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## PRIVATE EQUITY INVESTMENT AND THE FCPA

*When does owning the stock mean owning the corruption problem? FCPA liability may arise if the investor knew of bribery or was willfully blind to it. But it may also arise if the investor failed to have adequate accounting records and internal controls to detect and prevent improper payments. To avoid liability, investors need to make a genuine effort to gain access to and control over financial reporting in the portfolio companies, an effort that is surrounded with difficulties in the case of foreign firms.*

By Joel M. Cohen and Adam P. Wolf \*

Enforcement of the Foreign Corrupt Practices Act has grown exponentially in recent years, and shows no signs of abating. The DOJ and SEC, the U.S. regulators charged with enforcing the statute, continue to publicly affirm their commitment to the fight against corruption. In a recent speech, Lanny Breuer, the Assistant Attorney General overseeing the DOJ's FCPA enforcement efforts, noting how "in recent years, the Criminal Division has dramatically increased its FCPA enforcement efforts," reminded his audience that in 2004 the DOJ charged two individuals and collected approximately \$11 million in criminal fines, but that "by contrast, in 2009 and 2010 combined, we charged over 50 individuals and collected nearly \$2 billion."<sup>1</sup>

Similarly, the SEC recently formed a dedicated FCPA unit, with branches operating in major hubs throughout the United States. British regulators, though later to the dance, are expressing their intent to prosecute with regular frequency, as the U.K. Bribery Act has gone from legislative theory to reality. FCPA (indeed, all anti-corruption) enforcement has increased, measured through a wide array of metrics – number of cases brought (against both companies and individuals), penalties imposed, cross-border cooperation, types of "corrupt behavior" involved, and industries impacted, to name a few. This enhanced enforcement environment reflects not only more penalties, but encroachment into more business areas, including those involved in

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<sup>1</sup> Lanny A. Breuer, Assistant Attorney General, Remarks at the Franz-Hermann Brüner Memorial Lecture at the World Bank

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(May 25, 2011) (transcript available at <http://www.justice.gov/criminal/pr/speeches/2011/crm-speech-110525.html>).

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financial services and investing not formerly associated with “paying bribes.” Private equity firms fall within this expanding ambit and now must ensure that their anti-corruption processes and controls pass muster.

In the past, many private equity firms shied away from conducting pre-acquisition anti-corruption due diligence, carefully avoiding imposition of their own anti-corruption standards on portfolio companies post-acquisition to avoid giving the appearance that they controlled the companies in their portfolios. Such a strategy no longer is viable on a legal or, indeed, on an investment-risk basis, and hoping to simply pass along corruption risks or problems at portfolio companies to future acquirers at the end of a private equity turnaround window no longer is a tolerable risk. Vigorous pre-acquisition due diligence and post-acquisition oversight are critical, both because counterparties are taking these steps and because regulators assume it is happening. Private equity investors must assess corruption risk as part of their overall risk analysis in considering potential investments. Credit and risk committees at private equity firms should incorporate corruption concerns into their risk analyses, as these issues can meaningfully affect reputational, legal, and exit-timing calculations. Firms also would be wise to vet both the management teams kept on board at portfolio companies and their appointed additions to management to ensure that they consider such risks seriously.

Recent enforcement initiatives and public statements by regulators have caused some commentators to raise the specter that private equity investors might face efforts to hold them responsible for alleged corrupt activity at their portfolio companies that they neither condoned nor caused. For instance, the SEC currently is investigating potentially improper payments made by a foreign portfolio company over which the SEC would not have jurisdiction but for the fact that a U.S.-listed firm owns a majority stake in it.<sup>2</sup> Director Richard

Alderman of the U.K.’s Serious Fraud Office, the agency responsible for enforcing the U.K. Bribery Act which took effect July 1, 2011, caused a stir when he recently suggested that private equity firms could be held responsible for money laundering at a portfolio company, noting that “the owning company or partners may know nothing about this although they will have received the benefit through dividends or other distribution,” and adding that private equity firms have “a responsibility to society to ensure that the companies in which they have a shareholding operate to the right standards.”<sup>3</sup>

However, these recent events do not portend doom and gloom as some predict. Private equity investors can continue to invest in markets and companies that raise corruption risks as long as they conduct reasonably strong pre-acquisition due diligence and post-acquisition follow-up, which can be achieved through the manageable steps that are discussed below. Additionally, there are limits on the potential exposure facing private equity investors. Broad successor liability for prior bad acts, which applies, for instance, when one corporation acquires another, does not apply in the context of an equity investment. Two features remain central to any legal claim of responsibility imposed on private equity firms – control and knowledge.

## THE FCPA PROVISIONS

The FCPA’s anti-bribery provisions prohibit corruptly providing, offering, or promising anything of value to a foreign government official to obtain or retain a business advantage, while being aware of the conduct or substantially certain that the improper conduct will occur, or consciously disregarding a “high probability” that it will occur.<sup>4</sup> Before a private equity firm can be

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<sup>2</sup> See, e.g., Aruna Viswanatha, *U.S. Targets European Insurer in Foreign Bribery Probe*, JUST ANTI-CORRUPTION (Dec. 21, 2010, 3:46 pm), available at <http://www.mainjustice.com/justanticorruption/2010/12/21/u-s-targets-european-insurer-in-foreign-bribery-probe/>.

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<sup>3</sup> Richard Alderman, Director, Serious Fraud Office, Remarks at Private Equity and the U.K. Bribery Act event (June 21, 2011) (transcript available at <http://www.sfo.gov.uk/about-us/our-views/director's-speeches/speeches-2011/private-equity-and-the-uk-bribery-act,-hosted-by-debevoise--plimpton-llp.aspx>).

<sup>4</sup> 15 U.S.C. § 78dd-3(f)(2)(B) (providing that knowledge may be established “if a person is aware of a high probability of the existence of such circumstance, unless the person actually

held liable for an improper payment or offer by one of its portfolio companies under the FCPA's anti-bribery provisions, it must be shown to have had knowledge, either by being directly aware of the improper conduct or by being "willfully blind" to it. This principle applies equally to private equity investing.

Under the FCPA's so-called "accounting provisions," companies whose securities are registered in the U.S. or that are required to file periodic reports with the SEC ("issuers") are required to: (1) make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer (the "books and records provision"); and (2) devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are, among other things, recorded properly and executed in accordance with management's authorization (the "internal controls provision").<sup>5</sup> The statute notes that "the terms 'reasonable assurances' and 'reasonable detail' mean such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs."<sup>6</sup> With regard to minority investments, the FCPA provides:

Where an issuer ... holds [50%] or less of the voting power with respect to a domestic or foreign firm, [the accounting provisions] require only that the issuer proceed *in good faith* to use its influence, *to the extent reasonable under the issuer's circumstances*, to cause such domestic or foreign firm to devise and maintain a

system of internal accounting controls consistent with [the accounting provisions]. Such circumstances include the relative degree of the issuer's ownership of the domestic or foreign firm and the laws and practices governing the business operations of the country in which such firm is located. An issuer which demonstrates *good faith efforts* to use such influence shall be conclusively presumed to have complied with the requirements of [the accounting provisions].<sup>7</sup>

The SEC has made clear in recent enforcement actions that if an improper payment is made by a foreign subsidiary of a U.S. issuer and the SEC cannot make a case against the issuer under the anti-bribery sections, it is willing to bring an action against the issuer under the FCPA's accounting provisions.<sup>8</sup> This may be so even if the improper payment is made without any knowledge by the issuer, and the improper payment and any acts in furtherance of it took place entirely outside of the United States. Moreover, if the foreign subsidiary's books and records are consolidated into the issuer's books and records, then the SEC will not hesitate to use the accounting provisions to go after the issuer for the acts of the subsidiary. The scant precedent in the area suggests that the SEC might credit strong remedial measures and cooperation in setting penalties – one company did not receive any financial penalty because, it seems, of the forceful action it took and the cooperation it provided.<sup>9</sup> This likely is little comfort to issuers who do not want to be forced into any settlements with government regulators – regardless whether there is a financial fine imposed – both because of the attendant reputational harm and legal fees, and, perhaps most significantly, because the delay caused by investigation and settlement affects the expected investment window and exit plan envisioned by strategic investors.

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believes that such circumstance does not exist"); *see also* Jury Instructions at 35, *U.S. v. Lindsey*, No. 10-CR-01031 (C.D. Cal. 2011) ("A person has 'knowledge' for purposes of the FCPA if . . . he was aware of a high probability of the existence of such circumstance"); Jury Charge at 27, *U.S. v. Bourke*, No. 05-CR-518 (S.D.N.Y. 2009) ("When knowledge of the existence of a particular fact is an element of the offense, such knowledge may be established if a person is aware of a high probability of its existence and consciously and intentionally avoided confirming that fact.").

<sup>5</sup> 15 U.S.C. § 78m(b)(2). For an excellent discussion of the FCPA's accounting provisions, *see* F. Joseph Warin, Charles Falconer, Michael S. Diamant, *The British are Coming!: Britain Changes its Law on Foreign Bribery and Joins the International Fight Against Corruption*, 46 TEX. INT'L L.J. 1, 32-35 (2010).

<sup>6</sup> 15 U.S.C. § 78m(b)(7).

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<sup>7</sup> 15 U.S.C. § 78m(b)(6) (emphases added).

<sup>8</sup> *See, e.g., SEC v. ITT Corp.*, No. 09-cv-00272 (D.D.C. 2009); *SEC v. Con-way Inc.*, No. 08-cv-01478 (D.D.C. 2008); *In the Matter of Oil States International, Inc.*, Adm. Proc. File No. 3-12280 (Apr. 27, 2006). As with many SEC actions, these are "settlement actions" in which no court interposes its judgment regarding the limits to exposure, so they provide only a partial backdrop to assessing where the lines can be expected to be drawn for private equity investors.

<sup>9</sup> *In the Matter of Oil States International, Inc.*, Adm. Proc. File No. 3-12280 at 5 (Apr. 27, 2006).

Accordingly, for private equity investors, there exists precedent to assume that the private equity arm of a U.S. issuer can be liable under the SEC's accounting provisions for a violation by one of its foreign portfolio companies – even if the corrupt payment takes place abroad, has no connection to the United States, and the U.S. private equity firm did not know about it – predicated on the basis that the U.S. firm consolidates the portfolio company's financial statements into its own. These SEC actions, taken together (which itself is a challenge, as SEC "initiatives" often cannot be discerned from settled actions occurring over a long time span), might reflect the SEC's view that issuers properly should be held liable for failing to do a lot more with respect to reviewing their subsidiaries' books, records, and transactions, and that by not doing all that they could have done, they violated the accounting provisions.<sup>10</sup> In other words, if its past actions are a guide, the SEC seems to support a "you touch it, you own it" approach to investment liability. Of course, the settled actions set forth no meaningful guidance regarding what steps might be considered adequate.<sup>11</sup>

The willingness of the SEC to act under such attenuated circumstances, however, does not properly reflect the fact that parent entities usually exert more control over subsidiaries – and, therefore, likely have greater access to the subsidiaries' books and records – than a private equity investment firm has over a company in its portfolio. What if there is nothing that an issuer engaging in a private equity investment reasonably can do to uncover or prevent corrupt activities by a portfolio company? For instance, what if the issuer firm is not able to gain access to detailed

financial information at the portfolio-company level, and accordingly is not aware of improperly accounted-for transactions? What if the issuer firm does not have the right to require that the portfolio company adopt internal controls meeting the issuer's expectation for its own operations?

The SEC's response might be: "too bad" – issuers should not do business with foreign companies whose detailed books and records are not made available for review and control to the same degree as the issuer controls its own affairs. But this ignores the reality of how many foreign companies around the world, including in Europe, operate due to restrictive corporate governance standards.

For instance, in Germany, a joint stock corporation (Aktiengesellschaft) has a two-tier governance structure. The management board ("MB") represents the company and directs its management, and the supervisory board ("SB") supervises and controls the management of the company by the MB and renders advice. The MB must regularly report on the affairs of the company to the SB, but the SB does not have a managing role and cannot issue instructions to the MB. Members of the SB are not subject to instructions from the company's shareholders and are bound by a strict confidentiality obligation. They may not pass confidential information on to third parties – including the company's shareholders – and a breach of this obligation can lead to criminal prosecution. Similarly, the MB is under a strict obligation to keep all confidential information secret, unless the company is legally required to make a disclosure. This structure is designed to give the MB a significant degree of independence and reduce the influence of shareholders on the management of the company. In this legal regime, even a shareholder cannot obtain relevant information from the company in which it owns shares, as absent a legal requirement, the MB only can divulge such information if it determines – after weighing mandated factors including data privacy concerns – that doing so would be in the company's best interest. Therefore, there is no guarantee that a private equity firm acquiring a stake in a German company would have access to that company's confidential information.

Many other European corporate governance systems apply a similar dual-board structure that limits majority shareholder control over the affairs of the company. In other regions of the world, the limits on control are more functionally than legally mandated, yet they exist nonetheless, as any experienced investor in Russia, China, or elsewhere in Asia can attest. This is especially so where "local," or government-shadow involvement is

<sup>10</sup> For instance, in its complaint in *Con-way*, the SEC notes that "[n]either Con-way [the issuer] nor [Menlo, Conway's wholly owned subsidiary] asked for or received any other financial information from [Emery, a foreign company in which Menlo had a 55% voting interest]. Accordingly, neither Con-way nor [Menlo] maintained or reviewed any of the books and records of [Emery] – including the records of operating expenses, which should have reflected the illicit payments made to foreign officials." This language seems to imply that the SEC believed that Con-way or Menlo could have asked for additional financial information from Emery, and it was this failure to do so that the SEC considered an abrogation of those companies' duties under the accounting provisions.

<sup>11</sup> For a recent discussion of this issue, see *New Rules: Sovereign Fund Probe Awakens Financial Firms to Corruption Risk*, WALL ST. J. (July 11, 2011, 3:31 PM), available at <http://blogs.wsj.com/corruption-currents/2011/07/11/new-rules-sovereign-fund-probe-awakens-financial-firms-to-corruption-risk/>.

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required as a precondition for investing. All these regimes share a common issue: ownership of shares does not necessarily equate to control of corporate affairs, or even visibility into such affairs.

The challenge is that foreign companies into which private equity firms invest often agree only to provide top-level financial statements, but not the underlying, transaction-level detail. As a result, the U.S. issuers are able to consolidate the top-level financial statements into their books and records, but not to review the individual payments that are recorded in the foreign companies' books and records. The SEC has not specifically said that this occasions liability, but its prior enforcement efforts strongly suggest that it wishes to hold equity investors responsible for their inability to obtain deeper financial visibility and control over their portfolio companies where corruption problems emerge, regardless of these limitations. In effect, this represents an SEC effort to shape equity investors' behavior, offering them a choice between obtaining requisite control to ensure anti-corruption controls and reporting that meets SEC expectations, or simply declining to invest. Much like the DOJ and SEC's somewhat moralizing approach to anti-corruption enforcement generally, this approach is premised on the view that if the regulators force private equity investors to make a binary choice – ensure control or don't invest – those investors will over time force wide systemic change in the countries where access to control is not realistic. One might question whether regulators are being realistic if they expect that imposing so stringent a standard will impel a meaningful cultural shift in international business practices.

It would be a large step indeed for the SEC to hold a U.S. issuer liable for the accounting failings of a foreign portfolio company if the U.S. issuer or private equity investor did not have access to that company's books – and could not have had access to those books even upon request. As discussed above, the relevant statutory language requires that issuers that own a less than 50% interest in another company must use their influence “to the extent reasonable under the issuer's circumstances” to cause that other company to comply with the FCPA's accounting provisions. The logic that seems to underlie that requirement – that if company A cannot “force” company B to act in a particular way, then it is unfair to hold company A strictly liable if company B acts inappropriately – should apply equally in circumstances where the control limits arise from factors other than minority share status, notwithstanding any desire to “force change” on affairs occurring in non-U.S. corporate governance regimes. If a private equity firm's investment interest in a portfolio company is such that it

is unable to receive and review the detailed books and records from one of its portfolio companies to a degree that will allow it to ferret out or prevent corruption in the company, the statute itself supports rejection of an effort to hold the investor strictly liable for an improper entry in those books and records.

Absent any meaningful guidelines from U.S. regulators, investors are left to fashion broad standards on their own. While regulatory guidance plainly is preferable, there are some due diligence guideposts – for pre- and post-acquisition – that private equity investors can apply.

## STEPS PRIVATE EQUITY INVESTORS CAN TAKE

It remains a good practice for a U.S.-issuer private equity firm to request detailed information underlying the top-level financial data it receives from its foreign portfolio companies, especially if the U.S. firm intends to consolidate those numbers into its own, even if it knows or expects from prior circumstances that it might not receive such information. The days of not asking for such information because doing so might create the appearance of control are ending.<sup>12</sup> If any of the foreign portfolio companies refuse to provide this information, because of, e.g., data-privacy concerns, it will be up to the SEC to clarify what it expects from the U.S. firm. The SEC will be hard-pressed to hold a U.S. private equity firm liable under the FCPA's accounting provisions if the U.S. firm asks for and yet does not have access to the detailed underlying information – as there would be no way for the U.S. firm to “maintain or review” the books and records containing the improper entries. In such a scenario, assuming that the U.S. firm performed a reasonable level of due diligence on its portfolio companies prior to investing in them and achieved comfort that they were not making (either directly or indirectly) improper payments, a strong argument will be laid for asserting the fundamental unfairness of the SEC seeking to hold the U.S. firm liable under the accounting provisions should such a payment eventually come to light.

All of this underscores the critical importance of a private equity investor conducting adequate due diligence prior to acquiring a position in a portfolio

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<sup>12</sup> See, e.g., *New Rules: Sovereign Fund Probe Awakens Financial Firms to Corruption Risk*, WALL ST. J. (July 11, 2011, 3:31 PM), available at <http://blogs.wsj.com/corruption-currents/2011/07/11/new-rules-sovereign-fund-probe-awakens-financial-firms-to-corruption-risk/>.

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company.<sup>13</sup> A scorched-earth approach to such diligence is of course preferable yet often remains impractical. At a minimum, a private equity firm should conduct a pre-acquisition, targeted review designed to uncover potential red flags that might warrant additional, more in-depth analysis. While the particular nature of the due diligence will vary in accord with the unique aspects and metrics of the portfolio company, a central premise in conducting due diligence should be to consider actions that will demonstrate a genuine effort to gain access to and control over financial reporting in the portfolio company that would reasonably detail corruption. In simple terms, if the due diligence does not evidence a genuine effort to obtain such control, the record will lack indicia of good faith and will provide a more meager basis to demonstrate that such efforts were reasonably impossible to succeed.

Prospective investors should start by asking questions designed to assess a potential target's exposure to and contact with government-related entities and personnel. Each factual situation is unique, and the amount and type of information that should be sought will depend on a number of factors, including the locations in which the prospective target operates and the nature of its business. In every case, investors should seek to determine the state of the potential target's compliance program and controls. Does it have written anti-corruption compliance policies? Does it provide compliance and anti-corruption training to its employees? Has it ever been investigated or prosecuted for bribery or corruption? Does it do business with government officials? How about its customers or business partners – are any of them wholly or partly owned by a foreign government? Does the target use third parties such as agents, consultants, or intermediaries to win or conduct business? If so, what sort of diligence does it perform on them? Does it have written contracts with them, and if so, do those contracts contain clauses certifying that the third parties will comply with the FCPA and other anti-corruption laws?

The questions noted above are by no means exhaustive,<sup>14</sup> but they are indicative of the type that

private equity firms would be wise to ask before proceeding with an investment, especially in a company that operates in high-corruption-risk jurisdictions. It generally is preferable to provide a written list of such due diligence questions, which should be structured to elicit the most relevant information in the least intrusive way. Most target companies understand the need for such questions, and generally are willing to provide this information. Indeed, a company's reluctance to answer such questions may itself be a red flag, and should prompt additional scrutiny. If a private equity firm asks appropriate questions and receives comfort that its target's corruption-risk profile is low, then it can feel more confident proceeding with its investment. Adequate pre-investment anti-corruption due diligence is one of the lowest-cost, highest-reward activities a private equity firm can engage in. Of course, the risk of not conducting such diligence is enormous.

Many private equity investors consider it essential to maintain senior management from the old regime, as the investment is a strategic one with a target exit window several years away. Accordingly, investors attach great importance to the quality of the continuing management team. The diligence applied to these employees generally has not focused prominently on their attention to corruption risk. As these employees are the best window into imbedded corruption risk (regardless of the degree of control the investors can achieve), it is imperative to ensure that they understand the risks in secretly allowing old corruption practices to continue, and failure to demand transparency from them will be difficult to justify if the regulators begin to inquire.

More generally, after an investment is made, a private equity firm must decide the degree to which it will impose its own anti-corruption standards, policies, and procedures on its new portfolio company. As discussed above, in the past, many private equity firms have strategically hesitated in this regard, due in part to a desire to not be seen as "controlling" the affairs of the companies in their portfolios in the hopes of avoiding liability should an improper payment be made. But in today's heightened FCPA enforcement environment, more private equity firms are seeking to impress their own standards onto their portfolio companies – in many

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<sup>13</sup> As discussed above, acts of corruption that occurred in the past at a potential target should not result in liability for a private equity investor that, at a later date, acquires a position in that company. Principles of successor liability generally apply only to entities that acquire or merge with other corporate entities, not to those who merely purchase shares in another entity that may have had problems in the past.

<sup>14</sup> Other important areas to examine include the target company's involvement in joint ventures or other partnerships or teaming

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arrangements, and its practices with respect to charitable giving and political contributions. Each of these is a potential risk area for corrupt payments, and the company's controls surrounding them should be noted and, perhaps, explored.

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instances, as part of the investment agreement at the inception of the relationship. This reflects the reality that in today's environment, the risk simply is too great that a regulator will find the requisite level of control even absent some level of day-to-day operational management. "Control" remains amorphous, and courts and regulators have not adopted a bright-line definition. As a result, many private equity firms now find that the security of their portfolio companies having solid anti-corruption processes and controls in place is worth the cost of imposing these heightened compliance requirements. This is the safer course, and private equity firms, of course, should seek to satisfy themselves to the extent possible that their portfolio companies are complying with the FCPA and other relevant anti-corruption laws. It is in circumstances where this is not possible that guidance from the regulators is sorely needed.

## CONCLUSION

In sum, the dire warnings that private equity investors "own the risk" simply because they invest are not fully supported by the relevant jurisprudence. But while strict liability after acquiring ownership should not be the operative standard, the regulators can be expected to push for a standard not far from this one. Like all aspects of investment, corruption risk is a feature that cannot be completely marginalized. Just as investors model and monitor the myriad financial and market risks in evaluating an investment opportunity, they can "model" and plan the corruption risks imbedded in their deals to mitigate the impact of regulatory issues or scrutiny by others when they seek to exit the investment. This is all part of the risk/reward analysis, something which private equity investors have excelled at for decades.■