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Recent Enforcement Trends Indicate Increased FCPA Peril for Private Equity Firms


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Recently-announced Foreign Corrupt Practices Act (FCPA) invesigations by the Department of Justice (DOJ), the Securities and Exchange Commission (SEC), and cooperation by the United Kingdom's Serious Fraud Office (SFO) shortly after the U.K. enacted a sweeping Bribery Act indicate that financial institutions, including banks and private equity firms, that make substantial investments abroad, may form part of the next FCPA enforcement wave. Within the last year, the SEC and the SFO have announced probes into bank and private equity firm transactions involving sovereign wealth funds (SWFs) and national pension funds, joint ventures, and foreign private companies in a private equity firm's portfolio. In fact, Richard Alderman, head of the SFO, squarely took aim at the private equity industry in a speech on June 22, 2011, stating "[a]s owners of companies, private equity, as well as the big institutional shareholders, has a responsibility to society to ensure that the companies in which they have a shareholding operate to the right standards."[1]

The potential exposure to liability under the anti-bribery laws is enormous, with five separate companies entering into settlements to pay over $100 million each in FCPA-related fines and penalties to the DOJ and SEC in 2010. In order to accurately value investments, private equity firms and other financial institutions that invest internationally must identify and appropriately address FCPA risk in investments. By assessing FCPA risk at every stage of the investment process - from the fundraising stage to deal origination to investment due diligence to post-acquisition management - private equity firms and other financial institutions that invest internationally can identify and appropriately address potential FCPA issues. FCPA violations often have large fines associated with them, so ignoring the risk of successor liability for actions taken by a target entity can completely undermine the value of an investment. Taking adequate protective steps to detect and avoid FCPA problems makes business sense and will allow these risks to be included in the valuation of the asset to be acquired.

Background

Under the FCPA, it is unlawful for any U.S. company, U.S. person or resident, foreign company listed on a U.S. exchange, or any person or company acting within U.S. territory to offer, provide or authorize the payment of money or anything of value to foreign government officials to assist in obtaining or retaining business.[2] In addition, the U.K. Bribery Act imposes strict liability on commercial organizations for failing to prevent bribery by an associated person of either a government or a private person "to obtain or retain (1) business, or (2) an advantage in the conduct of business."[3] Unlike the FCPA, the Bribery Act does not provide an exception for "facilitation payments," small payments made for ministerial governmental action such as customs and vehicle registration.

The FCPA and Bribery Act include broad definitions of who is a foreign official and what constitutes a bribe. While it should be obvious that paying a bribe to an employee of a foreign government entity would violate both the FCPA and the Bribery Act, a wide range of people beyond just foreign dignitaries are considered foreign government officials, at least under the FCPA, including employees of government-owned enterprises, SWFs or national pension funds, employees of joint ventures that are only partially government-owned, and political parties and their officials and candidates. Furthermore, a bribe reaches far beyond cash payments, and encompasses giving or offering to give anything of value, including in-kind gifts, charitable donations made at the behest of a government official, political donations, promise of future employment, and travel, food and lodging expenses. For example, investors can incur liability for providing "lavish" hospitality to potential investors or business partners who happen to be employees of foreign government-owned entities. The U.S. and U.K. governments have not provided clear guidance on what hospitality would be considered a violation of anti-corruption laws, but have advised that hospitality expenses should be "reasonable" and business related.[4] Hospitality costs for family members of business participants will likely run afoul of the anti-bribery laws because they are not considered to be business related.

Indirect bribes are also unlawful. Therefore, using a third party to make a bribe does not prevent liability. As a result, another area to scrutinize is the role of any third party agents used to identify investors or potential transactions. There are numerous examples of government enforcement actions focusing on these sorts of violations. One of the best known is the DOJ enforcement action, in which oil services companies Shell, Pride International, Transocean, Noble, GlobalSantaFe, and Tidewater entered into deferred prosecution agreements with the DOJ and agreed to pay a combined $154.4 million in fines for paying bribes to Nigerian customs officials through their agent Panalpina World Transport Holding Ltd.[5]

In similar scenarios, private equity firms and other investors have been held liable for violations of anti-corruption laws conducted by an entity that they have invested in, acquired, or entered into a joint venture with. Although there is no hard and fast rule, the risk of liability tends to increase with the level of ownership and control of the entity being acquired or invested in.[6] An investor with a majority stake and management control is more likely to be found to have liability than one that has a minority stake and little to no management control. For example, the SEC recently announced a probe into a subsidiary of a company that was majority owned by a private equity fund.[7] On the other end of the ownership and control spectrum, the SFO has signaled that it is unlikely to take action against a shareholder in an investment who does not have any management rights.[8]

A shareholder with knowledge of a bribery problem can be held liable under the FCPA, regardless of the degree of ownership or control. In addition to actual knowledge, the FCPA includes within its scope willful blindness:

> "'Conscious disregard', 'willful blindness' or 'deliberate ignorance' – should be covered so that management officials could not take refuge from the act's prohibition by their unwarranted obliviousness to any action (or inaction), language or other 'signaling device,' that should reasonably alert them of the 'high probability' of an FCPA violation."[9]

For example, in the *Omega* case the DOJ entered into a non-prosecution agreement with a hedge fund.[10] The hedge fund itself had not been involved in any bribes. Instead, they were required to pay a $500,000 fine because one of Omega's former employees (a partner at Omega) knew of bribes being paid in connection with an oil and gas privatization project and had based the hedge fund's investment, in part, on that knowledge.

Similarly, in the *Bourke* case (involving the same oil & gas project as in the *Omega* case), an individual investor, with little ownership and no management control over the project, was found guilty of an FCPA violation, in part because two witnesses testified that he was aware of the bribes and had nonetheless decided to invest in the project.[11]

Even investors that do not engage in bribery or have knowledge of bribery can find themselves liable for violations of anti-corruption laws through successor liability. This scenario is more likely in the case of a stock transfer where both the assets and liabilities transfer from the target entity to the successor after closing or if the acquiring entity is acting as continuation of the selling entity (a scenario that is less common in the private equity context).[12] However, even in the case of an asset purchase where the acquiring investors explicitly did not assume the liabilities of the target company, investors cannot completely insulate themselves from the consequences of the predecessor entity's past bad acts. The discovery of illegal acts at the target company could lead the investors purchasing the assets to conduct extensive (and expensive) investigations to determine the extent of the prior bad acts which could lower the value of the assets. The scope of this type of investigation will increase significantly if an enforcement agency is involved.[13] Finally, even if investors limit liability and ensure that the target company and shareholders agree to robust indemnifications provisions (as discussed below), discovery of bad acts will lead to substantial legal costs and collectability issues in pursuing the sellers for indemnification.

Pre-Investment: Assessing Risk at the Deal-Origination and Fund-Raising Stages

Anti-bribery legal risks for a private equity firm can arise during the capital raising and deal origination stages of investment. Raising capital through SWFs can create legal pitfalls for the unwary investor. As of 2010, SWFs were a large potential source of funding with $4 trillion in assets, thriving in an otherwise sluggish world economy.[14] However, because of their foreign sovereign ownership, SWFs are foreign government entities under the FCPA and their employees are considered to be by foreign government officials. Therefore, improper benefits or incentives given to SWF employees could trigger liability under the FCPA and UK Bribery Act. The SEC and the SFO are specifically interested in the role of placement agents in arranging investment opportunities with SWFs. In January 2011, both large banks like Citibank as well as private equity firms, like Blackstone Group LP reported receiving requests for information from the SEC focused on whether these private equity firms paid bribes or provided other benefits of value to procure investments from SWFs.[15] In May, it was reported that the SEC's and SFO's focus had spread to dealings with national public pension funds.[16]

Separate from this probe, the SEC is also investigating Goldman Sachs' dealings with the Libyan Investment Authority (LIA), a sovereign-wealth fund controlled at the time by Colonel Moammar Gadhafi.[17] Specifically, the SEC is investigating a $50 million fee that Goldman had agreed to pay the LIA to help the fund recoup over $1 billion in losses it suffered in 2008 while Goldman was managing the majority of its assets.[18] Allegedly, Goldman planned for the LIA to pass this payment on to an "outside adviser," Palladyne International Asset Management, which was run at the time by the son-in-law of the head of Libya's state-owned oil company.[19] Although the payment was never made due to the current violent conflict in Libya,[20] Goldman could still face liability under the FCPA based on the interactions that took place with Libyan foreign officials and their families, and its attempt to make a possibly improper payment.

Especially in light of these recent cases, at the initial stages of a deal, all firms working with foreign sources to raise capital or identify deals should have written policies that the firm will not pay or offer bribes or kickbacks, and should ensure that everyone working with them to identify deals and raise capital are aware of and agree to comply with policies not to bribe people or offer kickbacks. Additionally, firms should perform due diligence on any placement agents used, including searches of public information, to make sure that they have not engaged in bribery in the past, and to be aware of any political connections they may have. Finally, firms should closely scrutinize the compensation structures of proposed deals to ensure that they do not allow room for kickbacks and bribes.

The Acquisition: Conducting Diligent Due Diligence

After capital is raised and investment targets are identified, before closing a transaction a private equity firm should evaluate anti-corruption legal risks that may arise as a result of acquiring or investing in a company that itself has violated anti-bribery laws. Front-loading anti-corruption legal risk analysis and due diligence is critical to avoiding and limiting liability. Knowing about potential FCPA and Bribery Act violations can ensure that private equity funds are not overpaying for an investment. Although the SEC and DOJ have repeatedly charged companies who discover bribery problems in the course of an acquisition, the SFO has said that it would be unlikely to bring charges against a corporate entity that self discloses corruption problems at a target company.[21]

A first step in this process is to require that all the owners of a target entity make representations that there are no violations of any anti-corruptions laws, that the company has an internal anti-bribery compliance regime, and that there has been full compliance with this compliance regime. This request may yield two different outcomes, both of which would be beneficial for a prospective investor. First, the owners will likely conduct due diligence of their own before making such a representation, which may identify any potential FCPA issues for the investor. If any FCPA problems are identified through self-disclosure or due diligence before closing, the attendant potential costs and risks can be priced into the purchase price of the investment. In addition, if the owners are not willing or able to make those representations, that raises a red flag for the potential investor to know to ask more questions on this point and request an in-depth investigation of foreign activities before making the investment.

For private equity firms purchasing less than a majority share and little managerial control, if possible, a clause should be entered into that would allow a special indemnification if bribery is detected or reported. The special indemnification should have no deductible and no liability cap other than the full amount of the investment for losses occurring at the company, and full indemnification for all losses occurring at the fund. Robust indemnification clauses can protect an investment and can increase the likelihood that the counterparty has done adequate anti-corruption prevention. Similarly, minority owners should insist on the right to audit the entity's books to make sure that no questionable payments are being made by the entity being invested in.

In addition to representations and warranties, private equity firms should be sure to do their own due diligence. The due diligence process must have a strong bribery detection component, focusing particularly on high-risk countries where bribery is more prevalent, as well as due diligence on the use of third-party agents who can be used either knowingly or unwittingly to make improper payments.

The best example of the consequences of failing to adequately assess anti-corruption legal risks in due diligence is eLandia International Inc's acquisition of Latin Node Inc. in 2007.[22] Only after the transaction closed, in a review of Latin Node's internal controls and compliance procedures eLandia identified serious FCPA violations involving payments to employees of state-owned telecommunications companies in Yemen and Honduras.[23] In the eLandia DOJ settlement, the DOJ credited eLandia with exemplary cooperation for disclosing these issues. In addition, it only charged the acquired entity, Latin Node, with violating the FCPA and levied a relatively modest fine of $2.2 million. eLandia was able to resolve the issue quickly, and, relatively, cheaply. But the financial toll of the failure to detect the FCPA problems before closing amounted to almost the entirety of the amount invested in Latin Node. eLandia allocated $18.2 million of the original $22.3 million purchase price as a direct operations charge against income to cover FCPA fines and anticipated investigation costs.[24] In light of these problems, eLandia was unable to find a buyer for the Latin Node business and had to wind it down.[25] Had eLandia conducted proper due diligence regarding FCPA issues before acquiring Latin Node, it would have been able to isolate and address the issues earlier in the acquisition process, or scuttle the deal.

The voluntary disclosure of any potential anti-corruption legal issues found during the due diligence process can allow the company making the investment to ensure that, at most, charges will be brought only against the target, not the potential investor or acquirer.[26] For example, Johnson Controls Inc.'s (JCI) pre-closing due diligence of York International Corporation showed potential FCPA-violations related to the United Nations Oil-for-Food Program.[27] Before entering into a merger agreement, JCI and York jointly disclosed the potential violations to the DOJ and SEC, and agreed to cooperate with those authorities.[28] York, the target company, entered into a deferred prosecution agreement with the DOJ and agreed to pay $22 million in fines, penalties and disgorgement to the DOJ and SEC. By discovering the issues early, and disclosing them to the government before the closing, JCI was able to ensure that FCPA charges were only brought against York, and not against JCI, ensuring that any negative public statements related to the DPA were associated solely with York.[29] In addition, it allowed JCI to take the $22 million in fines into account when pricing the deal.

By contrast to JCI, which conducted due diligence ahead of time, in a recent settlement with RAE Systems Inc., a publicly-traded manufacturer, the DOJ faulted RAE for failing to conduct adequate pre-acquisition due diligence, and failure to implement proper internal controls after discovering evidence of corruption and bribery.[30] RAE, the acquiring company, entered into a non prosecution agreement with the DOJ and paid $2.8 million in fines and civil penalties to the SEC and DOJ. Had RAE conducted adequate due diligence, it may have been able to avoid a significant portion of the fine and may have been able to remediate the procedures within the business units they were acquiring.

Post Acquisition: Managing an Investment to Limit Legal Risk

Although a significant amount of due diligence regarding FCPA issues is needed before a private equity firm makes an investment, the responsibility of the firm does not end at the time of closing. Rather, there are certain steps that investors, especially investors with significant ownership stakes in the investment, should take on an on-going basis for the life of the investment. This is especially important in avoiding liability under the Bribery Act, which allows companies to use their compliance programs as an affirmative defense to criminal liability.[31]

First, an investor with a lot of ownership or control should establish a robust compliance program that is carefully implemented across all business units. If the target already has a compliance program in place, it is important to conduct an extensive review of that program to be sure that it is up-to-date, meets all necessary legal requirements and is implemented rigorously.

Second, if it can assert management control the investor should ensure that the management of the target provides substantial support for the compliance program - this means financial resources, human capital and holding employees accountable for violations of the company's protocol. Any corporate program, no matter how well-designed, will not be effective if the corporate management is not making the implementation of that program a priority.

Third, if possible, the investor should conduct regular reviews of the target's internal guidelines and policies for interacting with foreign government officials and for hiring and paying consultants. These relationships must be highly regulated and carefully overseen to be sure that all interactions comply with the anti-bribery laws. Even activities or payments that are undertaken in good faith can be construed as violations of anti-bribery laws and must be closely monitored by disinterested employees and outside counsel.

Fourth, the investor must require companies in which they have invested to create verification procedures that allow for checks within the accounting system of business units that operate overseas and will ensure ongoing compliance with internal protocol.

Finally, even in a situation where there is little control or ownership but an investment company has been able to appoint a member of the board, the board member should act as the eyes and ears of the private equity firm and should be trained to detect potential bribery risks so that they will be able to ask the right questions and identify potential problems. If such problems are identified, the minority shareholder can work on improving the situation, and, if that does not work, can rely on the protective mechanisms they have hopefully been able to put in place like auditing rights and indemnification clauses.

Not only will taking these steps help prevent violations of anti-bribery laws from occurring, but they will also be viewed favorably by the DOJ in the event that a violation of an anti-bribery laws does occur despite the efforts made. For example, the DOJ stated that it would not prosecute the JPMorgan Partners Global Fund and its investment partners, after they had acquired certain companies that had FCPA-related issues, despite the fact that the investment targets were the subject of a prosecution by the DOJ.[32] In that case, JPMorgan promised to implement a strict compliance code in the new company being formed, to provide regular training regarding anti-corruption laws to all shareholders, officers, employees and business partners, create an internal system for reporting suspected violations, and institute an extensive pre-retention due diligence requirement for all business partners, including outside consultants.[33]

The timing for implementation of these steps is crucial. In 2003, the DOJ agreed not to hold a public company liable for any potential FCPA violations by its acquisition target as long as it implemented an effective compliance program on "Day 1" after the acquisition.[34] The SFO has also stated they are unlikely to bring charges against companies that disclose past problems with bribery and implement robust compliance programs on "Day 1."[35] Therefore, it is not wise for a private equity firm to wait until an investment has been made or an acquisition has been completed for a compliance program to be developed. Rather, it is important for the compliance program to be fully developed so that implementation, including training and monitoring, can truly begin on "Day 1" after the deal closes.

Conclusion

In conclusion, given the increasing risks, the time for private equity firms to implement anti-corruption procedures is now. Doing so will allow them to detect problems in enough time to take such issues into account when structuring a deal and could mitigate any penalties in the event that problems are not detected at the initial stages of a transaction.

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[1] "Private Equity and the UK Bribery Act," Speech by Richard Alderman (June 22, 2011).

[2] The FCPA also includes fines for books and records violations, *i.e.*, incorrectly characterizing transactions in your accounting records. Because these only apply to issuers, they are less likely to apply to private companies, but may come into play if a public company is being taken private, or a listed company owns a private company.

[3] Section 7 of the Bribery Act states: (1) A relevant commercial organisation ("C") is guilty of an offence under this section if a person ("A") associated with C bribes another person intending--(a) to obtain or retain business for C, or (b) to obtain or retain an advantage in the conduct of business for C."

[4] *See*, *e.g.*, DOJ Opinion Procedure Release 07-01 (July 24, 2007) and 07-02 (September 11, 2007 (approving travel expenses for foreign officials when, among other things, only economy class airline travel was provided, gifts were of a nominal value, and no expenses were paid for the family members of government officials); Lord Tunnicliffe's letter on corporate hospitality (January 14, 2010).

[5] DOJ Press Release 10-1251, DOJ, Oil Services Companies and a Freight Forwarding Company Agree to Resolve Foreign Bribery Investigations and to Pay More Than $156 Million in Criminal Penalties; SEC and Companies Agree to Civil Disgorgement and Penalties of Approximately $80 Million (November 4, 2010).

[6] *See* Sam Singer, Comment, *The Foreign Corrupt Practices Act in the Private Equity Era: Extracting a Hidden Element*, 23 Emory Int'l L. Rev. 273, 300-308 (2009).

[7] Joe Palazzolo, *Allianz Close to Settlement With SEC Over Bribery Allegations*, Wall St. J. (October 7, 2010).

[8] "Private Equity and the UK Bribery Act," Speech by Richard Alderman (June 22, 2011) ("[The SFO view] is that [the SFO] shall need to look at the nature of your interest. If this is simply a portfolio investment and your role is simply one of the owners, then employees and agents of the company are not performing services for you. It could be different though if you were far more actively involved in the management of the company and were running it.").

[9] *See* H.R. Rep. No. 100-576, at 920.

[10] DOJ Press Release 07-172, DOJ, U.S. Announces Settlement with Hedge Fund Omega Advisors, Inc. In Connection With Omega's Investment in Privatization Program in Azerbaijan (July 6, 2007).

[11] James G. Tillen and Dalal Hasan, Conviction of Oil Consortium Investor Provides Clarity on FCPA Interpretation, Bloomberg Law Reports, Risk & Compliance (September 2009).

[12] *See*, *e.g.*, SEC Press Release 2010-133, SEC, SEC Charges General Electric and Two Subsidiaries with FCPA Violation (July 27, 2010) ("GE agreed to pay $23.4 million to settle the SEC's charges against the company as well as the two subsidiaries for which GE assumed liability upon acquiring: Ionics Inc. and Amersham plc.").

[13] *See*, *e.g.*, DOJ Foreign Corrupt Practices Act Opinion Procedure Release No. 08-02 (Jun. 13, 2008).

[14] Giles Turner, *SWF Fire Power Grows as Fire Power Hits $4 Trillion*, Financial News (March 9, 2011).

[15] Ashby Jones, *SEC: Wall Street, Meet the FCPA*, Wall St. J. (Jan. 14, 2011.

[16] Joe Palazzolo, *SEC Looking At Firms' Dealings With Foreign Pension Funds*, Wall St. J. (May 6, 2011).

[17] Liz Rappaport and Ruth Simon, *SEC Probes Goldman Over Libyan Dealings*, Wall St. J. (Aug. 10, 2011).

[18] *Id.*

[19] *Id.*

[20] *Id.*

[21] "Private Equity and the UK Bribery Act," Speech by Richard Alderman (June 22, 2011) ("[The SFO] would therefore be sympathetic if a company came to us and said that it had recently taken over another company and that there were a number of issues concerning corruption that had been identified. In those circumstances I can *see* little benefit in an SFO investigation at the corporate level….").

[22] DOJ Press Release 09-318, DOJ, Latin Node Inc., Pleads Guilty to Foreign Corrupt Practices Act Violation and Agrees to Pay $2 Million Criminal Fine (April 7, 2009).

[23] *Id.*

[24] eLandia International, Inc, Form 8-K Jan. 11, 2008.

[25] eLandia International, Inc Form 10-K/A, May 20, 2008.

[26] Depending on the circumstances, the government may decline to pursue any sanctions.

[27] DOJ Press Release 07-783, DOJ, Justice Department Agrees to Defer Prosecution of York International Corporation in Connection With Payment of Kickbacks Under the U.N. Oil For Food Program (October 1, 2007).

[28] *Id.*

[29] *Id.*

[30] DOJ Press Release 10-1428 DOJ, RAE Systems Agrees to Pay $1.7 Million Criminal Penalty to Resolve Violations of Foreign Corrupt Practices Act. Voluntary Disclosure Results in Non-Prosecution Agreement (Dec. 10, 2010). RAE also paid a fine to the SEC of over $1 million.

[31] Section 7 of Bribery Act states "(2) But it is a defence for C to prove that C had in place adequate procedures designed to prevent persons associated with C from undertaking such conduct."

[32] DOJ Foreign Corrupt Practices Act Review Opinion Procedure Release No. 04-02 (July 12, 2004).

[33] *Id.*

[34] DOJ Foreign Corrupt Practices Act Opinion Procedure Release No. 2003-01 (Jan. 15, 2003).

[35] "Private Equity and the UK Bribery Act," Speech by Richard Alderman (June 22, 2011).