopher Rose:** What is Integrity Due Diligence (IDD) and how does it differ from the legal and financial due diligence exercises typically performed in investment and M&A transactions?

**Alex Davies:** The central goal of each of these categories of due diligence is to obtain a deeper knowledge and understanding of the target business, primarily from a risk perspective. IDD is generally conducted in parallel with legal and financial due diligence and differs from them in two crucial respects: areas of focus and methodology.

***“The financial and legal optics provide powerful insights into a target business but also miss out a great deal. Performed well, IDD comprehensively fills this gap in understanding, with the principal focus being on the key individuals owning and managing the business in question.”***

IDD on the one hand looks at the track records of the individuals concerned, their perceived competence and areas of expertise, their management modus operandi and the division of roles within the business between these key players, notably identifying the real decision makers on both strategic and day-to-day operational matters. IDD would usually set these issues within the context of the development of the company as a whole, looking at the historical and current roles of the principal founders, how both the strategy and market perception of the company has evolved over time, and any track record of partnerships with western companies. A final important feature of IDD work concerning the key individuals is to gain an understanding of the true beneficial ownership of the company, which leads us on to the other major focus of IDD work.

Alongside this intelligence gathering centred on the key individuals, IDD will also examine aspects of the target's operations which might pose major but unquantifiable financial or reputational risks to a putative acquirer. Here the focal point is the interface between business and politics: the nature and strength of the company's connections and how these are leveraged; the extent, nature and credibility of any allegations against the company or its key principals relating to bribery/corruption, money laundering, large scale tax evasion, fraud and asset stripping. Similarly, any alleged interface between the company and organised crime groups (or, more rarely, groups labelled as 'terrorist') will also be examined.

These issues tend to be those most frequently covered on an IDD project, but I would stress that this work can be highly-tailored according to the wishes and prior concerns of the client. In some cases, for example, issues such as labour rights abuses and a history of pollution problems (and associated trouble with regulators) can be central subjects of enquiry.

***“Both corporate and private equity clients also regularly ask us to undertake macro-level tailored country risk analysis work as a complement to an IDD project.”***

Methodologically, IDD is also substantially different from financial or legal due diligence. IDD work is undertaken confidentially and usually without access to any books or internal records of the target. IDD is essentially an investigative information gathering process, combining interrogation of a vast array of public records with in-depth human intelligence gathering through our network of tried and trusted sources on the ground in the relevant jurisdiction(s). The final and crucial aspect of the IDD methodology is to analyse, weigh, balance, clearly source and impose appropriate structure and context upon all the information thus gathered. In markets where press freedom is circumscribed and “black propaganda” a not-infrequent weapon of competition, the information gathering burden is quite heavily skewed towards our human intelligence networks in-country.

**Christopher Rose:** IDD is not yet a routine part of most corporate transactions. Is this set to change?

**Alex Davies:** Since 2001, the main impulse behind the conducting of integrity-related due diligence enquiries has been compliance, with a welter of new legislation reaching statute books around the world, intended to combat corruption, money laundering, terrorist financing and other illegal activities. What has perhaps been lost in this compliance-driven environment is a widespread understanding of the broader, strategic utility of IDD work, both for wider risk management purposes and in engendering more effective decision-making on new investments and partnerships.

***“Once essentially commissioned only by the very largest corporate multinationals and IFIs, this latter, strategic application of IDD is on the rise globally, with emphasis on emerging markets like Russia, as both strategic and institutional investors are requiring a more comprehensive examination of target companies.”***

**Christopher Rose:** Can you give an indication of what the costs would be for a typical IDD exercise for an investment transaction?

**Alex Davies:** There is a fair amount of variability in costs on these projects, but as an illustration I usually take a base case of undertaking IDD on a single company (or small, tightly-integrated business group) plus four to six key principals of the company/group, where the company is based close to a major economic centre. Typically at Baker Tilly we would charge fees of between £30,000 and £40,000 (plus out of pocket expenses and any applicable VAT) on a project of this kind, depending on the precise scope of work required and the location of the company. Larger, complex projects, may lead to fees of anything up to £100,000, though rarely more than this. The most important variable pushing costs up tends to be any requirement for on-the-ground investigation in multiple jurisdictions. Perhaps slightly counter-intuitively, it is often slightly more expensive to undertake IDD on smaller companies, as their lower profile means that a smaller circle of people will have an in-depth knowledge of them.

**Christopher Rose:** Many investors perceive IDD as a luxury rather than a necessity, opting to engage firms like yours only when they already suspect something may not be right with the target. What would you say to convince them that IDD should be a staple of every transaction?

**Alex Davies:** As an illustration of what a more sophisticated view of IDD work can achieve, and with a particular eye on the CIS market, I have briefly described here a selection of issues on which credible and specific reports have been picked up during my IDD projects in the region. In each case the information uncovered has had a significant impact on the decision making of the clients concerned. One important caveat to raise here is that governance environments, both business and political, can on occasion shift quite rapidly and with them the prevalence and salience of many of these specific risk factors. Nor is this list by any means exhaustive.

1. 'Round tripping' through offshore companies in order to artificially boost the share capital of a company. IDD work has found this to be an issue of concern notably with a number of banks, where they have made loans to offshore companies controlled by the bank's shareholders or directors. The money has then been reinvested into the bank as share capital, creating an illusion of solid capitalisation. This issue is not confined to banks, however, and in some regards might be seen as a special case of the risks associated with related party transactions (see also point 4 below).
2. Hidden ownership of the business through offshore structures. This obviously raises a host of questions about the true identity of your business partners/co-owners and matters of trust. Within certain categories of large enterprises, some improvement has been noticed over time with regard to transparency of ownership, with pressure from major investors such as the European Bank for Reconstruction and Development assisting this shift. It remains an enormous problem, however, and in

recent investigations I have continued to see even part-listed entities whose shareholding structure includes major stakes held anonymously through multiple layers of offshore companies. One should question the likely motives behind such a concealment of beneficial ownership in itself, but it clearly also raises the likelihood that certain of the other dubious activities highlighted in this list may be occurring.

3. De facto control/"ownership" of a business by key officials through strong political patronage. It pays both to be aware of allegations of this sort prior to entering into any investment deal or business partner, and also to examine the source and extent of the power the politician in question may wield over the company and details of what the alleged patronage relationship might involve. In extreme cases, the existence of the company as a going concern may be dependent on one or more political figures, for example where the company is reliant on them to grant essential operating licences which may require periodic renewal. I don't have sufficient space here to discuss all the risk dimensions of key political relationships (or indeed a lack of them), but this serves at least to highlight one of the major concerns in this category.
4. Asset stripping of a business through, for example, consultancy businesses owned by the Directors. The moral here for a potential acquirer is to beware of apparently small companies on the fringes of a main company or group and to ensure you are aware of any consultancy or other service agreements between them. On several occasions we have found such companies to be beneficially owned by key directors using such contracts to siphon money out of the core enterprise. On occasion, such consultancy agreements can also lock in such arrangements several years into the future.
5. Leakage of intellectual property and/or goods themselves, leading to grey markets, smuggling etc. This is a common issue with, for example, branded consumer goods companies. In addition to risks such as the undermining of pricing power in the market, the existence of significant problems with theft or grey market activity may point to deeper issues at a company around issues such as site security and relationships with local organised crime gangs.
6. Members of the board acting as representatives of specific interest groups, for example a branch of the security services or a regional governor. Making sure you have an understanding of the interests represented by particular directors is crucial to the understanding of the nature of your business partner or future investment/acquisition and also to your pre-deal negotiations with them.
7. Mismanagement by key principals of a business, frequently founders, leading to high staff turnover, over-centralisation of decision making or factionalism within the organisation. This is an issue often seen at fast-growing, formerly small organisations dominated by one or two founders, leading to difficulties in transitioning into a well-functioning larger enterprise.

8. Credible allegations of significant corrupt payments made to officials, whether as cash bribes or payments in kind, such as paying the school fees for an official's offspring, gifting membership of a prestigious golf club etc. Bribes, kickbacks and other corrupt payments are well-known – and extremely common – “red flags”, but it would be impossible to write an article such as this without some mention of them and the multifarious forms such payments, favours or payments-in-kind can take. I would stress here the importance of developing a thorough awareness not only of your potential acquisition or business partner but also of the macro environment as concerns corruption in the relevant country. Consequently, we frequently undertake tailored country risk analysis work for clients alongside an IDD project, in order to provide both a micro-level and macro-level view. Consider the potential impact on your reputation if allegations of corruption came to light, but also maintain an awareness of your potential exposure/vulnerability to investigation by authorities either within that country or elsewhere. It is also worth factoring into your risk assessment the possibility of future regime change in the country concerned, which brings us neatly to the next point.
9. Over-reliance on key political relationships, leaving the company potentially vulnerable to future regime shifts. An IDD investigation would typically examine your potential acquisition partner's key political relationships at local and regional levels as well as nationally (and in some cases internationally), the importance of each layer, the nature of the relationships in question and to what degree the company is reliant on one or two crucial political ties.
10. The use of the business as a conduit for money laundering, whether by organised crime figures or political patrons. An IDD investigation would aim to highlight current or previous allegations of money laundering against a company, but other factors will also provide you with clues as to future risks of this kind. Essential again here is to understand the true beneficial ownership of your potential partner company, the nature and extent of their political connections, as well as any allegations of organised crime links. The macro country situation with regard to corruption and associated money laundering should also be taken into account, as should the attitude projected by your potential partner's leadership team and the resulting corporate culture on these issues.
11. The use of “ghost workers” to boost payrolls on government contracts, frequently in combination with kickbacks paid to ministerial officials. This is an interesting specific case of corruption risk which has been seen a number of times in relation to companies focused on large infrastructure projects.
12. The existence of well-connected co-investors with a track record of not fulfilling investment promises, leaving you under pressure to pick up the tab. Co-investors with strong political connections can also pose future risks of asset confiscation or newly emergent fierce competition based on theft of your investee's intellectual property.

Whilst many of the risks highlighted above appear daunting, and the difficulties of handling them should not be minimised, it always pays to gain a thorough understanding of them in advance of any deal, and with access to good information many can be addressed in large part either during the negotiation process around the structuring of a deal or by new managers you are able to bring in post-acquisition.

Squire Sanders is one of the world's strongest integrated legal practices with more than 1,300 lawyers in 39 offices across 19 countries. Widely acknowledged for its international reach and diverse sector expertise it advises a wide variety of business enterprises, financial institutions and governmental entities around the world.

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