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How to steer clear of corruption

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Investors need to be aware of the severe implications of failing to identify and manage risks in certain jurisdictions. Lloyd Firth of WilmerHale guides readers through the minefield

As frontier and emerging markets develop and mature, they continue to offer the potential for outsized return on infrastructure investment for both companies looking to own and operate such assets ‘on the ground’ and for institutional investors, such as pension funds and investment banks, looking to generate an income by investing in infrastructure-focused funds.

Unfortunately, many of the countries in which these alluring infrastructure projects are located are also often high corruption risk jurisdictions. Taken together with the prospect of regular interaction with government officials and the complex and fragmented contractual nature of the projects (reliant as they often are on venture partners and third-party contractors), such investments, once set against the global reach and active enforcement of anti-corruption legislation, may present a corruption risk profile that is unacceptable to investors.

This article details why companies and institutional investors should be concerned about corruption risk, what those risks look like in practice and the pro-active compliance steps available to identify, mitigate and manage those risks.

A PERFECT STORM OF JURISDICTIONAL AND SECTOR RISK

Infrastructure investments located in emerging and frontier markets present a high corruption risk for two principal reasons: jurisdiction and sector. Markets such as the CIS, the Middle and Far East, Latin America and Western and sub-Saharan Africa all have a high level of perceived public sector corruption according to Transparency International's Corruption Perceptions Index.1 This is compounded by the fact that many of the sectors most closely associated with infrastructure investments, such as public works, construction, utilities, oil and gas and mining are all regarded as having the highest propensity to pay bribes abroad.2

CRIMINAL EXPOSURE

Failure to properly identify and mitigate corruption risk brings with it the potential for criminal investigation and prosecution of both the infrastructure project company and also its individual managers and directors.

This is a very real exposure. The Bribery Act 2010 (Bribery Act) affords the UK's Serious Fraud Office (SFO) extensive jurisdictional reach to investigate and prosecute individuals and companies for suspected bribery, which takes place wholly overseas. Of particular relevance for those looking to invest in infrastructure projects is that under section 7 of the Bribery Act, a company can be held liable for bribery committed by associated persons acting on its behalf (such as venture partners or third-party contractors), even where the company had no knowledge or awareness of the bribery.

The only defence open to a company is to show that it had adequate procedures in place to prevent bribery being committed by those venture partners, by way of example, who are associated with it.

The consequences of a successful criminal prosecution can be dramatic and include:
the imposition of unlimited fines;
imprisonment;
director disqualification;
the confiscation of assets;
debarment from participating in, or tendering for, government contracts;
the withdrawal of World Bank and Multilateral Development Bank funding;
a reduction in value of the underlying asset;
a diversion of management and board time;
reputational damage and adverse media attention; and
increased difficulty in securing prospective capital investment.

CIVIL RISKS FOR INSTITUTIONAL INVESTORS

The adverse consequences of failing to anticipate and manage corruption risks are not restricted to companies who own the asset on the ground and nor are they purely criminal in nature, however. Institutional investors should be equally cautious of the civil mechanisms of redress available to UK prosecutors.

By way of example, in May 2011, exercising its powers of civil recovery under Part V of the Proceeds of Crime Act 2002, the SFO clawed back dividends paid to the sole shareholder of Mabey & Johnson Ltd, a UK company convicted in 2009 for a number of corruption offences. In the accompanying press statement, the former Director of the SFO made it clear:

“Shareholders who receive the proceeds of crime can expect civil action against them to recover the money… investors in companies are obliged to satisfy themselves with the business practices of the companies they invest in… particularly so for institutional investors who have the knowledge and expertise to do it…We will be much less sympathetic to institutional investors whose due diligence has clearly been lax.”3

Whilst the settlement was reached prior to the appointment of the current Director of the SFO, David Green QC, the precedent remains valid. Pension funds, investment banks and other institutional investors are legally obliged to actively engage in assessing and managing the corruption risks faced by those infrastructure investments in which they hold an interest. To do otherwise is to take on a material legal and commercial risk.

COMPLIANCE PRESSURE POINTS

How then to address corruption risk? The first step is to be able to identify what those ‘compliance pressure points’ look like in practice. Clearly, each project will have its own unique set of facts but the following list reflects some of the most common pressure points:

Public sector interaction. Many of the entities involved in the infrastructure sector are likely to be either wholly or partly state owned and their employees are likely to be considered foreign public officials for the purposes of relevant anti-corruption legislation (such as the Bribery Act or the Foreign Corrupt Practices Act 1977). The high number of points of contact with government officials increases the likelihood of bribes being demanded, particularly in jurisdictions where public sector pay is markedly lower than that in the private sector.

Tender risk. During a competitive tendering or bidding process for a state-awarded contract, companies should be particularly alive to the risks of any excessive gifts and hospitality expenditure being made around the time of the tender award.

Contractual risk. Contracts for public works are often large and “one-off” in nature, making it difficult to effectively benchmark time and cost estimates against similar projects; making it easier to conceal additional or inflated expenditure.

Partner risk. Infrastructure projects are heavily reliant on a web of third parties, including contractors, sub-contractors, agents and venture partners, amongst others. This can make tracing payments a difficult task; a huge problem given companies can be liable for the action of a joint venture partner (as detailed earlier).

In-country regulatory risk. Many infrastructure projects rely on being granted and then retaining a government licence or permit of some kind. Approvals for example, for environmental, health and safety and community development licences will all inevitably increase the opportunity for corrupt payments to be made or demanded.

COMPLIANCE RESPONSE

Given the myriad possible combinations of risk that each company will face, a well-designed compliance programme needs to be bespoke, risk based and most importantly, proportionate. Whilst there is no one-size-fits-all, prescriptive approach, there are certain hallmarks of any effective anti-corruption compliance response. These include:

A public and unequivocal tone from the top, making it clear that corruption, in any form, will not be tolerated. This should be evidenced by anti-corruption being a standing item on the Board's agenda and responsibility for the implementation of the anti-corruption compliance programme extending up to Board level.

Carrying out a regular, by-country risk assessment, to effectively identify and prioritise corruption risk.

In response to the risks identified as part of the risk assessment, crafting and implementing a written set of policies and procedures that cover off, amongst other items: facilitation payments, gifts and hospitality expenditure, political and charitable contributions and sponsorships. It is crucial that such policies and related internal controls are subjected to routine external verification throughout the entire life cycle of a project (given the long-term nature of many infrastructure assets) in order to regularly test that they are not being bypassed in practice. Regular training should also be provided and should include a process of annual certification for those staff members who are in the country.

Proportionate, risk-based due diligence should be undertaken prior to entering into any contractual arrangements with third parties. This should include local site visits and in-person interviews where appropriate.

All joint venture agreements and third-party contracts should be drafted to include terms that provide for, amongst other items: audit rights over a third party's books and records, a unilateral right of cancellation in the event of a corruption related breach and a fixed annual term.

Establishing an effective and well-resourced whistleblowing programme. To ensure that this works well in practice, it should be available in the relevant local language and, where relevant, specific dialect and ideally be available for use by third parties.

Joining and actively participating in sectoral anti-corruption initiatives with stakeholders such as governments, suppliers, contractors and joint venture partners.

CONCLUSION

Whilst the corruption risks posed by investing in high-risk jurisdictions are real and potentially severe, it should also be apparent from this article that they are more than capable of being identified and mitigated against in a proportionate manner.