Paul|Weiss

Private Equity Digest

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A Sponsor's Guide to the FCPA and M&A

Enforcement of the U.S. Foreign Corrupt Practices Act is a high priority for both the Securities and Exchange Commission and the Department of Justice. In the last five years, almost $4 billion in FCPA fines and settlements has been collected, over 13 times that collected in the preceding five years. The financial industry, including private equity firms, has been the subject of increased scrutiny in recent years. For example, in early 2011, the SEC launched investigations into financial institutions', including private equity firms', dealings with sovereign wealth funds. More recently, the SEC and DOJ have commenced inquiries into firms' hiring practices. In addition to these U.S. enforcement efforts, other countries have also enhanced their anti-corruption enforcement efforts, increasing the threat of overlapping and even competing national investigations and prosecutions.

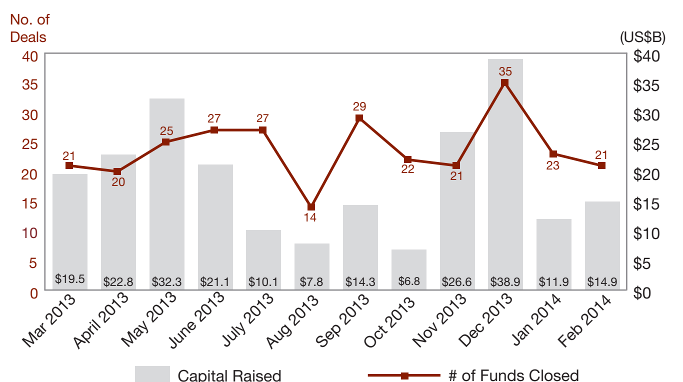
FCPA enforcement is a significant issue in the M&A context, and appropriate corruption due diligence and risk-mitigation for sponsors is essential to properly valuing a target while negotiating the investment, preserving the portfolio company's value on a prospective basis and protecting the reputation of the sponsor. Anti-corruption due diligence not only detects corrupt business practices, but also provides insight into a target's business integrity and the strength of its internal controls, which, if weak, can justify abandoning a transaction, hiring new management, lowering the purchase price or beginning a dialogue with the government. The direct costs of an FCPA-related fine or settlement are obvious, but ancillary costs of a government investigation or settlement, such as the disruption to the business, the expense of outside lawyers and accountants and the risk of a corporate compliance monitor, can be equally if not more significant. Further, where a target was subject to FCPA jurisdiction, the SEC and DOJ have stated that they may pursue enforcement actions against the target only and not the acquirer, if the acquirer "uncovered and timely remedied the violations or when the government's investigation of the predecessor company preceded the acquisition." Thus, the strength of a sponsors' due diligence process and timely remediation may be viewed by the SEC and DOJ as grounds for declining to bring any enforcement action against acquirers of targets with FCPA issues. Finally, while due diligence does not serve as an affirmative defense to FCPA charges, it may demonstrate that sponsors lacked the corrupt purpose or knowledge necessary to violate the statute. Thus, no business combination should be entered without robust diligence to assess the degree of "corruption risk" presented by a target and a clear plan for implementation of an effective anti-corruption compliance system going forward. Failure to do so may leave a sponsor with, at best, an investment that has depreciated in value and cannot easily be exited on a desirable timetable; at worst, a sponsor and individual investment professionals at the sponsor face potential criminal and civil liability.

Scope of the FCPA

The FCPA is divided in two parts – anti-bribery provisions and accounting provisions. In general, the statute creates a broad category of prohibited acts for which there are no *de minimis* or materiality exceptions.

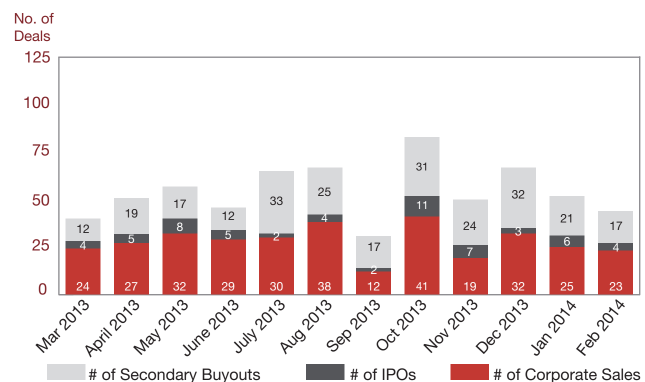
The anti-bribery provisions cover any SEC reporting company, U.S. citizen, resident or business entity, entity with a U.S. principal place of business and any person, who engages in a corrupt act, while in the territory of the United States. There must be a corrupt offer, promise, authorization of payment or payment of a thing of value to a foreign government official (including employees of state-owned enterprises) that is intended to influence the official, induce the official to act or omit an act in violation of his or her duty or secure an improper advantage. A thing of value includes overt payments (like cash or stock) but also other items of value (such as entertainment, travel expenses, charitable contributions and employment opportunities or internships).

U.S. Private Equity Fundraising



Source: Pitchbook

U.S. Sponsor-Backed Exits By Number



Source: Pitchbook

The accounting provisions apply only to "issuers" (*i.e.,* SEC reporting companies) and require every issuer to keep books and records that accurately and fairly reflect transactions involving the issuer's assets and to maintain a system of adequate internal controls. All kinds of accounting and record keeping deficiencies have been the basis of FCPA prosecutions, even where no actual bribery has occurred or been established. The accounting provisions have also been used to prosecute commercial bribery.

Conducting Due Diligence

The SEC and DOJ expect that M&A due diligence will include formal anti-corruption due diligence, whether the target's corruption risk profile is high or not, so long as the target engages in international business. The primary goals of such an exercise should be to focus resources on the parts of the target's business and internal control systems that are most likely to reveal existing corrupt business practices or insufficient oversight; take reasonable steps to identify such issues; and put in place a plan to remediate any existing issues and prevent future violations. In this regard, the value of obtaining an experienced law firm to lead the anti-corruption due diligence exercise should not be overlooked.

Corruption Risk Assessment. *Applicability of the FCPA* - Sponsors should first assess whether the target or its business activities are subject to the FCPA and to what extent.

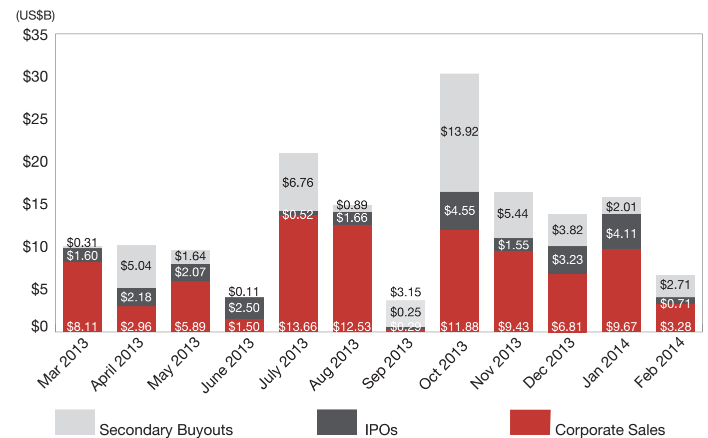
Determining SEC issuer status is relatively easy (simply look to whether the entity has a class of securities registered under the U.S. Securities Exchange Act of 1934 or is otherwise required to file periodic reports with the SEC). This would include non-U.S. entities filing under the SEC's multijurisdictional disclosure system and foreign private issuers.

Determining territorial status is less straightforward and requires identification of any U.S. nexus. Just because an entity is non-U.S. incorporated and has no U.S. operations or direct U.S. connection does not mean it is not subject to the FCPA. In one case, a non-U.S. company was prosecuted based on emails and phone calls from the company in Europe to its agent in Texas, directing its agent to facilitate a bribe. Further, even if an entity is not subject to the FCPA, it may be subject to home-country, anti-corruption regimes, such as the U.K. Bribery Act or Canada's Corruption of Foreign Public Officials Act, which may also have broad application.

Sponsors should be aware of the possibility of successor liability under the FCPA. The extent of sponsors' FCPA exposure for a target's pre-transaction conduct turns primarily on whether the target and its business activities were subject to the FCPA prior to closing. If the target is not an issuer or a U.S. business entity and has not engaged in any bribery-related conduct that touches U.S. territory (potentially including international fund transfers in U.S. dollars), pre-closing acts by the target are generally insulated from FCPA enforcement. If, however, the target or its business activities were subject to the FCPA prior to closing, the acquiring entity could be liable for the target's pre-closing FCPA violations. Successor liability could also attach where sponsors have a minority investment but effectively control the entity through other mechanisms (such as where a sponsor has control of the board).

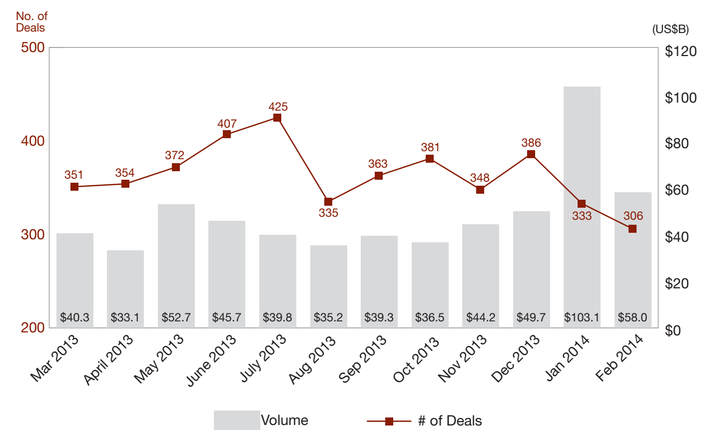
Country and Industry Risk - Two key indicators of a target's corruption risk are the countries and the industries in which it operates. Transparency International publishes useful indices of a country's perceived propensity for corruption, and sponsors should consult these as part of routine due diligence. Higher risk industries include sectors where governments exercise monopoly power, where there are a large number of government contacts by the target (for example by the target's sales force), or where government permits and regulatory approvals are fundamental to the business. Sponsors may also look at SEC and DOJ actions and public reports of ongoing investigations to assess

U.S. Sponsor-Backed Exits By Dollar Volume



Source: Pitchbook

Global Sponsor-Related M&A Activity



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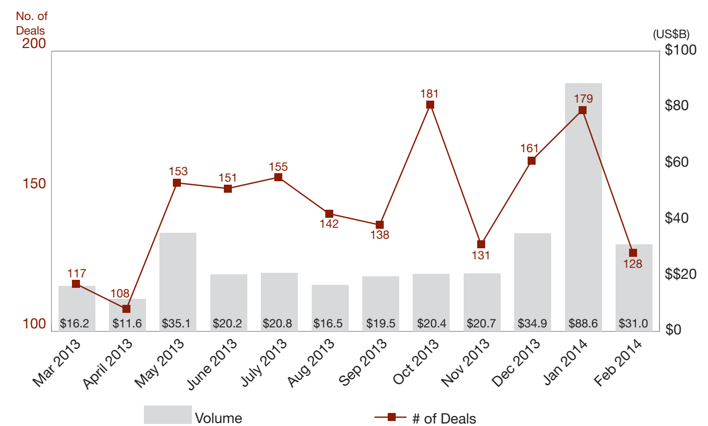
U.S. Sponsor-Related M&A Activity



Source: Dealogic

whether companies in the industry or geography have encountered issues, and if so, what kind (*e.g.* fund raising from sovereign wealth funds; customs brokers and freight forwarders).

Third Party Risk - An entity can be liable for acts of bribery undertaken by any of its employees or agents. FCPA enforcement actions involving third party intermediaries sometimes involve situations where the defendant directly instructed its agent to pay the bribe. Other cases involve agents who arguably acted without direct instruction, but where the defendant disregarded the risk or had knowledge that bribes would be made. Thus, whenever a target relies on third party agents to liaise with foreign officials, including public sector and state-owned customers, regulators and inspectors, sponsors should take steps to determine if proper agent due diligence was conducted; if proper training has been provided to the agent; if appropriate anti-corruption provisions appear in agent contracts; if contractual economic terms create incentives and opportunities for corruption; and, most fundamentally, whether there is a legitimate business justification for use of the agent.

Anti-Corruption Compliance Program. Sponsors should evaluate the target's anti-corruption compliance system. This includes the target's code of conduct, anti-corruption policy and procedures, internal financial controls, training activities, whistleblowing and reporting mechanisms, monitoring mechanisms, anti-corruption audit procedures, and resources devoted to compliance efforts. As part of this assessment, sponsors may need to interview the target's key management, employees and agents to evaluate the operation of the target's anti-corruption compliance system in practice, as well as to determine the corporate culture and general level of sensitivity to corruption and compliance matters.

Reputational Due Diligence and Background Checks. In most cases, sponsors should engage an investigative firm to conduct reputational due diligence and background checks on the target and key individuals associated with the target such as its principals/major shareholders and key executives. This research typically should include not only "Tier 1" diligence, including adverse media searches, corporate records checks, and searches of sanctioned parties, litigation and bankruptcy databases, but also discrete source inquiries with persons knowledgeable about the target and key individuals, usually called "Tier 2" diligence.

Books and Records Review. Where circumstances permit, anti-corruption diligence should include scrutiny of the target's books and records by a specialized team of forensic accountants specifically tasked with conducting a corruption-focused review. Such a review would examine, for example, select sensitive general ledger accounts for items such as commissions, gifts, charitable contributions, petty cash, marketing, facilitation payments and travel and entertainment. This exercise should be closely coordinated with the overall anti-corruption review. Where circumstances do not permit this level of scrutiny prior to signing, a sponsor may negotiate for the opportunity to conduct this review between signing and closing. Where that too is not possible, sponsors should carry out such a review promptly upon closing.

Contractual Protections and Post-Closing Compliance

Anti-Corruption Provisions. Sponsors should always seek appropriate representations, warranties and covenants regarding past and future compliance by the target and its directors, officers, employees, affiliates and agents with applicable anti-corruption laws and regulations. Sponsors may also seek indemnification from sellers for any losses resulting from a breach of such representations, warranties and covenants.

Remediation. Past FCPA violations are never washed away by a business combination. As quickly as possible after making a portfolio investment, sponsors should conduct a thorough corruption-focused audit, along with any other business audits that they would normally conduct. To the extent necessary, new policies, procedures and training should be promptly introduced at the target.

Conclusion

Not surprisingly, companies that engage in bribery typically do so in secret. This concealment poses a challenge not only for prosecutors, but also for sponsors attempting to understand the risks in acquiring a company. Fundamentally, anti-corruption due diligence is an important tool in helping sponsors assess and mitigate FCPA liability or in helping sponsors decide whether to abandon a transaction completely if the anti-corruption risks are just too great. Equally important, this specialized diligence assists sponsors in understanding a business' true value and negotiating a business deal that best reflects that value, including helping determine what post-acquisition remediation will be required.

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