

The Rising Storm: Private Equity and the Foreign Corrupt Practices Act

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Agenda

- Private Equity Compliance Developments
- The Basics: FCPA's Prohibitions and Essential Elements
- FCPA Challenges for Private Equity: What's at Stake
- Managing Anti-Corruption Risk
- Foley Resources



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Private Equity in the Spotlight

- WSJ recently reported SEC is launching a wide-ranging inquiry into the PE industry
- Dodd-Frank Act - new registration requirements for investment advisers formerly exempted from the SEC registration under the Investment Advisers Act of 1940
- SEC registration increases fiduciary, reporting, and compliance obligations, including information about fund trades, personnel and portfolios
- Also increases SEC's ability to regulate and investigate potentially improper payments



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Post Dodd-Frank Compliance Requirements

- IA's required to have a compliance program pursuant to Advisers Act Rule 206(4)(7) (the "Compliance Rule")
- Programs should be reviewed and updated at least annually for adequacy
- The SEC has stated that it expects Compliance Programs, to the extent that they are relevant to the firm, to address at least the following points:
 - 1. Portfolio management processes
 - 2. The accuracy of disclosures made to investors, clients, and regulators
 - 3. Proprietary trading by the firm/ preventing insider trading;
 - 4. Safeguarding of client assets

(cont.)



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Post Dodd-Frank Compliance Requirements (cont.)



- Compliance Program Requirements (cont.)
 - 5. Accurate records and established records maintenance policies
 - 6. Safeguards for the privacy protection of client records and information;
 - 7. Trading practices, including procedures to satisfy best execution obligation, use client brokerage to obtain research and other services, and the allocation of aggregated trades among clients;
 - 8. Marketing advisory services, including the use of solicitors
 - 9. Processes to value client holdings
 - 10. Testing of business continuity plans



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Recent Key FCPA Developments



- Increasing pressure on the DOJ from business community/Congress to provide clarity on FCPA
- Dodd-Frank Act program providing bounties for FCPA whistleblowers begins
- Continuing high levels of fines
- Increased international enforcement

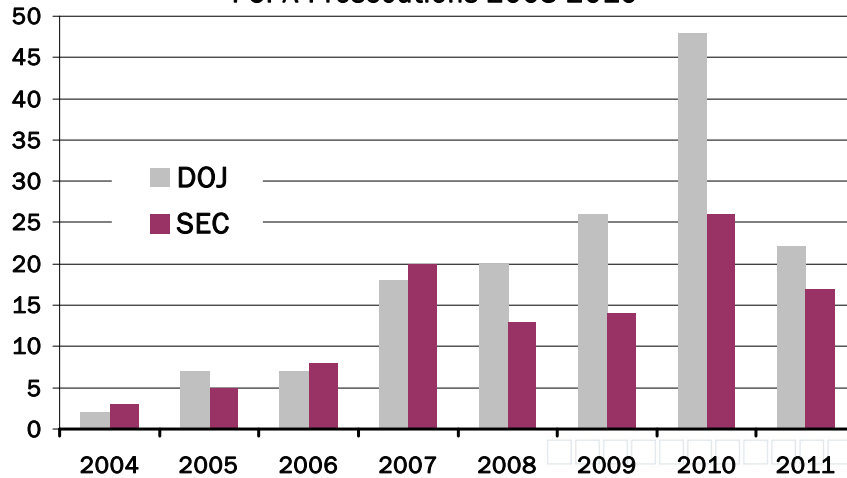


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FCPA Enforcement Activity

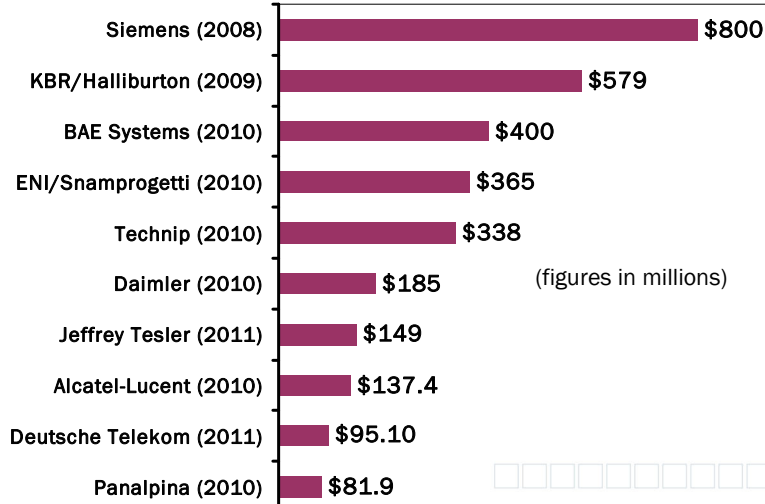
FCPA Prosecutions 2003-2010



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Top 10 FCPA-Related Monetary Settlements



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New Aggressive Law Enforcement Tactics



■ DOJ FCPA Sting Operation

- In January 2010, the U.S. Department of Justice (DOJ) arrested 22 executives and employees of companies in the military and law enforcement products industry for allegedly engaging in a scheme to bribe foreign government officials in order to obtain and retain an African country's presidential guard business
- FBI undercover operation represented the largest single investigation of individuals, to date, in the history of DOJ's enforcement of the FCPA
- DOJ says there were over 5,000 recorded telephone conversations
- However, DOJ recently moved to dismiss charges against more than a dozen defendants after prosecutors unable to convince two juries of guilt



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UK Bribery Act of 2010



■ Prohibits:

- Active bribery (paying bribes)
- Passive bribery (accepting bribes)
- ***Failure of commercial organizations to prevent bribery by "associated persons"***

■ "Relevant commercial organisation"

- Incorporated in the UK or under UK law
- Corporate entities that carries on a business or part of a business in the UK
- Affirmative defense: "Adequate procedures"



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UK Bribery Act of 2010



- Key Differences with FCPA
 - Bribery Act explicitly prohibits commercial bribery
 - No facilitating payments exception
 - No reasonable promotions exception
 - “Adequate procedures” as affirmative defense, as opposed to mitigating factor
 - No whistleblower incentives
 - Scope of indirect knowledge: “associated persons” versus knowledge standard
 - No books and records provision



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UK Bribery Act and Private Equity

- Richard Alderman, Director, U.K. Serious Fraud Office (June 2011 Speech)
 - Assumption that PE investors are highly sophisticated with high degree of knowledge in portfolio companies
 - Higher risk exists when PE firm are actively involved in management of company, or where PE representative is senior officer
 - SFO would welcome informal discussion regarding a target before acquisition, will provide advance guidance



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The Basics

The FCPA's Prohibitions and Essential Elements



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What is the FCPA?

- The U.S. Foreign Corrupt Practices Act (the “FCPA”) criminalizes the payment or offering of a payment or anything of value to a foreign official anywhere in the world where the purpose of the payment is to influence an official decision or secure an improper advantage in order to obtain or retain a business benefit
- The FCPA also requires companies whose stock is traded on a U.S. exchange to meet certain standards regarding their accounting practices, books and records, and internal controls
- The FCPA is jointly enforced by the DOJ and SEC (with regard to “issuers”)

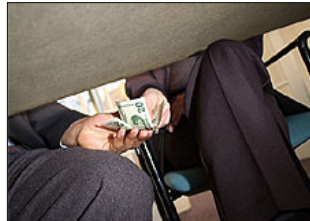


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Two Main Components

- Anti-Bribery Provisions
- Books and Records and Internal Control Provisions



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Anti-Bribery Provisions

- Applies to:
 - Domestic concerns (“private” companies, LLC’s, etc., and U.S. citizens);
 - Issuers (basically, “public” companies); and
 - Any person who, while in the U.S., commits an improper act
- Covers payments made by third parties with “knowledge” that the payment would be used to fund FCPA-illegal activity
- Extra-territorial jurisdiction



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What is Prohibited?

- The anti-bribery provisions prohibit:
 - Paying or offering to pay **“anything of value”**
 - Directly or indirectly
 - To a **“foreign official,”** or to any other person **“while knowing”** that all or part of the thing of value will be paid or offered to a foreign official
 - Corruptly
 - For the purpose of influencing the official in some official act or to secure any improper advantage
 - In order to **“obtain or retain business”**



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“Anything of Value”

Examples:

- Cash or a cash equivalent
- Travel expenses and/or payment of personal expenses
- Services
- Golf outings or other entertainment unrelated to customary entertainment connected with a particular deal or contract
- Charitable donations
- Loans



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“Foreign Official”

- Any officer or employee of a foreign government *or any department, agency, or instrumentality thereof*
 - Includes employees of state owned or controlled enterprises (“SOEs”)
 - No distinction made as to rank or title (CEO as well as engineer or procurement manager, or even the janitor)



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“Obtain or Retain Business”

- FCPA only covers payments made for a *business purpose*
 - Includes payments related to the renewal of contracts, the execution or performance of contracts, or the retention of existing business
- However:
 - DOJ and SEC interpret this element very broadly
- Even unsuccessful bribery attempts are grounds for prosecution
 - *Monsanto* (2005)



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“Obtain or Retain Business”

- *U.S. v. Kay*, 359 F.3d 738 (5th Cir. 2004)
 - FCPA prohibits making a payment to a foreign official to secure an "improper advantage" that will assist in obtaining or retaining business
 - This could include seeking favorable tax treatment from a foreign official even if not directly related to securing or maintaining a specific business relationship
- **TREND:** FCPA enforcement actions based on improper payments to secure a permit or license needed to do business in a foreign country
 - *Dow Chemical* (2007)
 - *Delta & Pine Land Co.* (2007)

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Exceptions & Affirmative Defenses

- Limited nature of exceptions
 - A payment does not violate the FCPA if its purpose is to expedite or secure the performance of a routine governmental action ordinarily and commonly performed by a foreign official
 - Emerging “best practice” – prohibition of facilitating payments except where the health and safety of an employee is involved



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Exceptions & Affirmative Defenses

- Affirmative Defenses (*i.e.*, company bears the burden of establishing the elements)
 - Payments lawful under the **written** laws and regulations of the foreign country
 - Custom is **not** the same as written laws and regulations
- Reasonable and bona fide expenditures directly related to the promotion or demonstration of product or services or the execution or performance of a contract



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Books & Records and Internal Control Provisions

- Apply to:
 - “Issuers” only, **but** SEC takes the view that they also apply to any affiliate whose financial results appear in the consolidated financial statements of the issuer
- Require:
 - Books, records, and accounts must be kept in reasonable detail to accurately and fairly reflect transactions and disposition of assets; and
 - Internal accounting controls sufficient to provide reasonable assurances that, among other things, transactions are executed in accordance with management’s authorization and are accurately recorded



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Books & Records and Internal Control Provisions



- Regulators do not need to prove an underlying antibribery violation
- Failure to describe what actually occurred is a violation
- Recent enforcement actions involved improper payments disguised as:
 - “commissions”
 - “consulting fees”
 - “advertising and promotions”
 - “transportation expenses”
 - “cost of goods sold”
 - “processing fees”
 - “miscellaneous expenses”



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Books & Records and Internal Control Provisions



- *Nature's Sunshine* (2009)
 - SEC enforcement action against company CEO and CFO in their capacities as control persons for violating books and records and internal controls provisions of the securities laws relating to corrupt payments in Brazil
 - Case is significant because neither individual was alleged to have been aware of the corrupt payments made by the Brazilian subsidiary, but as a result of their positions within the company and alleged lack of supervision, the government asserted they should be held liable for the illegal payments



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Agents & Distributors

- U.S. companies are not insulated from FCPA risks by doing business in foreign countries through third parties such as agents or distributors
- Rather, the FCPA also prohibits payments to third-parties if the company knows or has reason to know that all or part of the payment will be given to a foreign official
- Regulators do not need to prove that the third-party acted on the company's direct orders or even that a company actually knew the intermediary engaged in prohibited conduct

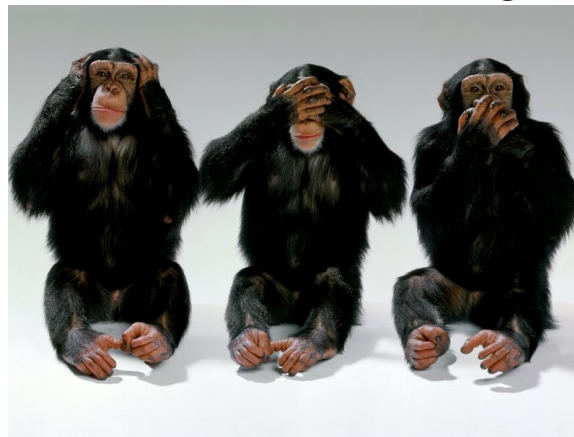


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Third-Party Payment Provisions

Willful Blindness = Knowledge



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Third-Party Payment Provisions

- *Baker Hughes (2007)*
 - Payments were made to agents under circumstances in which the company failed to “adequately assure” itself that such payments were not being passed on, in whole or in part, to foreign officials
- *InVision (2005)*
 - Company was aware of the “high probability” that its foreign agents or distributors were making improper payments in several foreign countries to secure sales of the company’s product
 - The “distributor wrinkle” – money used to fund the improper payments was not transferred from the company to the distributor, but generated by the distributor’s profit on resale

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Third-Party Payment Provisions

- *Halliburton (2009)*
 - KBR (former sub) part of JV to develop LNG facilities in Nigeria
 - JV hired two agents who paid bribes to Nigerian officials
 - SEC internal controls/books and records charges against Halliburton
 - Premised on:
 - Exercised control and supervision over KBR, which had control over the JV
 - Halliburton’s performed inadequate due diligence on agents hired by JV
 - Halliburton derived an economic benefit from contracts secured by the JV

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The Perils of Hosting Customer Visits

■ Lucent (2007)



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The Perils of Hosting Customer Visits

- Lucent acknowledged spending over \$10 million on approximately 315 trips (“things of value”) involving over 1,000 employees of Chinese SOEs (“foreign officials”) that had a disproportionate amount of sightseeing, entertainment, and leisure
- Officials did visit company facilities for one or two days, **but also** spent up to two weeks engaging in non-business travel
- Lucent agreed to settle parallel DOJ and SEC enforcement actions by paying \$2.5 million in combined fines and penalties

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FCPA Implications for Private Equity Firms

- Increasingly international nature of PE targets increases FCPA risk
- Potential for liability:
 - Direct liability
 - Liability for “willful blindness”
 - Exposure from portfolio company actions
- Additional sources of exposure



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Potential for Direct Liability

- *Sovereign Wealth Funds (2011 – ongoing)* – WSJ reported SEC investigating whether U.S. financial firms made unlawful payments in seeking to obtain investments from sovereign wealth funds (KKR recently disclosed it received SEC subpoena)
- *Allianz SE (2010)* - U.S. enforcement agencies investigated Munich-based Allianz SE (Europe’s largest insurer) in relation to potential FCPA violations by a German printing manufacturer that is majority-owned by Allianz’s private equity arm; **SEC settlement pending**



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Willful Blindness

- *Frederic Bourke* – private investor convicted of FCPA-related crimes (sentenced to a year of prison and a criminal fine of \$1 million) for deliberately ignoring signs that his investment consortium was obtaining contracts by paying bribes
 - Conviction stems from investment failed bid to privatize the Azerbaijani state oil company, SOCAR.
 - Bid involved multimillion dollar bribery scheme orchestrated by Victor Kozeny, referred to as "the Pirate of Prague."
 - December 2011 - Second Circuit denied Bourke's appeal
- *Omega Advisors* - Clayton Lewis, a former partner at the Omega (hedge fund), pled guilty to FCPA charges arising from Omega's investment in the scheme. Omega avoided criminal prosecution but agreed to a civil forfeiture of \$500,000.



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Exposure From Portfolio Company Actions

- The existence of an improper payment – even prior to the effective date of the agreement – can expose the acquiring or partnering company to an enforcement action based upon knowledge and benefit from past payments
 - E.g. GE - InVision liability
- *Sensata Technologies (2010)* - Bain Capital-backed Sensata Technologies Holding NV disclosed it was investigating potential FCPA violations by its subsidiary in China.
- *Kosmos Energy (2011)* – In a S-1 securities filing, Texas-based Kosmos Energy Ltd., (Blackstone Group LP and Warburg Pincus LLC), cited potential FCPA violations by a contractor it hired to extract oil from the Jubilee oil field.



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Additional Sources of Exposure

- Investors in the offending target companies' bottom lines will be negatively affected
 - Alderman of SFO: “The owning company or partners may know nothing about [the corrupt acts] although they will have received the benefit through dividends or other distribution. We are looking at how we recover the benefit.”
- When exiting an investment, prospective purchasers will conduct FCPA due diligence
 - Many require assurance or ongoing warranties
- FCPA violations (and ensuing investigations) lead to large disruption to operations



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FCPA Compliance Policies & Procedures

- Private Equity firms need to establish both:
 - Internal FCPA policies and procedures
 - Due diligence plans for target investments
- Should FCPA non-compliance occur, enforcement authorities will factor the absence of FCPA policies and procedures into their view of the matter and their assessment of appropriate fines and penalties:
 - *NATCO Group Inc. (2010)*
 - *United Industrial Corporation (2009)*



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Important Aspects of Internal Compliance Program



- Tone at the top
- Employee training program
- Comprehensive anti-corruption policy in place addressing key risk areas, including:
 - Use of third parties
 - Limits on travel, entertainment, and charitable contributions
- Continuous review of policies and procedures



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Target Company Due Diligence



- Consider investment target's FCPA risk profile early in the investment process
- Due diligence should include:
 - Evaluation of target's compliance program
 - Evaluation of target's financial controls
 - Evaluation of contractual arrangements with third parties
 - Evaluation of distributor and joint venture arrangements



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Assessing FCPA Risk

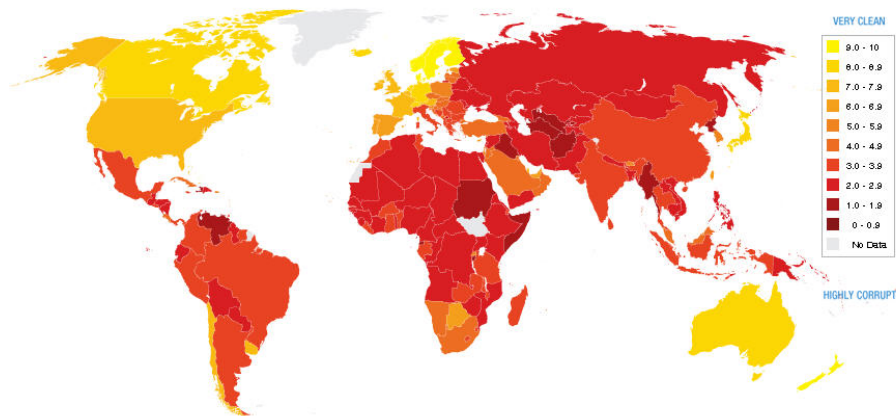
- FCPA compliance risk is a combination of
 - Who (public vs. private customers)
 - What (large public projects vs. producing widgets)
 - Where (the country's corruption reputation)
 - How (use of third parties)
- Focus on all variables
 - Recent FCPA enforcement actions instruct that while compliance efforts should focus on high-risk situations, business leaders must be alert to the risks present in all countries in all situations



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Corruption Perception Index (2011)



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Other Key Diligence Issues

- Accounting of all payments made to reimburse government officials
- Marketing initiatives (what sort of entertainment or marketing expenses are being incurred)
- Company's international political activities, community development programs, and charitable activities



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What if Violations or Red Flags are Uncovered?

- Does not necessarily mean the deal cannot go forward
- Need to assess
 - Severity of violation
 - Whether to require self-disclosure
 - Potential fines that may impact value of investment



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What if Violations or Red Flags are Uncovered?



- Investors can exert influence to minimize risk:
 - Insist target instruct employees to cease all illicit payments
 - Suspend employees implicated in the potentially violative conduct (pending conclusion of investigation)
 - Ensure target implements a system of internal controls designed to detect/prevent future FCPA violations



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Post-Investment Considerations



- Routinely conduct audits of compliance and FCPA programs to ensure FCPA policies are being followed
- Ensure comprehensive FCPA compliance and training programs are in place
- Ensure any post-investment violations discovered are immediately addressed



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Foley FCPA Resources for Clients

- Free FCPA Compliance Assessment
- Foley “Best Practices” Pieces
 - FCPA Best Practices for PE Investors
 - Essential Elements of an Effective FCPA Compliance Program
 - Engaging Agents, Distributors and Other Third-Parties
- Dedicated website:
FCPAenforcement.com



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