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Private Equity: Blindsided by the FCPA—Hedging Against Anti-Corruption Deal Risk

By G. Derek Andreson, James L. Kelly, Christopher M. Zochowski, Marc H. Axelbaum and Ryan R. Sparacino

Until a few years ago, private equity firms enjoyed relative insulation from regulatory scrutiny of overseas acquisitions and the operations of multi-national portfolio companies. No longer is that the case. Spurred by the unfounded belief that PE firms are not invested in compliance or the conduct of their portfolio companies, the DOJ and SEC are now training their attention on how PE firms exert oversight and control over their portfolios, with a particular emphasis on FCPA issues. PE firms should prepare for this new scrutiny by taking proactive measures to demonstrate both their awareness and their commitment to earning profits on a level playing field. Most importantly, PE firms must recognize that these efforts are not about appeasing regulators, but go directly to maximizing return on investment.

It's About Deal Risk, Not Legal Risk

A private equity firm's foreign investments carry unique risks in the anti-corruption world: the firm may have exposure to substantial fines, penalties and reputational harm through the conduct of a portfolio company, even though the firm maintains only partial control.

This risk arises not only in the context of acquisitions, but also in strategic combinations such as joint ventures. And under successor liability principles, the conduct at issue may have occurred years before the firm considered taking a stake in the company or venture.

These risks permeate the deal cycle, including the exit phase. A sophisticated buyer in today's market will take a hard look at a target's anti-corruption compliance. If the compliance program falls short of industry standards, that fact may persuade the buyer to look for other opportunities, or it may convey additional leverage in negotiations.

Add to that mix an expanding DOJ and SEC enforcement trend focusing on the relationship between PE firms and their portfolio companies, as well as the financial incentives recently offered by the SEC to

whistleblowers, and the risk profile substantially increases. In short, a PE firm must anticipate, identify and manage anti-corruption risk across its foreign portfolio companies and ventures. Absent such effort, the firm's financial analysis and ROI assumptions for a particular deal can be quickly derailed.

Recognizing Anti-Corruption Risk Throughout the Deal Cycle

Anti-corruption challenges create deal risk at each stage of a foreign portfolio company investment.

Pre-Acquisition. It is now widely recognized that proper pre-acquisition due diligence includes a review of the target's anti-corruption policies and risk. A target's anti-corruption risk profile should be analyzed through a tailored due diligence plan that takes into account an array of factors, including the target's business model, regions of operations and customer base.

There may be times when the diligence uncovers such significant anti-corruption issues that the buyer is better off walking away from the deal. But, more often, issues identified during this phase can be successfully resolved, though they may well impact valuation, negotiations and deal timing. If missed, latent anti-corruption issues may mean that the target's revenue streams are compromised, earnings projections are unsustainable in light of applicable law, or worse, that the target becomes the subject of a government investigation.

Developing an accurate anti-corruption risk assessment can also influence the nature of the acquisition, such as whether the firm acquires a majority interest, whether it employs joint ventures, as well as the management composition envisioned—particularly the roles played by employees or directors of the firm in the portfolio's management structure and oversight.

Post-Acquisition. In the post-acquisition phase, anti-corruption compliance is vital to maximizing value, warding off potential misconduct and ensuring the integrity of the portfolio company as it grows under the PE firm's watch. Specifically, the firm must determine how to extend its anti-corruption policies and procedures to its foreign portfolio companies. A failure to actively manage anti-corruption risk during the post-acquisition phase can result in a debilitating investigation if regulators catch wind of potential misconduct, distracting from the core mission of the business. Building and maintaining a record of compliance during this phase of the deal cycle adds value that will be recognized when it is time to exit.

Whistleblower Concerns. Post-acquisition compliance should specifically address whistleblower concerns. PE firms may have significant whistleblower exposure under the Dodd-Frank Act, which created a bounty-reward system for those who uncover securities law violations, or those who refer potential FCPA violations to the SEC. Given the number of portfolio companies many PE firms have, it is imperative to put in place internal controls that are designed to reduce the risk of a whistleblower knocking on the door of the SEC before trying to resolve an issue through the proper internal channels.

Exit Phase. Anti-corruption issues loom large in the exit phase. An effective anti-corruption program—one that combines written policies with strong internal controls— helps ensure the predictability of the firm's exit assumptions, while its absence may make potential buyers leery. A real or perceived failure to manage compliance risk will produce lower valuations, particularly in emerging market regions with a high incidence of corruption. Lastly, even post-exit, an effective program further advances the firm's interests by reducing the risk of an undetected corruption problem emerging after the sale, potentially causing reputational harm to the firm or embroiling it in costly litigation with the buyer.

Anti-Corruption Risk Management Strategies that Private Equity Firms Should Consider

Given the aggressive regulatory environment, PE firms should consider compliance strategies that minimize anti-corruption risk throughout the life cycle of the deal. Strategies should be designed to reflect

the specific risks of each situation, including:

- **Integrate Anti-Corruption into the Risk Committee Process.** The firm's Risk Committee should incorporate a layer of anti-corruption analysis at the outset of any international deals. In most cases, this means assessing risk factors such as geography (e.g., BRIC) and industry (e.g., are any of the target's competitors under investigation), to name but two. Such a preliminary risk assessment will provide a basic framework for designing a due diligence plan.

- **Prepare and Execute Focused Anti-Corruption Due Diligence.** Anti-corruption due diligence should focus on the target's existing business relationships, use of third parties, regulatory challenges, license and permit needs and other areas that create risk. Effectively gauging anti-corruption risk pre-acquisition can have a number of benefits, including: (i) avoiding successor liability issues; (ii) driving a better deal (lower valuation); and (iii) structuring the acquisition to minimize risk. In addition, effective due diligence can allow the company to secure terms that further reduce risk by, for example, requiring the seller to assume any anti-corruption liability by indemnifying the buyer against future anti-corruption exposure.

- **Consider Investment Structure and Management Composition.** PE firms should understand how the proposed structure and management of the deal affect liability. While the risk profile of every deal is unique, it is generally wise to assume that a PE firm's exposure and oversight responsibilities increase with its level of control over the portfolio company. For example, under the FCPA, if an issuer holds 50% or less of the voting power of the portfolio company, a less stringent accounting standard applies. Similarly, recent SEC enforcement actions suggest that a PE firm's level of "control" over a portfolio company's decision-making is crucial to the SEC's ability to hold the PE firm accountable for the company's conduct. Thus, if a deal presents elevated anti-corruption risk, consider whether (i) that risk can be reduced by changing the structure of the deal (opting for a minority vs. majority stake, for example), or (ii) whether it is practical to assume strong oversight of the target's business conduct. While no change offers a guaranteed outcome, investment structure and management composition play a critical role in how the firm manages anti-corruption risks.

- **Design a Tailored Code of Conduct and Anti-Corruption Policy.** Effective written policies, tailored to the company and its business, can greatly reduce anti-corruption deal risk. A PE firm should move quickly to ensure an effective policy is in place whenever it acquires a portfolio company. For most PE firms, it will make sense for the firm to have a standardized set of anti-corruption policies that will apply to all portfolios, and then tailor each to the specific needs and jurisdiction of the portfolio company. That said, in the eyes of DOJ and the SEC, even a well-drafted code of conduct is worth about as much as the paper it's printed on—the critical component, and one which many firms and companies overlook, is augmenting it with meaningful internal controls.

- **Give the Code of Conduct Teeth: Implement Controls that Provide Protection Across Portfolio Companies.** Effective and balanced internal controls allow a company to intercept wrongdoing before it takes root, and are therefore the most important means of minimizing anti-corruption deal risk. Strengthening the newly acquired company's controls is often the greatest immediate post-acquisition challenge, especially in countries such as China, India and Russia. Since time is a factor, we ordinarily recommend that the firm have a streamlined set of internal controls standards and policies, keyed to the geography or industry, which the firm can quickly roll out to the newly acquired company.

- **Avoid a Scorched Earth Approach to Internal Controls**. If there is any guarantee in the FCPA world, it is that neither the DOJ nor the SEC will criticize a company for implementing heavy-handed internal controls that impede business. Unfortunately, many FCPA practitioners rely on overly cautious resolutions to anti-corruption risks. We recommend a pragmatic approach that takes into account, first

and foremost, how the business works, and then designing a series of controls to reduce specific risks with the least amount of friction on business operations.

- **Maintain Existing Protections Under Foreign Laws to Further Minimize Risk.** When a PE firm acquires a foreign target, it should consider whether any proposed restructuring, or changes to a target's IT infrastructure, may impact existing protections under foreign law. For instance, many countries have "blocking" statutes in place that prevent the transfer of business documents beyond the country's borders. Recent cases, such as Allianz, highlight how companies can benefit from similar foreign laws that serve to deter overly aggressive U.S. regulators or disgruntled shareholders. Similarly, the physical location of a company's IT infrastructure is critical; relocating a new target's servers may unintentionally subject sensitive data to a greater risk of production to an adversary in litigation. This is not about concealing questionable documents—rather, it is about ensuring that the company does not forfeit existing legal protections it should otherwise take advantage of.

- **Consider Policies that Streamline Internal Investigations.** PE firms operate on relatively short time horizons. If the firm or the portfolio company detects potential anti-corruption misconduct, an internal investigation must be conducted swiftly to avoid undermining the exit strategy through a protracted investigation. That said, there are numerous hurdles that can delay the process, including local labor law, data privacy laws and server locations, among others. Most of these issues can be anticipated and avoided by adopting smart contingency planning from the outset. By planning on the front end, the firm and its portfolio company can compress the timeframe of any internal investigation—this can be the difference between an investigation that lasts months as opposed to years. That difference in preparedness can play a major factor in ensuring that the firm retains its ability to choose an ideal exit timeframe.

Conclusion

PE firms are known for their relentless attention to detail and the ability to anticipate and quantify risk in advance of a deal. Emerging markets will continue to attract savvy investors and firms that understand both the upside those markets provide, as well as the downside risks. For PE firms, allocating a relatively modest level of resources to hedge against anti-corruption risk is a compliance imperative—one that will maximize a firm's investment long after it exits the deal.

If you have questions, please contact the Pillsbury attorney with whom you regularly work, or the authors:

G. Derek Andreson (bio)
Washington, DC
+1.202.663.8034
derek.andreson@pillsburylaw.com

James L. Kelly (bio)
New York
+1.212.858.1121
james.kelly@pillsburylaw.com

Christopher M. Zochowski (bio)
Washington, DC
+1.202.663.8288
czochowski@pillsburylaw.com

Marc H. Axelbaum (bio)
San Francisco
+1.415.983.1967
marc.axelbaum@pillsburylaw.com

Ryan R. Sparacino (bio)
Washington, SC
+1.202.663.8042
ryan.sparacino@pillsburylaw.com

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