Political Risk and the Due Diligence Process

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With the ever-increasing role played by emerging markets in the world economy, it is crucial that any globally competitive company has a firm grasp of not only the economic factors impacting its business, but political ones as well. In emerging markets, where political and legal institutions are often underdeveloped, "relational capital" plays a critical role in any business transaction. Relational capital is a term coined by Clifford G. Gaddy of the Brookings Institution and denotes a company's formal and informal ties to a country's bureaucratic and political elite. To be sure, such ties are meaningful in virtually any business setting. But they take on a whole new meaning in countries like Russia, Kazakhstan, and China, where a company's political connections can matter more than its balance sheet in determining future success. Therefore, the ability to identify and mitigate such connections is crucial to the success of any company in an emerging market.

However, in cultivating such ties, companies should be aware they constitute both an asset and a liability. While they may provide a competitive advantage, they also expose the company to the very serious reputational risk of associating itself with unsavory political figures. In addition, such relationships may run afoul of U.S. law, specifically the Foreign Corrupt Practices Act (FCPA) of 1977. Therefore, it is essential that any due diligence inquiry includes a thorough examination of the subjects' political ties.

The FCPA was a revolutionary piece of legislation at the time. With its passage, the United States became the first industrialized country to prohibit its companies and citizens from bribing foreign officials in order to facilitate business. At first, the law was dismissed as both naïve and a detriment to American multinationals that would not be able to keep up with their European and Japanese competitors who were free to offer such inducements.

However, 30 years later, the law turned out to be ahead of its time. Today, most industrialized countries have enacted similar legislation, and the FCPA has proved a valuable weapon in fighting transnational organized crime, terrorism, and money laundering. Since September 11, 2001, U.S. authorities have enforced the FCPA with unprecedented zeal. According to an article from the New York Times dated November 25, 2007, the FBI has reportedly created a new five-member team devoted to unearthing possible FCPA violations, and there are currently about 60 such investigations taking place. In addition, some industry experts believe that the FCPA has surpassed Sarbanes-Oxley as a top concern in corporate compliance offices. On April 26, 2007, the U.S. Justice Department and the Securities and Exchange Commission (SEC) announced that Baker Hughes Services International, Inc., a wholly owned subsidiary of BHI, paid a record settlement of US$44 million in civil and criminal penalties for violating the FCPA in obtaining oil contracts. A central allegation in the U.S. government's case against Baker Hughes was its failure to conduct adequate due diligence to verify whether its more than US$1 million in payments to offshore firms controlled by Kazakh officials constituted bribes.

Furthermore, the SEC has made clear its determination to continue to prosecute U.S. companies under the FCPA. In April 2007, it released the following statement in connection with the Baker Hughes settlement: "The SEC will continue to hold U.S. companies and their subsidiaries accountable for foreign bribery, and the record penalties leveled in the Baker Hughes case leave no doubt that foreign bribery is bad for business. Companies like Baker Hughes will be held accountable when they circumvent the rules of fair play and honest competition by making improper payments to win business." In addition, in October 2006, the Norwegian hydrocarbon

giant Statoil, whose shares trade on the New York Stock Exchange, was fined US$10.5 million for FCPA violations in Iran. Statoil was nabbed for entering into an agreement with an Iranian official who requested that the company pay some US$15 million to an offshore company for "consulting services." In exchange, the Iranian official promised to steer a contract for developing the South Pars gas field towards Statoil.

Failure to conduct adequate due diligence and to identify the political ties of one's foreign business partners can subject a company to undue reputational risks and potential prosecution. Many recent examples of this can be found in Russia, the most famous being the expropriation of YUKOS oil and the jailing of its founder, Mikhail Khodorkovsky. Mr. Khodorkovsky's political activism combined with his search for a major foreign partner reportedly infuriated the Kremlin, which believed businesspeople should stay out of politics and that foreign companies had no place exploiting Russia's natural resources. Western minority shareholders lost more than US$6 billion as a result of the YUKOS affair, much of which may have been avoided had they thoroughly analyzed Mr. Khodorkovsky's political activities as part of the due diligence process. A review of widely available Russian and English media records would have revealed that when they came to power in 2000, Vladimir Putin and his advisors made it clear that they planned to reassert state control over the country's natural resources and had no patience for billionaires with a political agenda. According to the May 13, 2000, edition of *The Economist*, Mr. Putin vowed to "eliminate the oligarchs as a class." Furthermore, in 1997 and 1999, when he still served in St. Petersburg's city administration, Mr. Putin penned academic articles strongly advocating state control of Russia's natural endowment. Although Mr. Putin's agenda did not make the state-initiated breakup of YUKOS a certainty, it may have been more easily anticipated had the necessary due diligence and subsequent monitoring procedures been put in place.

Although Western investors would do well to use caution in partnering with individuals who draw the ire of their country's political elite, the same holds true for partnering with businesses that have too cozy of a relationship with a country's rulers. A prime example of this is the recently disclosed U.S. Department of Justice inquiry into the British military contracting giant BAE Systems, which has been accused of making at least US$2 billion in questionable payments to Saudi royals over the past 20 years.

Another prime example is Russian billionaire Roman Abramovich, whose Evraz Steel SA made a US$2.3 billion bid for Oregon Steel Mills in late 2006. Although the transaction was ultimately approved, the SEC, Justice Department, and the Committee on Foreign Investment in the United States (CFIUS) heavily scrutinized Mr. Abramovich's purported close financial ties to Russia's presidential administration.

The increasingly prominent role being played by emerging markets in the global economy means that, for the foreseeable future, companies will continue to be exposed to substantial political risks. The above cases underscore the importance of carefully vetting the political exposure of one's foreign partners, and make clear that companies that fail to include such procedures in the due diligence process do so at their own peril.

For more information, call, email or visit us online.

877.230.9082

edd-contactus@kroll.com

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