


MINIMIZING FCPA RISK FOR PRIVATE EQUITY INVESTORS

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The web of FCPA enforcement continues to expand. As recently reported by the Wall Street Journal, U.S. enforcement agencies are investigating Munich-based Allianz SE in relation to potential FCPA violations by manroland AG, a German printing manufacturer that is majority-owned by Allianz's private equity arm. An enforcement action against Allianz would represent the first FCPA enforcement action against a private equity firm, but it will likely not be the last. Coupled with the heightened FCPA enforcement efforts of U.S. authorities, resulting in companies including Siemens and Daimler AG paying multi-hundred million dollar fines to settle enforcement actions, now more than ever private equity investors should take heed of the risks posed by FCPA non-compliance of their underlying investments, and the appropriate measures private equity investors can take to minimize these risks.

FCPA Considerations For Private Equity Investors

First, in light of the extraordinary fines and penalties companies have recently paid to settle enforcement actions, as well as the substantial resources companies expend on fees and services related to investigation and remediation efforts, FCPA compliance issues can have a potentially significant impact on a company's bottom-line, which in turn directly affects investors. If a private equity investor determines the value of a target company, discovery of FCPA issues and potential liability for huge fines and other monetary consequences can quickly shrink the total value of the investment target. An accurate value assessment requires consideration of FCPA exposure.

Second, companies forced to address FCPA issues also must deal with the potentially significant accompanying disruptions to the company's operations as the company works to address the issue and to remedy the compliance shortcomings. FCPA investigations and remediation efforts are not only costly; they also require the investment of substantial time and resources from company employees, ranging from senior-level management to lower-level employees. In addition, remedying FCPA violations may require changes to the company's business model. It may, for example, be necessary for the company to terminate a valued agent, who has secured substantial business for the company in a particular country, thus impacting projected future income.

Finally, once a U.S. investor has some ability to control the company, it faces potential liability for being "willfully blind" to subsequent FCPA violations by the company. The fact that the private equity investor might be taking only a passive ownership interest in the company does not mean that it is immune from FCPA liability. The FCPA applies equally to passive and active ownership, including through private equity infusions of capital. Thus, although a passive owner such as a private equity investor may not have the same degree of control over the business operations of a foreign company as occurs in a normal parent-subsidiary relationship, if the private equity investor had knowledge of or arguably authorized the improper conduct, liability for an FCPA violation potentially could arise.

Because the question turns on knowledge and participation, the private equity investor should be especially cautious where it places officers or directors at the foreign company. In these situations, the presence of even a single representative can create liability under standard agency principles, even though the overall investment is passive. If there are several people who are either overseeing the investment or involved at the foreign company, if the collective knowledge would support a knowledge finding, there is the risk of liability.

What this means from a practical standpoint is that the common tactic of placing an advisor from the private equity fund on the board of an acquired company bears some FCPA risk. The higher the degree of involvement in the acquired company, the more likely that the private equity investor will be attributed with knowledge or with engaging in willful blindness for any FCPA violations at the investment. But even in cases in which there is only passive involvement, the private equity investor should not assume that its lack of overt involvement means that there is no FCPA risk. Given the current aggressive interpretation of the FCPA by U.S. enforcement authorities, even a passive investment could give rise to a significant violation risk.

Although it remains to be seen how widely the U.S. enforcement authorities will cast their nets to reach investing individuals, the *Bourke* case shows that the potential exists for private investors and corporate executives with an equity stake in companies (as opposed to maintaining operational control) to personally become targets of government FCPA actions. In light of the considerable penalties that coincide with FCPA actions, private equity investors would be wise to consider FCPA compliance when conducting due diligence in potential investments with international operations.

<u>What to do to Minimize Risk</u>

Private equity investors should conduct FCPA-specific due diligence of investment targets with international operations early in the investment process, particularly those with a high FCPA risk profile. This diligence should include more than a simple review of the target's financial statements, and should include formulating a comprehensive due diligence plan work plan that reviews such critical areas such as investment target's relationships with third parties and interactions with foreign officials.

To begin, private equity investors should evaluate a target's FCPA risk profile. The risk assessment should result in an evaluation of the risk profile of the target company, including with consideration of its industry and the level of government regulation, its use of agents, brokers and other third parties, the risks raised by its customer base (including sales to governments or state-owned enterprises), and whether the investment target does business in countries with a reputation for corruption.

If it is determined that a target presents FCPA risk, private equity investors should conduct an appropriate FCPA due diligence review (tailored to the target's risk profile) that focuses on important risk areas, including but not limited to, the ownership structure of the investment target, the company's relationships with third parties, including agents and joint-venture partners, the target's dealings with foreign officials and state-owned entities, and a thorough review of the target's anti-corruption compliance program, focusing on how it is implemented, monitored, and audited, including details on reported potential violations and information on the current status/disposition of any such matters.

If a potential FCPA red-flag arises during the due diligence review, it does not necessarily mean the deal cannot go forward. However, red-flags should be should be fully investigated, and if it is determined that the target has violated the FCPA, investors must make important determinations including an assessment of the severity of the violation and the potential for it to generate an enforcement action. Investors will also need to consider whether to demand self-disclosure by the target as a condition to proceeding with the deal, as well as account for the potential fines, other liabilities that may have an impact on the value of the target company. In appropriate cases, investors might wish to seek the further comfort of a DOJ advisory opinion, as the private equity investors did in Vetco.

Following the discovery of a violation, an investor has the ability to exert its influence and ensure that proper steps are taken to mitigate FCPA problems. The investor may insist, as a precondition for proceeding with the deal, (1) that the target issue instructions to all affected affiliates and employees to cease all illicit payments or other questionable conduct, (2) that the investment target suspend the most senior officers and employees implicated in the potentially violative conduct, pending the conclusion of the investigation, and (3) that the investment target implement a system of internal controls at the target designed to detect and prevent future FCPA violations.

Finally, after an investment decision is made, investors should insist on on-going anti-corruption compliance by the company. Appropriate and reasonable steps must be taken to prevent violations that could jeopardize the value of the investment and, potentially, subject the investors to direct FCPA liability.

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