

239 The Elements of Good Due Diligence Judgment Practical Tips to Improve Compliance Reviews of Third-Party Relationships



MICHAEL H. HUNEKE,
Partner, Hughes Hubbard & Reed LLP

JAN DUNIN-WASOWICZ,
Associate, Hughes Hubbard & Reed LLP

1. Background

1.1. Introduction

Third-party relationships carry significant risks of corruption for international companies. While the basis for legal responsibility may vary from one jurisdiction to another, all OECD jurisdictions recognize the principle that third parties should be vetted before being engaged due to the risk that they could pass on funds or otherwise bestow improper benefits to foreign public officials to facilitate sales or obtain other advantages.

In-house and external professionals operating in this area are accordingly well aware of the fundamental importance of conducting risk-based due diligence of third parties to guide the development of compliance programs and inform business decisions. Appropriate due diligence remains the only way to reduce the bribery risks arising out of third-party relations.

More recently, large international companies have increasingly been evaluated not only on *whether* they conduct due diligence but also on *how* due diligence is performed, including the quality of the analysis. The assumption that, beyond being required to perform due diligence, companies are expected to conduct due diligence in a certain way raises at least two difficult questions. Which standard should govern the compliance review of third-party relationships? When is due diligence deemed sufficient to meet external expectations?

No one-size-fits-all rule answers these questions. For those in search of unifying principles, the cacophony of standards potentially appli-

cable to global companies is harmonizing around the need to develop and demonstrate good due diligence judgment.

After touching on the legal frameworks in the U.S., U.K. and France, we describe below what we mean by the exercise of good judgment applied to due diligence, and we then propose some ways to develop and practice good due diligence judgment.

1.2. Legal Frameworks

There is an international convergence around the proposition that companies expose themselves to civil and criminal liability if they pay third parties to act as their agents in the face of unmitigated red flags, in the absence of risk-based anti-corruption due diligence. The U.S., U.K. and French legal standards illustrate this.

For decades now, the U.S. has aggressively tackled the “head-in-the-sand problem” by sanctioning those who purposefully or willfully avoid knowing about the wrongdoing. Under the Foreign Corrupt Practices Act (“FCPA”), “knowledge” of corrupt payments made via third parties can be established by showing not only actual awareness that the third party will make an improper indirect payment, but also awareness of a “high probability” of the existence of such a “circumstance”, i.e. the existence of unexplained or unmitigated “red flags” that should put someone on notice that the third party may be engaged in improper activities. Only by demonstrating - through risk-based due diligence - an actual belief that these circumstances do not exist can a person defeat this presumption.

Approaching the same ends via a different means, the U.K. Bribery Act provides for strict liability for commercial organizations for the acts of a third party (associated person), with an affirmative defense available to companies who can demonstrate they had adequate procedures to prevent bribery by associated persons. Whereas the FCPA's anti-bribery provisions require "knowledge" (as defined above) of the agent's conduct in order for liability to attach, under the U.K. Bribery Act the actions of the third party will be attributable to the corporation, regardless of whether any corporate officer or employee had knowledge of the third party's actions. The affirmative defense places a great emphasis on designing and implementing appropriate due diligence on third parties.

France requires that compliance programs identify and address third party risks. Under the Sapin 2 Law, certain companies and legal entities are required to implement third party due diligence and risk-assessment procedures for clients, lead suppliers and intermediaries. The AFA's guidelines provide that due diligence should be conducted before starting any relationship, updated periodically, and proportionate to the risk level.

The legal framework we outline above is no secret. Much has been written about effective or adequate compliance programs and the fact that risk-based due diligence on third parties is the cornerstone of any compliance program. Risk-based due diligence often is understood simply to mean that increased risk factors require increased due diligence activity.

Yet, of the companies against whom enforcement actions have been brought, particularly in the last decade, many had in place some form of policies and procedures for conducting due diligence on third parties, even risk-based due diligence. Their third party due diligence programs included, to varying degrees and in varying combinations, processes for due diligence on third parties, vetting by third party vendors, compliance with ISO 37001, reliance on reputable due diligence vendors or third parties' adherence to these vendors' certification standards, and significant headcount and effort devoted to compliance.

What went wrong?

2. Commentaries

2.1. What is Good Judgment?

While any program depends on many factors, including a company's overall compliance culture, the organizational context in which the compliance department sits, and the decisions made by individual employees, we believe that any compliance program would be significantly enhanced by focusing on identifying and developing good due diligence *judgment*. It is not enough that a due diligence file is thick, that it is thicker for third parties for riskier countries, or that existing due diligence processes are followed with precision, with the precision memorialized on fully completed *fiches* or control sheets. What is critical is the ability to exercise judgment based on the facts received, not to treat the facts as an end in themselves, and cultivate growth among compliance teams of good due diligence judgment. This judgment is particularly important given the increasing sophistication of interna-

tional bribery schemes that today mimic, to the process-driven eye, legitimate commercial arrangements or transactions.

Good judgment, as explained by Sir John Likierman in a recent *Harvard Business Review* article, "is what enables a sound choice in the absence of clear-cut, relevant data or an obvious path" (See *Sir J. Likierman, The Elements of Good Judgment: Harvard Business Review, Jan.-Feb. 2020*). This easily describes the world in which anti-corruption compliance professionals operate on a daily basis. Sir John identifies 6 basic elements of good judgment, in the context of developing good leaders: learning, trust, experience, detachment, options and delivery. He explores these elements at length and proposes how to use them as a framework for developing better leadership.

Paraphrasing Sir John, we recast these below as 6 elements of good due diligence judgment, and suggest some practical advice about how to develop these traits.

2.2. How to Obtain and Exercise Good Due Diligence Judgment

Compliance professionals seeking to develop good due diligence judgment ought to develop the "skills and behaviors that collectively create the conditions for fresh insights and enable decision makers to discern patterns that others miss". Following Sir John's guidance, we propose the following 6 basic elements of good due diligence judgment.

Learning. - There are inherent limitations in how we learn, but that we can overcome. Sir John observes that "few of us really absorb the information we receive", excluding (even subconsciously) the unexpected or unwanted facts and coping with an overload of information. Additionally, in spoken conversation we benefit from non-verbal clues to evaluate what we are hearing, but that context is lacking in written communication - exposing us to "taking the written word at face value" instead of being "skeptical of information that doesn't make sense".

For example, if a third party is proposed to help secure access to decision-makers at a potential customer or relevant regulator, this might look on paper like a valid justification. But does your company really have no ability to speak to the decision-makers? If your company does have that ability, what is the purpose of engaging the third party?

Trust. - Sir John discusses trust in the context of good leaders' ability to seek a diversity of opinions, not simply validation of their own. In the context of good due diligence judgment, trust is more relevant in terms of "trust but verify". "Look for gaps or discrepancies in what's being said or written", and identify the source of data and the likely interests of the source. Also trust your gut reaction. Our initial reactions - particularly with the benefit of experience - are often right. In third party due diligence, doubts or concerns do not always mean that a third party must be rejected, but they will help you to test and challenge the proposed engagement such that these concerns are either confirmed or mitigated in a risk-based manner. Do a third party's initial answers to a questionnaire sit well with you, even before you are familiar enough with the file to articulate why? Do not accept the burden of explaining your own lack of understanding - ask more questions, and more, until you receive a sufficient answer and understanding.

Experience. - Sir John explains that *relevant* experience informs judgment, not *narrow* experience. Encourage team members in compliance departments to acquire relevant experience by working on different types of projects, working closely with external vendors to understand how they work and think, and receiving training with a focus on case studies and root-cause analysis. Too much experience with a narrow perspective breeds familiarity or, worse, complacency or over-confidence. This is particularly true if what appear to be traditional deals or transactions are hijacked to generate opportunities for misconduct.

For example, complacency bred by years of narrowly focusing on know-you-customer checks might limit your ability to understand how changes to the identity of the customer entity might create opportunities for others to abuse the financial arrangement to provide, in effect, success-fee remuneration to third parties. By knowing more about the latter, you are best able to evaluate the risks in the former.

Detachment. - Sir John notes that “[t]he ability to detach, both intellectually and emotionally, is (...) a vital component of good judgment”. Acknowledge but do not succumb to what sometimes feels like unbearable pressure and time constraints, both of which will only increase when the current global health and economic crises have passed. There is an important distinction between working hard and working fast, and be aware that in some circumstances crises might be deliberately manufactured in order to reduce your ability or stamina to appropriately identify and evaluate compliance risks.

Options. - Test the feasibility of the business justification. Press for clarification from a proposed third party’s advocates. Make sure the experience of the proposed third party closely matches the context in which it is being proposed, and press on why the work is relevant.

In the context of good due diligence judgment, this means scrutinizing the business justification, not only for just any third party (e.g., because the company lacks the internal resources) but also for this specific third party (e.g., because this person is uniquely qualified).

Delivery. - What service is the third party actually going to provide? What records of this activity are being created, and will they stand up to scrutiny - including scrutiny by a hostile outside party many years later? There are myriad reasons - not all of which suggest corruption - why a third party might have difficulty preparing reports of their activities, including lack of resources or limited language capability. But a contemporaneous record of what a third party has been doing is invaluable - to the compliance professional monitoring performance and payment today, and to the compliance professional defending the company years later. Do not accept excuses, do not hesitate to ask questions.

3. Conclusion

We all find ourselves routinely facing decisions that must be made in the absence - even unobtainability - of anything remotely approaching complete information; having to make those decisions in the absence of experience, and a corresponding absence of confidence in one’s due diligence judgment - can be daunting. Fortunately, while judgment can take time to obtain, adopting a framework in which to cultivate good judgment need not. We offer the above elements as such a framework. Using this framework to seize opportunities to identify and discuss these elements amongst compliance teams can help to grow team members’ confidence in their good due diligence judgment, putting them in the position to make the correct - and sometimes difficult - decisions that best protect companies and individuals from unnoticed or unchallenged third party risks.