

2B.IV Case story: Integrity Due Diligence

Michael Price* | Statoil

“If carried out thoroughly and early enough, the Integrity Due Diligence process will provide valuable ‘red flag’ warnings.”

Integrity Due Diligence is the process of mitigating risk arising from association with a third party who may be or may have been engaged in unethical or illegal practices. The risk may exist as a direct liability incurred by the company through its association, or it may take the form of reputation damage as guilt by association. This type of risk is particularly significant when the company is operating in an unfamiliar environment where local partners are previously unknown to the company and information on local ethical practices is scarce.

The process of Integrity Due Diligence seeks to secure as much information as possible about a prospective third party before any business relationship is entered into. The process covers the third party's interests, reputation, activities, associations, track record and motives, and may be used for assessing any type of business associate, from prospective partners, suppliers, customers, consultants or agents to candidates for prospective mergers.

The Integrity Due Diligence process is progressive and layered. It begins with the acquisition of basic information directly from the third party and open inquiries made to follow up the business and financial references provided. Depending on what this information shows, specific issues may then be examined in more depth. Open

sources such as the Internet can be supplemented with the services of external consultants and some confidential field work in order to identify and further investigate specific indicators. The extent and level of detail of this further research will depend on several factors, including the financial value involved, the commercial importance of the third party, and how much is already known about them.

If carried out thoroughly and early enough, the Integrity Due Diligence process will provide valuable “red flag” warnings indicating that further checks and mitigation are needed or even that the business relationship being considered should not be pursued at all. Integrity Due Diligence also provides useful documentation of a company's own risk management. The very fact of having executed an Integrity Due Diligence process may help to meet criticism if a business relationship should later lead to liability or reputation damage in spite of the investigation.

The risk environment

In short-term relationships involving agents or intermediaries, a company may be at risk by association if these third parties pay or take bribes on its behalf. The third parties may also have vested interests that are unknown to the company and in conflict with its own interests. In

*Vice President Business Integrity, HSE, Statoil ASA

“The level of risk to which companies are exposed through their relationships with third parties is increasing as business becomes more international.”

longer-term partnerships and joint ventures, the company's risk exposure may also stem from hidden differences, concealed information and ulterior motives, or there may be a failure to comply with applicable laws. In the case of a merger or acquisition, the acquiring company should be aware of additional so-called legacy risks if the enterprise being acquired is engaged in unethical or illegal practices or is in possession of assets that have been obtained through such practices.

Generally, the level of risk to which companies are exposed through their relationships with third parties is increasing as business becomes more international. Opportunities now arise more often in unfamiliar environments where the ground rules may be different or unclear. At the same time, international legislation is becoming stricter, and practices that were generally accepted less than a generation ago are now criminal offences with serious legal, commercial and reputation consequences.

The United Nations Convention against Corruption, which came into force at the end of 2005, is the first global legally binding instrument on corruption and includes measures on prevention, criminalization and international cooperation, as well as specifying ground-breaking provisions on asset recovery. The Convention is the latest and most wide-reaching addition to an expanding legal framework to combat corruption, in which the 1997 OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions and the pioneering US Foreign Corrupt Practices Act of 1977 are also important elements.

Basic information

The extent of the initial screening in preparing an Integrity Due Diligence will depend on the nature and reputation of the third party under consideration. The scope should be decided in consultation with people who are familiar with the due diligence process and the applicable laws and regulations. The process should then be explained fully to the third party in order to secure their cooperation, possibly extending to the provision of a formal letter of

authorization for the Integrity Due Diligence team to use when carrying out their research.

The research team should request basic information about the third party, including ownership information, corporate structure, place of incorporation, composition of boards and higher level committees, and the names, locations, telephone numbers and c.v.'s of officers and key personnel. Ownership interests in the company should also be given with company registration details for the parent company and any holding companies. A full description of the company, including a brief history, should also be requested.

Ownership and interests held by the third party, key management personnel and their immediate family in other organizations should be stated, in order to identify possible conflicts of interest. The third party's business, Governmental and political affiliations, including those of key management personnel and their immediate families should also be documented and particular attention given to any relationships with Government officials.

Local laws protecting privacy need to be considered in carrying out this research. In countries with unstable political regimes, a confidentiality agreement may be useful in persuading a third party to provide details of political affiliations.

Business and financial references capable of verification should be obtained and the third-party asked to notify referees. Obtaining audited financial statements for the previous two years is advisable, but failing this, unaudited accounts certified by senior management may be accepted.

The standard terms of business, if any, of the third party should be requested together with instructions required for invoice payment. Legal disclosures should be requested regarding any involvement by the third party or key management personnel in previous, pending or potential insolvency proceedings, criminal convictions or investigations, or civil litigation.

Finally, it may be a good idea to compare local market rates with rates quoted by the third party for the supply of any goods or services.

Verification and further research

The next phase of the Integrity Due Diligence work comprises verification and follow-up of the basic information. It may be that this work can be completed using only open sources such as the Internet, subscription databases, media searches, public records and industry information. However, independent field work may be needed to supplement these results, involving the use of external sources. Here it should be borne in mind that any information obtained will be only as good as the source that provides it and that checking the credentials of external sources may also be a necessary, if time-consuming, feature of this work. In order to ensure impartiality, personnel independent of the business unit concerned should be responsible for any external research.

A growing demand for support services related to Integrity Due Diligence has unfortunately encouraged some unqualified individuals to pass themselves off as specialists. This problem, and the likelihood of unacceptable methods being used to obtain information, can mean a company risks compromising its own standards in the process of trying to document that they are being met.

The following areas should be considered in carrying out the verification and completion of an Integrity Due Diligence process:

Business and financial references

Independent confirmation of reputation, integrity and political relationships should be obtained directly from the referees provided by the third party. If personal interviews cannot be obtained, then a telephone conversation or a written statement on a reference form may be acceptable. Audited financial records for at least two years should be examined, but failing that, a financial referee may give an opinion on reliability, probity and financial capability. A bank reference should always be obtained.

Ownership interests and accounts

Official registries of companies and other organizations usually make their records available to the public in some form,

by personal application at the office concerned, by written request or even on-line. Examples of company registries available over the Internet are the UK Companies House on www.companieshouse.gov.uk and the United States Securities and Exchange Commission on www.sec.gov.

Key personnel and officers

For information on individuals connected with the third party, a variety of sources may be used, including electoral records, local Government business records and commercial business libraries. Local resources may be useful in tracing the appropriate sources. Criminal records should be checked for key personnel, if this is legally permissible in the country concerned and if necessary with the authority of the subject of enquiry. Court judgements, like the official registries of organizations, are normally available for public scrutiny, either by visits to the court involved, through websites, or, if sufficiently serious, in local or international media reports. An example of an on-line service is the site for judgements handed down in the UK High Courts on www.courtservice.gov.uk/judgments/judg_home.htm.

Credit ratings and restrictions

Credit ratings are available for many companies from one of the reputable commercial sources offering a rating service on individuals and organizations. Other facilities for checking bankruptcy or insolvency records include registers available to public scrutiny and Internet listings. Such a service covering insolvency notices and databases, creditor meetings, liquidations, receiverships and administrations in the UK can be viewed at www.insolvency.co.uk. A check should also be made to see that the third party does not appear on local or international listings of individuals or organizations restricted by trade regulations imposed by certain countries or debarred from bidding for contracts. The World Bank site at www.worldbank.org/html/opr/procure/debarr.html provides a list of debarred individuals and companies judged to have committed acts of bribery or corruption in bid processes.

Media search and local legal assistance

Free and subscription databases should be used to re-search the third party, beginning with a simple Internet search using one of the larger search engines, such as www.google.com. If the third party has a website, this should be examined together with Government sites designed for use in combating cartel activity or fraud. Here too, there are many large international commercial concerns that will carry out media searches for a fee. If advice on the local legal system and practices is not available from internal resources, a reputable local legal firm could explain their significance. Such a firm would also be able to assist with the verification of local corporate registration, or in checking local criminal or civil court records.

Field work

Some information may be obtained only through discreet and sensitive research in the field. This should be carried out by qualified professionals. Considerable caution needs to be exercised to avoid methods that may compromise the company ethically and legally.

“Red flag” warning signals

The following sections give examples of so-called “red flags,” the warning signals indicating that further research is needed or that a relationship with the third party may not be advisable:

“Red flags” in the basic information provided by the third party:

- A public official holds interests in the third party in a personal capacity rather than in an official one;
- The third party has been recommended by an official who has discretionary authority or influence over the business in question;
- An officer, executive or key employee of the third party has interests in a competitor or is related to someone there;

- The business or financial references are ambiguous or missing information;
- The third party’s normal terms of business differ significantly from local business terms and conditions;
- Payment instructions given by the third party include split payments, payments to unrelated entities or payments to a bank account in an offshore tax regime;
- Company auditors have qualified the accounts produced by the third party;
- The information makes mention of a criminal charge, the conviction of an employee for bribery and corruption, or the unsuccessful defence of a civil action for such an offence;
- The third party discloses previous involvement in insolvency proceedings;
- There is a significant difference between the remuneration rates quoted by the third party and local market rates;
- The third party refuses to sign a statement promising to abide by all local and international laws regarding bribery and corruption or by the company’s business ethics policy;
- The third party refuses to disclose the identity of the directors, owners or employees.

“Red flags” in verification and further research:

- Qualifications claimed by the company are denied by the issuing body, or the issuing body is not a bona fide professional entity;
- Written business references differ significantly from what the referees say in interviews;
- Financial referees express reservations regarding the financial probity of the third party;
- The third party is a shell company or has some other unorthodox corporate structure.

- Records from the official registry of companies do not agree with the information given by the third party on ownership, directorships or any other details in required official documentation;
- The company or its holding company is registered in an offshore tax haven;
- The company representative refuses to reveal the identity of the owners or directors;
- Records show a different location for the company;
- There is a record of a criminal charge, a conviction of an employee for bribery and corruption, or the unsuccessful defence of a civil action for such an offence, which has not been disclosed by the third party;
- A reputable credit agency has provided a poor credit rating on the third party or has drawn attention to previous liquidity problems not disclosed by the applicant;
- The third party appears on a list of organizations debarred from bidding on local, national or international contracts;
- Media searches reveal potentially damaging information regarding the applicant;
- Research uncovers close associations with local or national politicians, potential competitors, criminals or political activists.

Documentation and conclusions

A final Integrity Due Diligence report should be prepared documenting the scope and individual phases of the investigation, summarizing the findings, specifying areas of uncertainty and drawing conclusions on their potential consequences for the company. This will form the basis for management to decide whether or not to proceed with the business relationship.

Case studies

Case story A: Beta Energy

Business opportunity

Beta Energy was a Western oil and gas exploration and production company with interests in several developing countries, including B_____. Statoil was considering the acquisition of Beta Energy's B_____ portfolio by purchasing the company's local subsidiary outright.

Reasons for Integrity Due Diligence

Any business relationship between Statoil and Beta Energy would be limited to the purchase of the subsidiary company and would cease as soon as this was completed. However, corruption was known to be endemic in B_____, and as Beta Energy was a company unknown to Statoil, there were questions related to how it had acquired its assets.

Basic information

A preliminary study showed nothing irregular in the formalities concerning Beta Energy's establishment as a company and its initial domestic trading. However, a look at its more recent history showed that Beta Energy had experienced a rapid expansion into international exploration beginning less than ten years ago. This came after many years of unremarkable performance in its domestic oil and gas business. Beta Energy's international attention was quickly focused on B_____, where it soon acquired the central assets in its current portfolio in negotiations with the national oil company, NOCB. The speed with which these negotiations were concluded and the successful outcome for Beta Energy were said to have surprised many observers, especially as the company's evident optimism was soon vindicated by the discovery of substantial reserves. The suspicion that the main asset may have been secured by unethical or illegal means made further investigation advisable.

Verification and “red flags”

- During further investigations, it became clear that Beta Energy had encountered a certain Dr F_____, working for Gamma Services, a foreign petroleum consulting company, as their business development expert for B_____. Dr F_____ had also previously worked at NOCB;
- When inviting bids for the license in which Beta Energy later made their hydrocarbon discoveries, NOCB made 30 per cent of their technical information available to interested parties. According to a reliable source, Dr F_____ had paid a named NOCB technician to gain privileged access to a further 40 per cent of the technical information on the relevant area. This gave Beta Energy prior knowledge that the license had a high potential for a discovery, prompting the company to make a more generous offer than its competitors, and ensuring its success;
- After the license had been awarded, it was alleged that the same NOCB technician had continued to receive payments from Dr F_____, acting on behalf of Gamma Services, for further information supposedly required by Beta Energy prior to drilling;
- Two years after the license award, Beta Energy granted a 10 per cent net profit interest in the asset to another company, Delta Petroleum, of which Dr F_____ was believed to be part-owner. No contracts between this company and Beta Energy, apart from the net profit interest agreement, could be traced. Based on subsequent estimates of producible reserves, the agreement was said to be worth over US\$80 million at the time it was made.

Assessment

- Although the reported account of Beta Energy's acquisition of its main asset in B_____ was impossible to verify, two independent investigating entities had encountered the same story;
- The payments allegedly made to the NOCB technician implied bribery of an official, which indicated that Beta Energy had acquired its assets in an unethical and illegal manner;
- The net profit interest granted to Delta Petroleum was substantial and raised serious questions as to whether it was appropriate and proportionate to services rendered.

Conclusion

Statoil's evaluation of Beta Energy's assets in B_____ with a view to negotiating their acquisition was terminated.

Case story B: Omega Offshore

Business opportunity

Statoil was looking for a service company to act for it in marketing a drilling rig it wished to sub-contract. The rig was available for use in an area off the coast of C_____, a developing country with an established oil and gas industry. The most competitive terms had been offered by a local company, Omega Offshore.

Reasons for Integrity Due Diligence

Corruption was endemic in C_____, Omega was a company not well known to Statoil, and there were questions related to its ownership and associations.

Basic information

Omega Offshore responded to Statoil's request for information by filling in the candidate questionnaire satisfactorily and providing external business references, which included two international oil companies. Among the entities specified in the questionnaire as owners, part-

ners or shareholders, the name of a holding company, Epsilon Investments, appeared as owning over 90 per cent of Omega Offshore's shares. This entry was followed by a breakdown of the ownership of Epsilon Investments, in which appeared the following:

"14 per cent held by Caicos Trust Company in a blind trust for the benefit of Mr J_____, serving politician in the Government of C_____."

This information was confirmed further on with affirmative responses to the questions "Have any of the key people mentioned above ever held a Government job or served in the military?", "Do any...perform services for any Government-controlled entity?" and "Do any...currently hold any position with or have any duties for any political party or political campaign?"

In each case the name of Mr J_____ appeared. The question "Will Omega Offshore market to a Government or Government agency, including the military?" was also answered in the affirmative, and the agency was identified as the national oil company of C_____.

Verification and "red flags"

- In following up the references provided by Omega Offshore, it became evident that several of the referees had not been aware of the interest held by Caicos Trust Company for the benefit of Mr J_____, although there was no evidence from their response to Statoil that Omega Offshore had ever intended to conceal the fact;
- The concept of an interest being held for someone in a "blind trust" was then discussed in detail with a specialist, who confirmed that this was an acknowledged step that could be taken in order to minimize the risk of a conflict of interest in such a case. The trust had total discretion to invest, buy or sell assets and to gather the benefit of the assets on behalf of the beneficiary of the trust, who had no insight into the management of the assets

and so, in theory, had no motivation to act in a manner that might benefit any of the holdings. This arrangement was mandatory under the laws of C_____.

Assessment

- The Integrity Due Diligence check had been carried out openly with Omega Offshore, and without the need for any investigation other than the questionnaire and reference verification.
- The arrangement of placing Mr J_____’s interest in a "blind trust" appeared to mitigate the risk of an actual conflict of interest, especially as the trust itself was based outside C_____.
- The senior position of Mr J_____ in the Government of C_____, and the possibility of their rig being marketed to the national oil company of C_____ made it extremely important for Statoil to err on the side of caution, to avoid not only actual conflict of interest but also any appearance of such a conflict.
- The security given by the "blind trust" arrangement was not considered to be evident enough to outside observers to mitigate sufficiently the risk of reputation damage to Statoil in the event of controversy about Mr J_____’s interest in Omega Offshore.

Conclusion

Omega Offshore was dropped from the list of bidders for the services required by Statoil.

Case story C: Alpha Exploration

Business opportunity

Statoil was offered the opportunity to participate in an exploration license in A_____, by entering into partnership with a local oil and gas company, Alpha Exploration. The license

in question was to be awarded to Alpha Exploration independently of the normal oil and gas bidding rounds in A_____.

Reasons for Integrity Due Diligence

Corruption was endemic in A_____, Alpha Exploration was a company unknown to Statoil, and there were questions related to its associations and to the process by which it expected to acquire the asset it was now offering to share.

Basic information

A candidate questionnaire submitted to Alpha Exploration was returned completed and accompanied by c.v.'s for officers and references for the company. On examination these were found to contain nothing to raise suspicions. However, the recent date of registration of the company, only a little over a year previously, seemed to limit significantly the value of these findings. It was therefore decided to carry out further research.

Verification and “red flags”

- The personal references provided for officers of Alpha Exploration were checked and revealed nothing that contradicted the positive impression given by the initial information. In the course of further investigations, however, the name of a certain Mr G_____ was mentioned by several independent sources as having recently been an adviser to Alpha Exploration;
- Mr G_____ had attracted a lot of negative publicity in recent years because of the activities of a company belonging to a group owned by him, which had allegedly been involved in criminal activity. An external investigation of the matter was still ongoing and, in the meantime, several libel actions brought by Mr G_____ against those who had made or repeated the accusations against him had been dropped;
- When researchers took up with Alpha Exploration the matter of their use of Mr G_____, the company claimed they had since severed their connections with him but that, in any case, they had not believed the allegations against him;

- Further investigation showed that other business connections might exist between Mr G_____ and several key officers of Alpha Exploration, as well as members of the ruling family in A_____. The main representative of Alpha Exploration in A_____ was said to be a personal friend of a member of the President's family, while the registered owner of Alpha Exploration was also reported to be employed as general manager of a company in Mr G_____’s group. Another of Alpha Exploration’s owners was said to have been a technical director for the same group and to have graduated from the same college and at the same time as Mr G_____.

Assessment

- The possibility that Mr G_____ was still associated with Alpha Exploration could not be ignored, and it may even have been the case that he was the company’s real beneficial owner;
- The reputation damage that Statoil risked by being seen to be associated with Mr G_____ was considerable;
- The connection to the ruling family in A_____ raised the possibility that the expected licence award would be made to Alpha Exploration on a discretionary basis in which personal relationships and privilege would play a part;
- Taking advantage of a business opportunity that existed because of a possible abuse of entrusted power was not consistent with Statoil’s values;
- No conclusive evidence was likely to be obtainable to finally confirm or deny continuing connections between Alpha Exploration and Mr G_____ and Mr G_____ and the ruling family in A_____.

Conclusion

Statoil decided to refuse the offer of participation with Alpha Exploration in the license it expected to be awarded.