



K&L GATES

# Biggest Risk of Corruption in The Construction Industry

*The Global Picture*

2014

“Like many business men of genius, he learned that free competition was wasteful, monopoly efficient. And so, he simply set about achieving that efficient monopoly.”

—*The Godfather*

The construction industry is big business. A recent study<sup>1</sup> has predicted that global construction output will increase by more than 70%, to US\$15 trillion per year worldwide, by 2025. The dominant sources of this growth will be three countries in particular, China, India and the U.S., with much of the remainder in the emerging markets.

This growth is a cause for celebration, but it will not come without challenges<sup>2</sup>. Some of those countries where the highest growth is predicted are also perceived as having the highest levels of corruption<sup>3</sup>.

Aside from the locations of growth, the sector itself can be inherently challenging. Transparency International, the world’s most prominent anti-corruption organisation, ranked public works contracts and construction as the most likely out of 19 industry sectors to find bribes being paid<sup>4</sup>

Combining a high-risk industry with high-risk jurisdictions and additional risk factors, such as the need to use and interact with intermediaries and government officials, the global construction industry is one where it will be challenging for businesses of all shapes and sizes to avoid becoming involved in bribery and corruption.

The problem is highlighted in the news on a global scale every day. Recent examples include Russia, where some believe there is little appetite for transparency or enforcement of domestic anti-corruption law: the Sochi 2014 Winter Olympics’ initial budget of US\$12 billion rocketed up to US\$51 billion allegedly as a result of kickbacks and embezzlement through corrupt building contracts<sup>5</sup>. The issue has also raised its head across Arab nations where, in October last year, the Arab News reported that a study conducted by the International Federation of Consulting Engineers found that judicial bodies in Arab countries had issued rulings against over 60,000 people on various corruption charges in the last five years. And no one should believe that bribery does not remain a significant problem in Europe. A recent European Commission report<sup>6</sup> included the results of a survey of EU companies conducted in 2013. Half of those surveyed said that corruption was a serious problem when doing business in the construction sector.

Governments are, therefore, not only alive to the high risk of bribery and corruption within the construction industry, but also have the increasing will to punish those who they catch giving in to corrupt business practices. Both the UK Serious Fraud Office (the “SFO”) and the U.S.

Department of Justice (the “DoJ”) have taken scalps from some serious players in the construction industry in recent years.

Balfour Beatty agreed a civil settlement of £2.25 million in 2008 with the SFO in relation to allegations of corruption during the building of the Bibliotheca Alexandrina in Egypt. The SFO agreed a civil settlement with the engineering group AMEC for £4.9 million in 2009 in relation to irregular receipts and irregular accounting entries during the contract for the construction of the Incheon Bridge in Korea. And perhaps most famously, the Mabey Group, a British engineering group, paid £6.6 million in total and pleaded guilty to paying bribes to win contracts in Iraq, Ghana and Jamaica in 2009 following an SFO investigation.

Meanwhile, Technip, the French engineering and construction firm, paid the DoJ US\$240 million in 2010 for their part in a joint venture which paid bribes in Nigeria on the Bonny Island project and in 2011, JGC Corporation, a Japanese construction firm, paid DoJ US\$218.8 million for payment of bribes to Nigerian officials. Other companies caught out in the Bonny Island project include M.W. Kellogg (“MWK”), a UK subsidiary of the U.S. based Kellogg Brown and Root LLC (“KBR”), a global engineering, construction and services company. £7 million was paid to the SFO representing profits made by MWK from the Bonny Island project obtained through the payment of bribes to Nigerian officials by KBR. In 2009 KBR paid US\$402 million to the DOJ to settle the case.

Companies which are neither listed nor established in the UK nor the U.S. may think themselves safe, but they could be wrong. The DoJ is currently the most-aggressive prosecutor of bribery and corruption, and the U.S. government has given the DoJ tremendously wide jurisdiction to prosecute non-U.S. companies, with jurisdiction to prosecute a company being founded on connections such as a dollar bribe payment passing electronically through a New York bank.

More recently, the UK has been looking to position itself as a global prosecutor of bribery and corruption. The UK cases referred to above came before the advent of the UK Bribery Act 2010 (the “UKBA”). This new piece of legislation poses a greater threat of prosecution than ever before for companies which carry out any business in the UK, no matter where they are incorporated. It makes those companies criminally liable for bribes paid on their behalf anywhere in the world, regardless of any actual connection between the bribe and the UK.

Other countries are also beginning to ramp up their anti-bribery legislation. Brazil has recently introduced new anti-bribery law, as have China and Canada; recently, China charged a former director of GlaxoSmithKline for bribery of Chinese public officials. It is, therefore, no longer just the U.S. who is prepared to bring high-profile prosecutions, and we expect other nations to follow suit. So, it seems no matter where in the world you go, there is an increasing anti-corruption climate and a growing political will to prosecute those involved in corruption.

1 The Global Construction 2025 by Global Perspectives and Oxford Economics.

2 The Chartered Institute of Buildings found that 49% of respondents to a 2013 survey thought that corruption was common within the UK construction industry.

3 China is listed at number 80 and India is listed at number 94 out 177 countries ranked by Transparency International on their corruption perceptions index in 2013.

4 2011 Bribe Payers Index, Transparency International.

5 Guardian, 9 October 2013.

6 The EU Anti-Corruption Report, 3 February 2014.

So, if bribery risks are inherent in the global construction industry, how do you mitigate the risks? Risks may arise at various stages of a construction project, from tendering to sourcing materials and setting up a supply chain, as well as the construction stage of the project itself. In order to identify where the risks lie, it is common best practice to conduct risk assessments both of the company generally and its transactions specifically. These risk assessments will form a key part of the company's anti-bribery and corruption compliance programme.

Such a programme will have multiple uses and benefits. It reduces the chance that you will face a bribery and corruption issue, but also, if you do find yourself with a problem, U.S. and UK prosecutors have their own ways of recognising the implementation of a compliance programme as not only risk mitigation, but also a defence in certain circumstances to bribery and corruption charges<sup>7</sup>.

The gold standard is an individualised bespoke risk profile risk assessment as the basis for a compliance programme. Based on our experience in working with construction companies on their policies and also conducting internal investigations, this is our list of the most-common risk areas for the construction sector, together with some tips for risk mitigation to include in your compliance programme:

### **1. Permits, licences and the regulatory environment**

Sadly, those in the construction industry will have heard stories of public officials in jurisdictions across the globe and at all levels requiring bribes to be paid for construction permits, licences, planning permissions and the like. High levels of regulation and the requirement for such permissions from government increases this risk factor.

Whilst certain personal payments to government officials are legal in the U.S.<sup>8</sup>, U.S. companies will still need to be careful that they do not breach the Foreign Corrupt Practices Act (the "FCPA"). For example, where inflated payments are made on behalf of the company to obtain a local work permit from a public official, this could still be an FCPA books and records offence.

#### Risk mitigation: Assess for weakness

Companies need to identify the vulnerable points in their processes and which permits are required during the risk assessment stage. Companies also should consult internally and with external professionals about how to mitigate the risks of requests being made, and how to support their personnel in responding to those requests and in dealing with any potential negative consequences of refusals to pay.

### **2. Procurement**

Procurement is one of the biggest areas of internal weakness to bribery and corruption risk for all businesses. The procurement process, if not effectively managed, creates windows of opportunity for illicit payments made both to your own staff (who may, for example, be bribed to use one supplier over another), or by your staff to others by mechanisms such as fake invoices and credit notes to cover their tracks. Aside from the corruption issue itself, such problems will affect the quality and value of

the supplies procured, since the bribes will bias the selection of the best product for the job.

#### Risk mitigation: financial controls

Internal financial controls and audit procedures are key to restricting and monitoring financial activity within the company. It is critical that such systems and procedures are made the cornerstone of detecting issues within the business and that they are part of broader anti-bribery, corruption and fraud programmes which businesses should have in place for their financial protection.

### **3. Facilitation payments, tender process and interaction with government officials**

Procurement risk is also connected to dealing with public officials, since supplies moving through ports and airports may be held up by officials seeking facilitation payments in order to permit entry of goods and services in the country. These interactions often involve solicitation of bribes of small value made to encourage usually low-ranking government officials simply to do their jobs.

Such payments may be considered normal practice in a particular country and may not be prohibited under the U.S. FCPA; however, they are illegal under the UK Bribery Act. A company may be open to prosecution if it carries on a business, or part of a business, in any part of the UK and the actions of a person associated to that company amount to payment of a facilitation payment. Even in the U.S., a failure to record a facilitation payment accurately in the company accounts is an offence under the FCPA, even if the payment itself is not.

The tender process, particularly for public procurement work, is also a recognised area of vulnerability and stories abound in the construction industry of contracts "bought" with bribes during the tendering process or invalidated post-award by the same method. Gifts and hospitality for public officials during the tender process may also not be illegal under any law, but are a grey area often subject to abuse and use as a form of bribery to influence tender decisions.

#### Risk mitigation: clear and comprehensive policies

Companies may decide that facilitation payments can be accommodated within the company's systems; however, consideration needs to be given to how these payments will be accounted for, what their limits should be and how to ensure such payments do not create potential criminal exposure for the company.

Likewise, reasonable gifts and hospitality are legal per se, but companies will need to be very clear with employees about what types of hospitality are permitted, when and to whom.

The key for dealing with issues such as these lies in having a clear, comprehensive and accessible policy which is communicated to staff so they know what is required and, most importantly, what is prohibited in relation to issues such as facilitation payments and how to deal with gifts and hospitality for public officials involved in tender processes, and others.

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<sup>7</sup> In the UK see section 7 of the Bribery Act guidance on DPAs. In the U.S., see case histories where deferred prosecution agreements ("DPAs"), rather than prosecutions, have been offered on the back of corporates good compliance programmes.

<sup>8</sup> See facilitation payments.

#### **4. Kickbacks to main and subcontractors**

Passing kickbacks and secret commissions to main contractors and subcontractors may be considered normal practice in a region or country and not always illegal or anti-competitive. However, secret, undisclosed and unrecorded payments are all bribery and corruption risk areas for a business, as they are liable to distort the market and the price of goods and services.

UK and U.S. companies that do not have financial controls in place to prevent unauthorised kick-backs being paid or received and fail to prevent employees, third parties or subcontractors from paying unauthorised kickbacks on their behalf may face heavy fines, debarment from entering into future public contracts and possible prison sentences for the senior directors concerned, as well as disgorgement of profits.

For example, Mr Elton McCabe III, a Louisiana businessman, worked for a U.S. company in Afghanistan that provided construction services to the U.S. military. He awarded a \$3.2 million subcontract in a military construction project in Afghanistan to a co-conspirator in 2009 in exchange for \$60,000 in kickbacks. In August 2013, Mr McCabe was sentenced to 10 months in a federal prison.

In another example in October 2013, the Mayor of Nanjing, China, Mr Ji Jianye, was removed from his post for “suspected serious disciplinary violations”. It is believed that the allegations related to the mayor awarding construction contracts to companies with which he had ties<sup>9</sup>.

##### Risk mitigation: training

Education is key to fighting corruption. Getting the message across that bribery and corruption distort markets and ultimately eat into profits is a major part of preventing corrupt activity. Training your workforce and, in some instances, those that you work with, is not only an effective tool in the long term in preventing corruption but also, in jurisdictions like the UK and the U.S., a necessary part of a compliance programme and something which may not only prevent bribery happening but which may also prevent a prosecution if bribery occurs<sup>10</sup>.

#### **5. Cost-cutting on building materials**

There is always a risk in construction projects that sub-standard construction material will be used in order to cut cost on buildings. This is particularly the case where there is bribery and corruption, which diverts the funds otherwise available for sourcing materials to line pockets. This may then lead to a knock-on effect through the use of bribes to health and safety personnel in order to approve defective or poor quality materials.

Following the Sichuan Earthquake in 2008, it was alleged that local government and construction companies had been responsible for the poor construction of schools in the area. Allegations surfaced that civil engineering standards had been ignored, poor quality materials had been used and the surplus funds had been pocketed.

##### Risk mitigation: oversight and supervision

Companies contemplating projects in higher-risk jurisdictions will need to ensure that they supervise projects adequately, and in some cases,

closely. Supervision of methods and materials is important. If you note building work being signed off by local government officials, you will want your own eyes on the ground to cross-check and supervise, especially if using local or temporary labour for low-level management.

Companies will need to ensure that they maintain strong visibility and control over their participation in any contemplated project. In particular, controlling and monitoring the withdrawal of cash is vital.

#### **6. Third-party intermediaries and unlawful subcontracting**

Companies working in new markets are likely to be reliant initially on agents and introducers to get things done. Such companies may not have their normal ability to oversee the project and may have no direct contact with the end user. This is a high-risk factor, as it creates opportunities for things to happen below the radar, such as unlawful subcontracting.

A prime example of a company who suffered from this risk is Walmart. Walmart’s anti-corruption practices require background checks on all third-party agents, such as lawyers and lobbyists representing the company before government agencies. In 2011, Walmart identified significant weaknesses in the implementation of these anti-corruption practices in its subsidiaries in Mexico, Brazil and China. Specific allegations were made by a former lawyer of Walmart in Mexico that substantial bribes were paid, sometimes through intermediaries, to government officials in order to obtain construction permits and licences to open new stores. Walmart was forced to conduct a global compliance review, as well as the internal investigations into specific allegations of bribery and corruption. To date, Walmart is estimated to have spent in excess of US\$200 million on that investigation.

##### Risk mitigation: good corporate governance

One of the remedies adopted by Walmart in response to the issues it faced in Mexico involved changing the chain of command so that general counsel in each country report directly to the general counsel for Walmart International, bypassing national chief executives who may be parties to corruption. It may also be helpful for a senior compliance officer to report directly.

Good corporate governance, including clear lines of reporting and authority, and rules on who and when third parties and intermediaries may be used, are important steps to implement in order to reduce corruption risk.

#### **7. Joint venture**

The actions of third parties and joint venture partners or employees may result in a UK company falling foul of the UKBA and/or money laundering offences under the Proceeds of Crime Act 2012. For the purposes of the UKBA, a “relevant commercial organisation” is defined widely at s.7(5)(b) as “any other body corporate (wherever incorporated) which carries on a business, or part of a business, in any part of the United Kingdom”. Companies will need to closely monitor the appetite prosecuting authorities demonstrate in how widely they construe whether a corporate carries on “part of a business” in the UK.

9 Guardian, 19 October 2013.

10 Education and training is part of “adequate procedures,” a defence to a section 7 UKBA charge.

Whilst your local joint venture partner in the country where the construction project is taking place may not consider it to be a problem, a joint venture partner which also carries out business in the UK, may be guilty of failing to prevent bribery under s.7 UKBA if a bribe is paid by the joint venture.

*Risk mitigation: due diligence*

Companies will need to carry out enhanced due diligence on proposed joint venture partners and consider adequate procedures to monitor the actions of these parties during the lifetime of the project.

Companies will need to red flag the use of agents that may have connections with the parent company or the joint venture company.

There will need to be thorough due diligence in order to ensure that joint venture partners do not abuse a position of power, either on a commercial or governmental level, in order to influence the decision over to whom a contract should be awarded. In some cases, it will be necessary to consider what third parties a joint venture partner employs, such as lawyers or lobbyists, in order to understand the nature of the risks.

**8. Cartel behaviour**

Cartels have arisen in several areas of the construction industry. Particular examples include the most-recent concrete cartel case in the U.S. investigated by the DoJ in 2011, which resulted in three individual convictions and four companies pleading guilty each facing a potential US\$100 million fine.

A number of construction firms were also found to be guilty of collusive tendering in relation to infrastructure contracts for the 2010 World Cup in South Africa. Several companies, including Avery, Basil Reed, Murray & Roberts, Group 5 and WBHO, agreed to settlement agreements worth in the region of R1.46 billion in relation to corrupt practices. In addition to fines, companies may also face disqualification from bidding for future state tenders for cartel behaviour.

*Risk mitigation: help lines*

Cartels often involve very senior officers of the company who have the power to fix prices. Corporates should be aware of the threat from whistleblowers with respect to this kind of alleged behaviour, since employees who feel they would not be listened to may take information about perceived illegal activity such as cartel behaviour straight to the regulator.

Some companies find a confidential and/or anonymous helpline where people can report such problems and raise any queries privately to be very useful for communicating with staff for such issues and to inform about the risks they face on the ground.

## How can we help?

Bribery and corruption may provide short-term gains, but ultimately, they are bad for business.

Our experience of conducting internal investigations and evaluating compliance programmes for global companies has yielded surprising results. Although corrupt practices, kickbacks and bribes are more prevalent in territories where there is little enforcement of any domestic anti-corruption law, vendors and purchasers in all jurisdictions are waking up to the fact that corruption results in expensive, wasteful and poor-quality goods or services. It is in their commercial interest for construction companies competing for work or tendering for subcontracts to send a clear message that they will compete in the marketplace as a quality brand, with a strong compliance function, and their price reflects the quality of the product that the customer receives. Companies can make the business case that the vendor is paying for quality, certainty and efficiency, which is more cost effective in the long run and disincentivises a large proportion of the procurement and supply chain from engaging in corrupt practices.

Other than criminal liability, financial penalties and debarment from procuring public contracts, the other deterrent from engaging in corrupt practices may well be the brand protection that a strong compliance function provides to a company. Ultimately, it is more cost effective and less painful to beef up anti-corruption compliance internally and avoid the need for a DPA or a court-appointed monitor. To revive the message of one well-known beer brand, there may be plenty of mileage in being “reassuringly expensive”.

Some construction companies may have a bribery policy, but many do not. Those that do tend to, in many cases, adopt a generic policy. However, (a) such policy can only go halfway towards meeting the requirement of adequate procedures if it has not been made bespoke to the risk profile of the company, and (b) a policy on the shelf is worth nothing without implementation, training, assistance and controls and monitoring.

Our knowledge of industries worldwide and our understanding of the specific risks your business faces enable K&L Gates to work with you to develop policies tailored to the needs of your company and to help you with the vital task of effective implementation, monitoring and review.

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**Key Contacts**

Elizabeth Robertson  
London  
+44.(0)20.7360.8255  
elizabeth.robertson@klgates.com

Laura Atherton  
London  
+44.(0).20.7360.8322  
laura.atherton@klgates.com

Dylan G. Moses  
London  
+44.(0).20.7360.8154  
dylan.moses@klgates.com

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