

FCPA Best Practices: Private Equity Investors

Foley GRS has identified best practices for private equity investors responding to new regulations concerning international transactions.

AT A GLANCE

- Dodd-Frank greatly strengthens whistleblower activity in the securities industry
- The DOJ and the SEC have targeted cross-border securities violations, resulting in substantial fines and penalties
- Private equity investors should conduct FCPA due diligence of investment targets with international operations, particularly those operating in high FCPA risk markets

Both the DOJ and the SEC have been aggressively asserting claims against companies operating abroad, resulting in substantial fines and penalties. Such claims are likely to increase with the recent passage of The Dodd-Frank Wall Street Reform and Consumer Protection Act, which contains a noteworthy whistleblower provision awarding between 10 percent and 30 percent of any monetary recovery exceeding \$1 million, for reporting securities violations to the SEC, including violations of the FCPA.

FOR MORE INFORMATION

In today's ever-evolving regulatory environment, can your company really afford not to have the right internal controls in place? Foley is here to help. Contact Foley Partner **David Simon** at 414.297.5519 or dsimon@foley.com today.

For these reasons, it is imperative that you, as a private equity investor, conduct FCPA-specific due diligence of investment targets with international operations, particularly if the investment target or the industry in which that investment target operates has a high FCPA risk profile. As explained below, FCPA risk in the international private equity context is not something that in most cases can be dealt with simply by including representation and warranty provisions.

EARLY INVESTMENT EVALUATION

You should consider the investment target's FCPA risk profile early in the investment process, including whether the investment target does business in FCPA high-risk countries or in industries that are a common source of FCPA violations, such as the energy, defense, or pharmaceutical industries.

An investment in a company that does business principally in the United States and Western Europe carries a much lower FCPA risk than one that does business in China, India, Venezuela, many countries in the former Soviet Union, and the Middle East.

Additionally, determine if the investment target has foreign government customers or substantial government contact (keeping in mind that employees of state-owned or state-controlled enterprises are considered to be "foreign officials"), or if the industry is subject to heavy government regulation (e.g., aerospace, defense, telecommunications, or health care). Also of concern are companies that heavily rely on agents, distributors, or other third parties, which are a frequent source of FCPA violations.

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Assess whether the target has increased FCPA risk because of its ownership structure and/or based on its reputation.

To learn this information, ask potential investment targets to complete a detailed FCPA questionnaire prior to conducting full due diligence. Consider engaging a reputable investigative firm and/or consult with the U.S. Department of Commerce, the U.S. Department of State, or the relevant U.S. embassy to learn more about the target and assess the FCPA risk associated with the investment.

FORMULATING AN FCPA DUE DILIGENCE PLAN

If it is determined that a company presents a potential FCPA risk, prepare an FCPA due diligence work plan tailored to the investment target's risk profile. It is critically important that FCPA due diligence include more than just a review of the company financial statements. Effective FCPA due diligence also should include a review of the following:

- The ownership structure of the investment target, including whether any individual who may be deemed a "foreign official" owner or is involved in the operation of the business
- The company's relationships with third parties, including agents, vendors, joint-venture partners, distributors, and so forth
- The company's dealings with foreign officials and its commercial dealings with state-owned or state-controlled customers
- The company's tax, customs, and immigration matters and its government licenses, permits, and certifications, and its procedures for dealing with these issues
- The company's international political activities, community development programs, and charitable activities
- The company's anti-corruption compliance program, with a focus 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

- The investment target's policies regarding entertainment of government officials, including an analysis of all such expenses and the officials involved
- An accounting of all payments made to reimburse government officials for any reason, including visits to conferences or meetings
- Any suspected bribery or corruption issues that have been investigated by the target, and any investigation results
- Any inquiries from any government regarding potential bribes, whether current or settled
- Any prior complaints/issues raised by whistleblowers or others relating to relevant corruption issues
- The investment target's financial and accounting records, including a detailed analysis of third-party expenses such as commissions and travel, entertainment, and marketing expenses
- Any concerns raised by an audit of the company books or inquiry by the government into the accuracy of the company's books and records or the adequacy of the target's internal controls
- The investment target's financial and accounting controls

WHAT IF A POTENTIAL FCPA VIOLATION IS UNCOVERED?

In general, discovery of a potential FCPA issue during due diligence does not necessarily mean the deal cannot go forward. How you manage the information obtained from FCPA due diligence, however, will have significant implications for you and the investment target in terms of potential FCPA exposure.

Investigate any FCPA red flags discovered during due diligence. If it is determined that the investment target has violated the FCPA (and this requires a conclusion

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that the target was subject to the FCPA — wholly foreign-owned companies that are not Issuers and have few contacts with the United States may not be), assess: (1) the severity of the violation and the potential for it to generate an enforcement action; (2) whether to demand self-disclosure by the target to the enforcement authorities as a condition to proceeding with the deal; (3) the potential fines, other liabilities, and business consequences that may result and the impact they may have on the value of the target company.

It is clear that the DOJ expects outside investment and acquiring companies to be vigilant and to identify FCPA issues prior to closing. Although an investor will not have direct operational oversight, it can nevertheless exert influence to ensure that proper steps are taken to address FCPA issues that are uncovered. FCPA risk will be mitigated if:

- The investor insists that the target issue instructions to all affected affiliates and employees to cease all illicit payments or other questionable conduct
- The investment target suspends the most senior officers and employees implicated in the potentially violative conduct, pending the conclusion of the investigation
- The investment target implements a system of internal controls at the target designed to detect and prevent future FCPA violations

As an investor, you are required to respond to identified corruption and bribery issues, even if the target company is not subject to the FCPA. For one thing, the target may be subject to liability under the increasingly aggressive enforcement of anti-corruption laws of other countries that do have jurisdiction over the target. The same impact on the value of the investment discussed above could result from a non-U.S. enforcement action.

In addition, once a U.S. investor comes into the picture and has some ability to control the company, the U.S. investor could be held liable for being “willfully blind” to subsequent FCPA violations by the company. U.S. enforcement authorities expect that those with ultimate control will take reasonable steps to understand FCPA risk and prevent violations.

The key question will be whether, after due diligence and a reasonable investigation into potential FCPA red flags, the investor can reasonably conclude that, despite past irregularities, the target company is not likely to violate the FCPA in the future. If it is reasonable to conclude that the target is committed to compliance and will not pay bribes going forward, it is unlikely that the investor will be found “willfully blind.” Even so, the SEC continues to take an aggressive approach towards FCPA accounting violations that resembles strict liability, including conduct that occurred prior to a target company’s acquisition. With the elevated possibility of penalties for pre-acquisition conduct, it remains necessary for private investors and acquiring companies alike to conduct proper FCPA due diligence prior to making an investment.

POST-INVESTMENT FCPA CONSIDERATIONS

The risks noted above continue to exist for private equity investors even after an investment has been made. With these risks in mind, and although the level of control over the company may be limited, as an investor, seek to ensure that the company remains FCPA-compliant moving forward.

At a minimum, ensure that the company maintains an appropriate FCPA compliance program, including a code of conduct governing corruption concerns and FCPA-focused training for relevant employees. Companies that use foreign sales agents and distributors should require these third-party intermediaries to sign contracts containing FCPA and anti-corruption representations and warranties. Finally, a systematic audit process should be in place to continuously evaluate any known or discoverable FCPA red flags.