POHLMANN & COMPANY

International Compliance Update

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Our "International Compliance Update" portrays current developments and trends in international compliance legislation, jurisdiction and practice with a focus on their relevance for Germany.

Germany

Sponsoring – All parties may risk a "red card"

- The widely spread practice of sponsoring may constitute passive or active bribery.
- There are no higher court decisions on permissible sponsoring, but a thorough check of the specific facts can at least determine the risk potential.

Four years ago the "Volkswagen sponsoring affair" hit the headlines in a big way. The emerging settlement of such criminal proceedings deserves some attention:

During ongoing negotiations between Volkswagen ("**VW**") and Deutsche Telekom subsidiary T-Systems on the extensions of multi-million Euro contracts in 2010 for, VW supposedly made it a condition that Telekom sponsor the VW-controlled premier league soccer club VfL Wolfsburg with several million Euro. Instead of signing the contract, Telekom disclosed this matter to public prosecution.

The public prosecutor's office in Stuttgart investigated against VW as well as the employees allegedly involved in the negotiations on both sides and eventually pressed charges against two employees of VW (for passive bribery) and three former employees of T-Systems (for active bribery).

According to the media the proceedings have been closed now: The indicted individuals will have to pay fines between EUR 20,000 and over 100,000 and will have to perform social services. Moreover, VW has to pay a fine of EUR 2 Mio. The District Court of Stuttgart (Landgericht Stuttgart) closed the proceedings due to a lack of public interest and based this decision on the fact that the advantages of the sponsoring deal would have privileged VW only and not the defendants themselves. The court explicitly criticized that VW as well as T-Systems did not have sufficient measures in place to prevent the unlawful linkage of soccer-sponsoring with other businesses.

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Even though the parties finally did not enter into the contract, the case received broad media presence. But "sponsoring" is neither new on the agenda nor is it a highly uncommon practice putting business in context with sports. However, in practice it is apparent that there is a general uncertainty relating to this topic: Sponsoring is a common practice of "customer care", isn´t it? Is the linkage of two respective contracts already unlawful? Or is it only the economic value of the prosed sponsoring agreement that creates the problem? Is it easier to enable a permissible sponsoring if the contracting party and the recipient of the sponsoring are members of the same group?

Two of the many arguments brought in favor of sponsoring are that it enhances the image of the company and improves the relationship with the clients. But if sponsoring and the generating of business contracts are directly linked, the suspicion of active or passive bribery is likely to arise. Decisive criterion of the offence of bribery is the existence of an "unlawful agreement" (*Unrechtsvereinbarung*) between the parties that aims at granting the beneficiary an advantage as a return for the future preferential treatment of the party granting the advantage. The existence of such an unlawful agreement can yet be ruled out if the benefit to be granted could be considered socially adequate. But social adequacy is not only a very broad term that may also be construed controversially. Nevertheless, some well-established indicators should be considered in an overall assessment of a prospective sponsoring initiative:

- What is the economic value of the sponsoring?
- Is the proposed sponsoring part of an established sponsoring concept?
- Are there any contract negotiations running in parallel to the sponsoring talks?
- Are private and business interests being mixed?

All in all it can be concluded that due to the lack of any higher court decisions there is currently no definite right or wrong as to the criteria or limits of a permissible sponsoring. However, a thorough check of the specific facts of the case at least determines the risk potential at hand. In any event, an adequate awareness of the parties for the potentially problematic nature of the topic is a first important step.

World

New compliance standard ISO 19600 to be introduced

- Adoption of the new ISO 19600 standard in July 2014.
- ISO 19600 should offer companies of all sizes guidance in the implementation and operation of compliance management systems.
- The essential component is a risk-based approach, at present a widely employed best practice.
- ISO 19600 follows an approach similar to the German IDW PS 980 of the German Institute of Auditors.
- A certification process of the new ISO 19600 remains to be seen.

In mid-July the International Organization for Standardization ("**ISO**") adopted the new ISO 19600 "Compliance Management Systems-Guidelines" ("**Standard**"). It is expected to be released with worldwide applicability in early 2015. The Standard is based on an existing Australian Standard (AS/NZS2806) from 1996 and the Austrian Compliance Standard ONR 192050[1] from 2012.

The structure of the new Standard takes into account different levels of integration of Compliance Management Systems ("**CMS**") – from development to implementation and continuous development. With about 50 clauses on about 40 pages in total, this Standard is supposed to be lean and manageable. The individual provisions are preceded by general principles for the design of a CMS such as good corporate governance, proportionality and flexibility.

The centerpiece of the new Standard is a risk-based approach which is already established as best practice for designing an appropriate CMS. Following this approach, a risk analysis (or so-called risk assessment) has to be conducted in order to identify the specific risks of each business model (so-called risk map). Subsequently, specifically required compliance measures must be derived. Each company may then decide which measures, systems and controls should be implemented in order to meet the requirements and to ensure the effectiveness of the system. A risk-based approach thus provides companies of different sizes - from small businesses to global enterprises - the possibility of introducing an effective and cost-efficient CMS.

The new Standard should also be compatible with existing structures. If a company's general management system already follows the ISO High Level Structure approach ("HLS"), the new Standard can be integrated as an additional "plug-in". This overarching structure is available for all ISO management system standards and aims at unifying the development of new and revised standards.[2] For example, companies that already implemented the ISO 9000 quality management system standards can add items of the new Standard without abandoning existing elements. The already implemented management system will simply be expanded to include a compliance component.

The new Standard follows a similar approach as the existing Guidelines for the Audit of CMS of the Institute of Public Auditors in Germany.[3] IDW PS 980 requires a risk analysis, too, and leaves the decision of the detailed CMS design to the company. For companies that have already implemented a CMS according to IDW PS 980, adapting to the new Standard could be relatively simple. Meanwhile it remains to be seen what future certification procedures for the new Standard may eventually look like.

However, the raison d'être of such certifications remains a sometimes controversial issue among professionals. The need to implement a CMS strictly according to standards such as the existing German IDW PS 980 or the new ISO Standard is also questioned. For several years, the methodology and recommendations applied by the two standards are recognized as international best practices and already applied by compliance industry leaders since longer. Thus it remains to be seen to what extent the new Standard can achieve a widespread recognition.

[1] https://shop.austrian-standards.at/Preview.action;jsessionid=A6CBF3CEC2E03AD86B414E4E9A7942F1?preview=&dokkey=447051&selectedLocale=de
[2] http://www.dnvba.com/de/DNV%20%20Downloads/%C3%84nderungen_ISO_9001_website1.pdf
[3] http://www.idw.de/idw/portal/n281334/n281114/n302246/index.jsp

World

Let the buyer beware – Compliance Due Diligences in M&A Transactions

- Highest number of take-overs with German involvement since 10 years.
- Increasing liability risks also for financial investors in anti-trust violation cases.
- World Bank Integrity Compliance Guidelines as advanced assessment criteria.

The market for corporate take-overs is booming: in the first six months of 2014 749 companies were acquired with German involvement. This number does not only represent a 13% rise against the same timeframe of the preceding year. It also displays the highest amount ever since 2004.[1] But the currently record-low interest rates are not only firing up the sheer number of transactions. The deal volumes, too, have increased significantly: with an amount of EUR 92 billion buyers paid altogether 50% more for the acquired targets than in the preceding year. And nine times one billion or more was paid – with the prestigious take-over targets Celesio (EUR 4,6 billion), Rhön-Kliniken (EUR 3 billion) and Grohe (EUR 2,7 billion) on top of the list. In 2013, purchasing prices were exceeding the one-billion-Euro-threshold only five times.

1. Price is what you pay - Value is what you get

Following the bonmot of serial US-investor Warren Buffet actual pricing should not take center stage in acquisition projects – but fair value should. However, compliance problems can create serious harm to valuations of target companies and potentially trigger post-closing liabilities for buyers. And this no longer applies to strategic investors only. In April 2014, the European Commission for instance imposed anti-trust fines amounting to EUR 302 million against eleven manufacturers of high-voltage cables on the grounds of systematic price-fixing and market demarcation agreements.[2] The Italian company Prysmian, formerly part of the Pirelli group and subsequently divested in a flat sale to Goldman Sachs, belonged to this list of violating companies. Although the US financial investor was eventually reducing his equity stake down to 43%, the European Commission held Prysmian and Goldman Sachs jointly and severably liable and imposed a fine of EUR 37.3 million. The financial investor argued unsuccessfully that he would not have obtained any evidence of market-abusive practices prior to the take-over. In this case, the European fair market guardians were focusing on the concept of "economic unity" as an underlying principle in every majority acquisition – and not on the individual shareholder. In addition, the principle of 'decisive influence' determined the liability against Goldman Sachs. The European Commission argued that in fact board members were selected by the financial investor thus influencing strategic decision-making as well as gaining continuous operational insight in Prysmian.

2. Risk comes from not knowing what you're doing

How can buyers – no matter if financial- or strategic investors – protect themselves against anti-trust or corruption-risks that had already materialized in target companies prior to their acquisition? According to another proverbial Buffet quote, they need to know what simply has to be done in such situations: thorough compliance due diligence has to be performed.

Since long specific legal-, financial-, tax- or commercial due diligence exercises have become undisputed best practice in transaction projects. Because of the described anti-trust fine of the European Commission, but also because of the wide extraterritorial reach of international anti-corruption legislation such as the US FCPA, the UK Bribery Act or the Canadian CFPOA and their grave sanctions – and let's not forget the ever increasing impact of additional legal requirements in environmental- or data protection laws – it has become highly recommendable to conduct on top specific compliance due diligence in order to prevent irreversible reputational damage and contamination with liabilities. The scope and methodology of such compliance due diligences exercises will often differ significantly from 'classic' data room reviews. In general, not all distinct features of an effective and efficient compliance management system ("**CMS**") can be written down in the first place and documented accordingly. Furthermore, even the most seasoned investor should not expect that explicit written evidence of market violations or corruptive behaviors will show up in a data room. According to our experiences, these four steps should regularly be examined:

(1) Compliance Risk-Analysis

Without a systematic compliance risk-analysis comprising structured interviews with the target's senior management and additional key functions such as the Chief Compliance Officer or the Head of Internal Audit it will get nearly impossible to evaluate effective compliance communication, adequate tone from the top and a genuinely embedded compliance culture. Market abuses or corruptive behavior will most likely not be admitted to freely. Therefore the specific market environment and peer group characteristics must be analyzed in addition.

(2) Compliance Program Assessment

The existing compliance program of the target company must be assessed in detail. As a starting point, the structure and the components of the CMS of the buyer should be applied as benchmark. The direct comparison normally displays the differences in efficiency and effectiveness of the target's compliance program in the sense of a 'gap analysis'. This gap analysis in return provides the backbone of the inevitable planning of post-closing integration. Additionally, further frameworks such as the US FCPA Resource Guide,[3] the US Sentencing Guidelines,[4] the UK Bribery Act Guidance[5] or the German public auditing standard IDW PS 980[6] can be applied. Prudent investors should also consider the Integrity Compliance Guidelines of the World Bank Group as a particularly comprehensive and advanced compliance framework. Quite frequently target companies will not display robust CMS. In these cases buyers must at least compile all exhibited single measures and controls as a basis of the assessment of the existing capabilities to identify and manage compliance risks.

(3) Review of litigation and other legal proceedings

In close and real-time collaboration with the legal- and tax-due diligence tracks risks out of pending or future criminal law- or administrative proceedings must be reviewed. In this regard all active enforcement activities of domestic as well as international courts and authorities against the target company and its legal representatives, i.e. directors and officers, have to be considered.[7] This includes proceedings against employees on the grounds of anti-trust and anti-corruption laws – but also violations against public contracting requirements or corporate finance covenants. The potential or actual loss of public contracts, large-scale projects, access to debt finance or public subsidies can significantly impact valuations and reduce the target's overall attractiveness.

(4) Integrity Checks

It is also highly recommendable to conduct specific background research and commission detailed integrity checks on the target company beyond the information made available to the data room both on entity- and on individual level. These reviews should not only be conducted as mere internet researches. In compliance with all applicable data protection- and privacy laws available information resources and international databanks compiling entries from public registers, sanctions- and embargo lists, blacklistings e.g. of the World Bank Group or press archives should be reviewed.

3. Let the buyer beware – Conclusion

Caveat emptor – or let the buyer beware: a thoroughly conducted compliance due diligence protects from being dealt dead hands and against making it inadvertently fast to the headlines. Reputational damage oftentimes creates similar havoc for investors as contamination with target liabilities regularly does. The systematic capability to plan, execute and evaluate compliance due diligences in typical M&A situations must form an integral part of an effective and efficient CMS of any buyer.

[1] FAZ of 21.07.2014, S. 22.
[2] Press Release European Commission of 02.04.2014, http://ec.europa.eu/deutschland/press/pr_releases/12248_de.htm
[3] http://www.justice.gov/criminal/fraud/fcpa/guide.pdf
[4] http://www.ussc.gov/guidelines-manual/2013-ussc-guidelines-manual
[5] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/181762/bribery-act-2010-guidance.pdf
[6] http://www.idw.de/idw/portal/n281334/n281114/n302246/index.jsp
[7] *Moosmayer*, Compliance – Praxisleitfaden für Unternehmen, 2nd edition 2012, S. 80.

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We'd like to know your areas of interest.
Please send us your suggestions via e-mail to:
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