Bloomberg BNA

Securities Regulation & Law Report™

Reproduced with permission from Securities Regulation & Law Report, 45 SRLR 445, 03/10/2014. Copyright © 2014 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

FOREIGN CORRUPT PRACTICES ACT

Private Equity and the FCPA

BY JEFFREY A. LEGAULT, PAUL ALFIERI AND JOHN TAN-

Although volume remains down from its 2007-2008 peak, private equity remains an important and vital sector of the world economy, with the total volume of assets under management worldwide estimated at $3.46 trillion as of June 2013. In 2013, private equity firms raised $454 billion in aggregate capital, the highest total since 2008. 2013 also had a record 1,348 private-equity backed exits, totaling $303 billion.[1] As in numerous other industries, private equity firms are increasingly looking to emerging markets, raising $21 billion and investing $16 billion in emerging markets through the third quarter of 2013[2].

Jeffrey A. Legault, a partner in the New York office of Reed Smith LLP, specializes in mergers and acquisitions, both public and private, with an emphasis on private equity transactions in a variety of industries, ranging from industrial/manufacturing to financial services.

Paul Alfieri, also a partner in the firm's New York Office, focuses on white-collar criminal defense, government regulatory matters, internal corporate investigations, and complex civil litigation matters. He has particular experience with accounting and securities fraud, foreign corrupt practices and antitrust enforcement investigations.

John Tan, Counsel in the firm's Shanghai office, focuses his practice on internal investigations, corporate compliance, dispute resolution, and due diligence for corporate transactions. He is fluent in Mandarin and has lived in Shanghai since 2005.

Foreign Corrupt Practices Act enforcement remains a high priority for both the U.S. Department of Justice (''DOJ'') and the Securities Exchange Commission (''SEC''). Deputy Attorney General James Cole, speaking to an industry conference in November 2013, noted that the DOJ has ''made enforcement of the FCPA a priority. . . . we are pursuing more cases than ever before, and we are using all of the investigative tools available to us from subpoenas to search warrants, from body wires to wiretaps.''[3] Speaking at that same November 2013 conference, Charles Duross, deputy chief of the Fraud Section estimated that the DOJ currently has 150 open FCPA cases under investigation, while Kara

[1] Ignatius Fogarty, *Private Equity in 2014: The Year Ahead*, *in* 2014 PREQIN GLOBAL PRIVATE EQUITY REPORT 7 (2014).

[2] *Data and Statistics*, EMERGING MKT. PRIVATE EQUITY ASS'N, *available at* http://www.empea.org/research/data-and-statistics/.

[3] James M. Cole, Deputy Attorney Gen., Address at the Foreign Corrupt Practices Act Conference (Nov. 19, 2013), *available at* http://www.justice.gov/iso/opa/dag/speeches/2013/dag-speech-131119.html , at 2-3.

Brockmeyer, chief of the SEC's FCPA Unit, estimated their open caseload at 100 cases.[4]

The financial industry, and private equity firms in particular, have been an area of increasing focus for U.S. regulators. In January 2011, the SEC sent letters of inquiry to a number of leading private equity firms. These letters, seeking information about the firms' interactions with foreign governments' sovereign wealth funds, were viewed by many observers as paralleling prior industry sweeps conducted by the DOJ and SEC in the pharmaceutical, medical device, and energy industries. The DOJ's recent inquiries into investment banks' hiring of ''princelings,'' the children of China's senior leadership,[5] signal that the financial industry remains a high priority for U.S. regulators.

The Dodd-Frank Wall Street Reform and Consumer Protection Act[6] whistle-blower program provides U.S. regulators with a large volume of potential investigative leads and provides employees with financial incentives to contact regulators. Started in 2011, this program generated 3,238 complaints in fiscal year 2013, an 8 percent increase over FY 2012. In FY 2013, 149 complaints were FCPA related, a 30 percent increase over the prior year. Also in FY 2013, the SEC received 404 complaints from overseas, 36 percent of which were received from emerging markets. BRIC (Brazil, Russia, India and China) countries were well represented, with China providing the third largest source of overseas complaints, Russia ranking fourth, and India tying for fifth.

Given this enforcement environment, private equity firms should seriously consider implementing risk-based compliance measures to meet these regulatory risks and to preserve investors' value.

Regulatory Incentives

Originally enacted in 1977 and amended in 1998, the FCPA contains two types of provisions: (1) anti-bribery provisions and (2) accounting provisions. The anti-bribery provisions prohibit covered individuals and companies from offering or making corrupt payments to foreign officials to obtain or retain business. The accounting provisions require regulated companies to make and keep accurate books and records and to maintain adequate internal controls. Although the law was enacted in 1977, FCPA enforcement increased significantly in 2007, when both enforcement actions and the resulting fines began to escalate rapidly. Since 2007, the DOJ and SEC have brought a total of 94 FCPA enforcement actions against corporations, with a total settlement value of $4.63 billion.

U.S. regulators have not only brought more and higher value FCPA enforcement actions in recent years, they have also taken increasingly expansive interpretations of the law's scope. In recent settlements, the DOJ and SEC have held companies liable for the corrupt acts of their overseas subsidiaries even when there is no evidence that the parent companies were involved in or aware of the misconduct.[7] Indeed, companies have been held liable not only for the actions of their subsidiaries, but of their joint ventures as well.[8] This enforcement strategy has obvious implications for private equity firms, which may hold dozens of overseas portfolio companies.

U.S. regulators have also aggressively pushed the principle of successor liability when enforcing the FCPA. In their 2012 FCPA guidance, the DOJ and SEC reaffirmed that:

> when a company merges with or acquires another company, the successor company assumes the predecessor company's liabilities. . . . Successor liability applies to all kinds of civil and criminal liabilities, and FCPA violations are no exception.[9]

In 2009 alone, more than one third of corporate FCPA enforcement actions implicated successor liability issues, a trend which shows no signs of abating. In some cases, the DOJ and SEC have held successor companies liable for the conduct of their subsidiaries years before the acquisition.[10]

Compliance risk affects all aspects of private equity:

- When raising capital, private equity firms should be cautious in their interactions with sovereign wealth funds and investors who may be linked to foreign governments to ensure that no improper payments, gifts, or other benefits are provided. Recent years have seen investigations of financial institutions' relationships with Libyan and Qatari sovereign wealth funds by the SEC and the U.K.'s Financial Services Authority.[11]. The DOJ and SEC have made it clear that companies will be held liable for their third parties' conduct, making placement agents an obvious source of risk.

- When selecting targets for investment, compliance due diligence helps private equity firms to avoid compliance risks. Without adequate due diligence, firms may acquire a company with FCPA issues, risking a time consuming and costly internal investigation. Compliance issues can also potentially affect a portfolio company's valuation and the private equity firm's exit timeline. In a worst case scenario, U.S. regulators may bring enforcement actions against the portfolio com-

---

[4] Remarks at American Conference Institute Foreign Corrupt Practices Act Conference (Nov. 17-20, 2013), reported in Yin Wilczek, *DOJ, SEC Have 'Substantial Pipeline' of Major FCPA Investigations, Officials Say*, 45 Bloomberg BNA Sec. Reg. & L. Rep. 2169 (Nov. 25, 2013).

[5] Christopher M. Matthews, *Law 2014: In White Collar Crime, It's Déjà vu All Over Again*, Wall St. J., Dec. 31, 2013, *available at* http://blogs.wsj.com/law/2013/12/31/law-2014-in-white-collar-crime-its-deja-vu-all-over-again/

[6] Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub.L.No.111-203, § 922(a), 124 Stat 1841 (2010).

[7] Press Release, U.S. Dep't of Justice (Jan. 9, 2014), *available at* http://www.justice.gov/opa/pr/2014/January/14-crm-019.html; Press Release, U.S. Dep't of Justice (Apr. 22, 2013), *available at* http://www.justice.gov/opa/pr/2013/April/13-crm-456.html

[8] Press Release, U.S. Dep't of Justice (Nov. 26, 2013), *available at* http://www.justice.gov/opa/pr/2013/November/13-crm-1260.html

[9] U.S. Dep't of Justice Criminal Div. & U.S. Sec. & Exch. Comm'n Enforcement Div., A Resource Guide to the U.S. Foreign Corrupt Practices Act 28 [*hereinafter* Resource Guide].

[10] Press Release, U.S. Sec. & Exch. Comm'n (Dec. 17, 2012), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171486902#.UuktPSfF35M

[11] Liz Rappaport & Ruth Simon, Wall St. J., Aug. 10, 2011, *available at* http://online.wsj.com/news/articles/SB10001424053111904140604576497950009027990; David Enrich & Max Colchester, Wall St. J., July 27, 2012, *available at* http://online.wsj.com/news/articles/SB10000872396390443343704577552221781046032

COPYRIGHT © 2014 BY THE BUREAU OF NATIONAL AFFAIRS, INC.

ISSN 0037-0665

pany or the private equity firm itself under an agency or successor liability theory.

■ When structuring investments, compliance due diligence is key in helping private equity firms decide whether to take a majority share and what type of management role to seek. The SEC and DOJ will assess a company's degree of control, ''including the parent's knowledge and direction of the subsidiary's actions''[12] when determining whether to hold the parent liable for the subsidiary's conduct. Private equity firms might therefore restrict themselves to a minority share of higher-risk investments. However, firms should also be aware that taking a minority position does not eliminate all liability. Under the accounting provisions of the FCPA, minority shareholders face potential liability for their subsidiaries' conduct, and are expected to use their ''best efforts'' to ensure compliance with the FCPA' s internal controls requirements.[13] Firm employees serving on the boards of portfolio companies could also potentially face personal liability for misconduct taking place at the portfolio company.

■ When holding and operating portfolio companies, effective compliance programs can help private equity firms mitigate the regulatory risk from potential misconduct by employees of portfolio companies.

■ When exiting, sophisticated buyers will conduct compliance due diligence and insist on FCPA-related warranties. This can not only affect the valuation and timing of the deal, but can potentially lead to litigation between the private equity firm and the buyer.

Compliance Programs

Private equity firms can protect themselves from these regulatory risks and ensure greater value for their investors by setting up robust and effective compliance programs. There are a number of basic measures which private equity firms can take to reduce their compliance risk without significantly increasing overhead. In their November 2012 guidance, the DOJ and SEC set forth ten ''hallmarks'' of effective compliance programs.[14] An effective compliance program can be designed according to these principles while still accommodating both the business realities faced by the companies in a private equity firm's portfolio and the firm itself.

Pre-Acquisition Due Diligence. In their November 2012 guidance, the DOJ and SEC clearly stated that they view pre-acquisition compliance due diligence and post-acquisition compliance integration to be one of the hallmarks of an effective compliance program.[15] Although the FCPA does not formally require companies to conduct such due diligence and integration, the guidance notes that:

> DOJ and SEC may decline to pursue charges against a company based on the company's effective compliance program, or may otherwise seek to reward a company for its program, even when that program did not prevent the underlying FCPA violation that gave rise to the investigation.[16]

The DOJ and SEC have shown a willingness to carry out this portion of the guidance, publicly acknowledging that ''that even the best compliance program will not prevent every violation of the FCPA.''[17] Given these regulatory incentives, and the business incentives discussed below, it is in private equity firms' interest to conduct compliance due diligence before engaging in transactions.

Due diligence for potential acquisitions should be individualized and risk-based, and can be designed to avoid or minimize impact on the deal. Private equity firms should initially consider target companies' geography, industry, and degree of contact with government officials. The publicly available data published by nonprofit Transparency International[18] provide a useful index of the background levels of compliance risk in the various countries where portfolio companies operate. Firms should then consider the degree of compliance risk associated with the industry in which target companies operate. For example, the energy industry has historically been a subject of significant FCPA enforcement actions. Finally, firms should consider target companies' specific business models to determine the degree of risk and degree of contact with government officials. For example, a pharmaceutical company operating in China will have hundreds, if not thousands, of contacts with government officials daily, because the doctors in China's state-owned healthcare system are classified by the DOJ as government officials under the FCPA.

Compliance Programs for Current Portfolio Companies. Assessment of current portfolio companies is another key component of a private equity firm's compliance program. Firms should first conduct a risk assessment of their portfolio as a whole, once again balancing issues such as geography, industry, and business model, before focusing their efforts on the companies with the highest risk profiles.

When assessing high-risk portfolio companies, the process largely parallels the pre-acquisition due diligence discussed above, with a notable difference being that the private equity firm is already an owner of, or significant investor in, the portfolio company and therefore has greater access to information. The private equity firm should continue to take a risk-based approach, focusing its attention on the highest-value and highest-risk transactions.

Payments to third parties such as agents or consultants are often a high-risk area because of the potential for the transfer of large quantities of money to government officials. Indeed, the SEC's Brockmeyer recently noted that 60 - 70 percent of their cases involve allegations of improper payments through third party intermediaries.[19] Private equity firms should conduct risk-

[12] Resource Guide, *supra* note 9, at 27.
[13] The Securities and Exchange Act of 1934 § 13(b)(96), 15 U.S.C. § 78m(b)(6).
[14] Resource Guide, *supra* note 10, at 57-63.
[15] *Id.* at 62.
[16] *Id.* at 56.
[17] James M. Cole, Deputy Attorney Gen., Remarks at the American Conference Institute's 30th International Conference on the Foreign Corrupt Practices Act, Nov. 18-21, 2013.
[18] Transparency Int'l, www.transparency.org (last visited Feb. 5, 2014).
[19] Yin Wilczek, *DOJ, SEC Have 'Substantial Pipeline' of Major FCPA Investigations, Officials Say*, 45 Bloomberg BNA Sec. Reg. & L. Rep. 2169 (Nov. 25, 2013).

based due diligence of their portfolio companies' third parties, and include appropriate anti-corruption language in agreements. Requiring third parties to provide compliance certifications can be another valuable measure in reducing compliance risk from third parties. Payments to import/export agents to facilitate the movement of goods across borders and payments to third party representatives to obtain government approvals are two examples of such risk.

Compliance training is another area of concern. In their 2012 guidance, the DOJ and SEC list periodic training and compliance certifications for employees as one of the hallmarks of effective compliance programs, noting that ''[c]ompliance policies cannot work unless effectively communicated throughout a company.''[20] Although implementing a centralized training program across portfolio companies may be impractical, given their number and variety, private equity firms should consider portfolio companies' training programs as part of their overall compliance assessment. As with third parties, requiring compliance certifications from employees can be another useful measure in reducing risk.

Whistle-blower Complaints. Private equity firms should also ensure that all employees—of the firm and of portfolio companies—have clear channels to file complaints, either in their own names or anonymously. These types of reporting channels have been listed by the DOJ and SEC as another hallmark of an effective compliance program in their 2012 guidance.[21] Additionally, establishing and publicizing these reporting channels may serve to reduce the risk of a company becoming the subject of a complaint to the SEC under the Dodd-Frank whistle-blower program. It is far better to receive allegations of misconduct in e-mails and phone calls from employees than in subpoenas from U.S. regulators.

Business Incentives

Compliance programs not only help private equity firms protect against regulatory enforcement risk, but help ensure strong returns for investors. The money spent on compliance will be realized in greater valuations at exit.

Sophisticated buyers will almost certainly conduct pre-acquisition compliance due diligence, including due diligence on FCPA risk. A 2011 survey of private equity firms, hedge funds, and other financial services executives found that 80 percent conduct ''very or somewhat detailed'' compliance due diligence on acquisition targets or potential partners.[22] Moreover, 63 percent of survey respondents had canceled or renegotiated deals due to FCPA issues in the three years leading up to the survey.[23] The importance of compliance due diligence and companies' sensitivity to FCPA risk has only increased in the years since this survey. If due diligence reveals potential compliance issues, buyers may look for other opportunities. Alternatively, buyers may proceed with the transaction, but from a position of greater leverage, discounting the company's value due to known or potential compliance risks and the costs of remediating such risks.

Private equity firms that fail to conduct pre-acquisition due diligence are potentially overvaluing the companies they target for acquisition. Corrupt behavior by a portfolio company may lead to costly and time consuming internal investigations and remediation measures. The value of a target's contracts could be wiped out if the contracts were obtained or retained through corrupt payments.[24] Pre-acquisition corrupt conduct may also impact whether current management, who may be critical to the business, can remain with the company post-acquisition. In a worst case scenario, undetected compliance problems may lead to a regulatory investigation of the portfolio company or of the private equity firm itself.

A private equity firm is buying high and selling low when it fails to conduct compliance due diligence. Even if no compliance issues arise with the portfolio company during the investment period, the firm is not collecting important information that affects valuation before investing. Purchasers will almost certainly require this same information at exit, meaning that the exit valuation will be more accurate—and likely lower—than at acquisition.

Failure to implement compliance programs in portfolio companies may also impact the exit timeline. Sophisticated buyers will recognize that the portfolio company bears potential compliance risks, and discount the company's value accordingly or decline the transaction altogether. Implementing compliance programs in portfolio companies is therefore not only a way to reduce regulatory risk but to maximize return on investment.

Private equity firms should also consider the reputational risk and other costs that government investigations bring. Even if the firm or its portfolio companies are not found culpable, responding to government investigations is a time consuming, costly endeavor. Government investigations, particularly in the FCPA space, can last years and cost tens if not hundreds of millions of dollars to resolve. Moreover, these investigations are frequently high profile matters covered in the media, and can cause significant damage to a firm's brand and the brands of its portfolio companies.

Conclusion

Private equity firms operate in a challenging environment. The DOJ and SEC are increasingly aggressive in their enforcement of the FCPA. The industry itself is increasingly globalized, with firms placing greater focus on emerging markets, which bring increased FCPA exposure. The implementation of effective compliance measures can help firms reduce their regulatory enforcement risk and preserve strong returns for their investors.

---

[20] Resource Guide, *supra* note 9, at 59.
[21] *Id.* at 61.
[22] Deloitte, Look before you leap: Managing risk in global investments 1-2 (2011), *available at* https://www.deloitte.com/assets/Dcom-Canada/Local%20Assets/Documents/FA/ca_en_fa_look_before_you_leap_040611.pdf.
[23] *Id.* at 1.
[24] Carolyn Lindsey, *More Than You Bargained For: Successor Liability Under the U.S. Foreign Corrupt Practices Act*, 35 Ohio N.U. L. Rev. 959, 982 (2009).

 COPYRIGHT © 2014 BY THE BUREAU OF NATIONAL AFFAIRS, INC. SRLR ISSN 0037-0665