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Frank Aquila, Melissa Sawyer and Neil Toomey on

Speed Reading: Top 10 Issues to Consider With Respect to the Foreign Corrupt Practices Act in M&A Transactions and Joint Ventures

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Congress enacted the Foreign Corrupt Practices Act ("FCPA") in 1977 in an effort to curb bribery and illicit payments by U.S. companies to foreign officials. During the first two decades of the FCPA's existence, the SEC and DOJ rarely brought cases under the statute. In the past few years, however, the government has made FCPA enforcement a priority. The sheer number of cases brought under the FCPA has increased dramatically—from just one or two per year in the 1980s to more than one hundred between 2007 and 2009.

In addition to the growing number of cases brought under the FCPA, government enforcement of the statute has become far more aggressive. Recently, the SEC created a specialized unit focused exclusively on FCPA enforcement, and the DOJ has started working with an FBI squad dedicated to FCPA investigations. The government has also stepped up efforts to encourage self-disclosure. The Dodd-Frank Act, enacted in July 2010, includes a provision that allows the SEC to give whistleblowers up to 30% of certain monetary sanctions awarded in successful securities enforcement actions, including actions under the FCPA.

Heightened enforcement of the FCPA is a growing concern for companies engaging in mergers, acquisitions and joint ventures involving non-U.S. entities. Such transactions involve many challenges that may implicate the FCPA. Buyers must navigate different cultures, unfamiliar legal systems and situations in which transparency is limited. Given recent trends in FCPA enforcement, the danger of successor liability in these situations is extraordinarily high. In addition, as evidenced by the many non-U.S. companies recently charged with corruption under the FCPA, enforcement is not limited to U.S. companies. Related issues may also arise under the U.K. Bribery Act.

To avoid liability, companies pursuing M&A or joint venture transactions involving non-U.S. entities must perform increasingly thorough due diligence. Buyers should also protect themselves through negotiation of contractual remedies. This article focuses on ten key issues that any acquiror should consider in light of potential FCPA liability in M&A transactions and joint ventures.

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Pre-Deal Considerations

1. Red flags. When conducting due diligence, the team representing the buyer should keep an eye out for any red flags that point to bribery or corruption on the part of the target. The following is a non-exhaustive list of common red flags:

- *Corruption in the country.* Is corruption presently or historically a problem in the countries where the seller or target operates? Is corruption a problem in the countries where the seller's or target's subsidiaries operate? The Corruption Perception Index (available at http://www.transparency.org/policy_research/surveys_indices/cpi/2010) provides useful guidance regarding the corruption levels in different countries. Does the seller or target operate in a country that has no FCPA equivalent, or a country that has only recently enacted an anti-bribery or anti-corruption law? Countries that have only recently enacted such laws may have lingering issues with bribery and corruption.
- *Corruption in the industry*. Is corruption a common problem in the industry? Certain industries may be more susceptible to corruption, such as defense, oil and gas, pharmaceuticals and telecommunications.
- *History of bribery or corruption by the seller or target*. Does the seller or target have a history of violating the FCPA or any similar non-U.S. laws? Is the U.S. government or any non-U.S. government investigating the seller or target for corruption or bribery? Does the seller or target have a reputation for corruption?
- *Government contracts*. Does the seller or target derive a substantial amount of business from government contracting in other countries?
- *Government licenses and relationships*. Does any of the seller's or target's business depend on government licenses or relationships?
- *Lack of transparency in accounting*. Is there a lack of transparency in the seller's or target's accounting records? Is there a lack of documentation by the seller or target more generally?
- *Unwillingness to cooperate*. Is the seller or target unwilling to cooperate in the due diligence process? Is the seller or target unwilling to provide requested information? Is the seller or target unwilling to agree to certain representations or warranties regarding corruption or bribery?
- *Employment of government officials*. Does the seller or target employ current or former government officials? Have certain employees been rec-

ommended by government officials? Do these employees seem to lack appropriate qualifications for the positions that they hold?

- *Unusually high commissions or payments to employees, agents or third parties*. Does the seller or target make payments or offer commissions to any employees, agents or third parties that do not seem commensurate with services performed?
- *Suspicious use of intermediaries*. Does the seller or target use non-U.S. sales agents, consultants or intermediaries for no apparent reason?
- *Other suspicious practices or requests*. Has the seller or target requested that bids be made through a specific individual or entity? Has the seller or target requested that any payments be made to a third party in another country? Does the seller or target use offshore tax haven bank accounts?

2. Due diligence process. In M&A transactions or joint ventures involving non-U.S. entities, a thorough, commercially reasonable due diligence process is the best way to avoid potential FCPA liability. Effective diligence will help the buyer's team unearth red flags, and will guide the buyer's subsequent negotiations and remedial measures. While there is no clear definition of commercially reasonable due diligence, the following recommendations may provide the buyer's team with a good baseline from which to start.

- *Begin the due diligence process early*. Due diligence takes time, particularly when dealing with non-U.S. entities, foreign-language documentation, and non-U.S. legal systems. Starting the process early will ensure that the buyer has adequate time to deal with these and other obstacles.
- *Conduct a preliminary "desktop" review*. The buyer's team should conduct a preliminary analysis of publicly available information on the seller or target. Preliminary analysis will help the buyer's team identify red flags, and will also help the team determine the nature and scope of any due diligence that will be required going forward. A preliminary analysis may include the following:

    - <u>Background checks on directors, officers and the target</u>. The buyer's team should run background checks on all relevant employees of the seller or target. When running background checks on employees, the diligence team should focus on government affiliations and relationships with government officials.
    - <u>U.S. government inquiries</u>. Subject to consideration of potential leaks, the buyer's team should seek information about the seller or target from the

Department of Commerce, the Department of State, and U.S. Embassies in all relevant countries.

- General electronic research. The buyer's team should perform basic electronic research on the nature of the seller's or target's business, its customers and any relevant news pertaining to the countries in which the seller or target operates. The buyer should also search for any information on pending litigation against the seller or target, as well as any information regarding FCPA issues, ongoing government investigations, settlements and plea agreements.
- Developing a risk profile. Using this preliminary review, the buyer should develop a tentative risk profile on the seller or target.

- *If possible, interview the seller's or target's management and compliance officers*. Interviewing the seller's or target's management and compliance officers will help the buyer's team test the risk profile developed in the preliminary review. Interviews will also help the buyer's team determine what kind of due diligence is required going forward. In some cases, for example in the context of a hostile offer, such interviews may not be possible.
- *If possible, review the seller's or target's FCPA compliance policies and procedures*. The buyer's team should try to review the following policies and procedures: (i) policies on gifts, hospitality, procurement, bidding and political contributions, (ii) procedures for obtaining required approvals, (iii) employee training programs, and (iv) screening and monitoring practices for agents, intermediaries and partners. The buyer should also try to evaluate whether there are discrepancies between policies and actual practice.
- *If possible, request information on the seller's or target's prior compliance issues relating to bribery or corruption.* Request any information concerning prior problems with corruption or bribery, as well as any information that may shed light on the seller's or target's track record for catching and punishing non-compliant personnel.
- *If prevented from conducting thorough pre-acquisition due diligence, consider seeking guidance from the DOJ or SEC*. In 2008, Halliburton sought a non-prosecution opinion from the DOJ with respect to its proposed acquisition of a U.K. oil services group. Certain U.K. laws made it impossible for Halliburton to access information necessary for appropriate diligence prior to closing. In DOJ Opinion Procedures Release No. 08-02, the DOJ agreed not to take enforcement actions against Halliburton for post-acquisition FCPA violations of the seller, so

long as Halliburton complied with a detailed post-closing FCPA compliance program.

3. Scope of due diligence. Thorough FCPA due diligence should cover at least the following areas: (i) agents, intermediaries and representatives, (ii) major litigation and regulatory, tax or customs actions or inquiries, (iii) significant contracts and bids, (iv) gifts and hospitality, including travel and entertainment, (v) political contributions, (vi) charitable donations, (vii) corporate sponsorships and (viii) employment of foreign officials and their relatives. The necessary scope of due diligence will unfold and evolve throughout the diligence process. The buyer's team should try to be as comprehensive as possible in its diligence efforts.

4. Address potential FCPA issues in negotiations and through contractual representations. The buyer's team can further protect the buyer from FCPA liability by addressing compliance issues in the negotiation process. The buyer's team should clearly articulate and document its compliance expectations as well as the consequences of non-compliance by the seller or target. The buyer's team should also try to protect the buyer from liability through contractual provisions and representations. Effective contractual representations should explicitly reference the FCPA and should track the language of the statute and any other relevant anti-corruption statutes. The buyer's team should seek representations on specific subjects of concern (e.g. that no corrupt payments were made to foreign officials in securing necessary approvals). The following examples are just a few of the provisions that the buyer's team may want to include in the agreement:

- A right of termination for any breach of the FCPA or any breach of related representations, warranties or covenants.
- Indemnification for damages caused by a material breach or by any undiscovered corruption-based violations.
- A reasonable "hold back" amount for (i) any fines imposed due to pre-sale violations or corruption by the seller or target and (ii) any additional services that may be required from outside counsel to investigate or negotiate issues relating to prior FCPA violations.

5. If the buyer's team discovers red flags indicating bribery or corruption by the seller or target. Discovery of red flags may give the buyer reason to reassess the transaction. Successor liability under the FCPA can involve heavy fines and may cause damage to the buyer's reputation. The buyer should consider whether the benefits of

the transaction are worth the financial and reputational risks of FCPA liability. If red flags arise, the buyer's team should try to determine the extent to which the corrupt practices or employees are necessary for the successful operation of the business. If corruption is particularly bad or pervasive, or if key elements of the seller's or target's business rely heavily on corrupt practices, the buyer might want to consider walking away from the transaction altogether. If the level of corruption uncovered by due diligence is minor or peripheral, enhanced contractual protections and an enhanced compliance program may provide sufficient protection for the buyer. On the other hand, the buyer may want to consider seeking an alternative deal structure. Corrupt practices or employees need not necessarily preclude the achievement of the buyer's goals. The buyer may be able to acquire certain non-corrupt assets without acquiring the business as a going concern. Finally, if the buyer's team discovers red flags, it should consider seeking regulatory consent and guidance from the SEC and DOJ.

6. Voluntary disclosure. In some circumstances, voluntary disclosure to the SEC or DOJ may be the best course of action for the buyer. The buyer may wish to proceed with a transaction despite the discovery of red flags. If this is the case, seeking government consent and guidance may provide the only reasonably safe means of pursuing a deal without running afoul of the FCPA. For example, in 2003, a U.S. company seeking to acquire another U.S. company discovered that officers of one of the seller's non-U.S. subsidiaries had been making illegal payments to foreign officials. Despite the potential FCPA liability, the buyer wished to proceed with the acquisition. The buyer disclosed the results of its due diligence efforts to the DOJ and sought approval for the transaction. The DOJ agreed not to take any enforcement actions against the buyer, provided that the buyer (i) continue to cooperate with the DOJ, SEC and non-U.S. law enforcement agencies, (ii) ensure that responsible employees were disciplined, (iii) disclose any additional pre-acquisition payments made to foreign officials that it discovered after the acquisition, (iv) implement its compliance program in the target, and (v) ensure that the target implemented a sufficient system of internal controls and maintained accurate books and records.

Discovering red flags during the course of due diligence does not always warrant voluntary disclosure to the SEC or DOJ, however. If diligence reveals suspicious activity, but such activity does not violate the FCPA, the buyer is free to disclose but not obligated to do so. In such circumstances, it might make more sense for the buyer to remediate the suspicious conduct after completing the acquisition.

7. Pre-closing remedial action. Pre-closing remedial action may also help a buyer avoid FCPA liability. Pre-closing remedial action is advisable regardless of whether the buyer discloses red flags to the government. If possible, the buyer should make sure that all existing corrupt activity in the seller's business is terminated prior to closing. In addition, the buyer should attempt to establish additional controls and procedures to prevent future corruption by the seller. The buyer should design these controls and procedures in light of any discoveries made during the due diligence process. Effective monitoring also requires that the buyer itself have strong policies in place. The buyer should look at its own procedures and controls, and ensure that they are sufficient for tighter monitoring of the target.

8. Special considerations for joint ventures. Transnational joint ventures pose unique FCPA risks and involve additional considerations beyond those already discussed. In this context, exposure to FCPA liability depends on the extent of a company's legal or effective control of the joint venture. In addition, control will likely have some bearing on a party's ability to negotiate policies and contractual provisions. In all joint ventures, a company should conduct enhanced investigative due diligence on its prospective joint venture partner. Before engaging in a joint venture, a company should also consider requiring its prospective partner to complete a comprehensive due diligence questionnaire. If the prospective partner is a state-owned enterprise or is otherwise controlled by a government entity, the joint venture may be particular susceptible to FCPA issues. If the parties have never worked together before, a company should proceed with added caution before agreeing to the deal.

If a company has a majority interest in the joint venture, the company should consider the following recommendations prior completing the deal:

- Include FCPA representations, warranties and covenants in the joint venture agreement.
- Include a right of termination for breach of FCPA warranties or covenants.
- Require the joint venture to follow Generally Accepted Accounting Principles. The joint venture should keep books and records in English and conduct an annual audit by an independent accounting firm. The majority interest holder should reserve the right to conduct ongoing audits.
- Require dual signatures for checks and electronic fund transfers drawn from joint venture bank accounts.
- Require that investigative due diligence be conducted on agents, consultants and other third parties retained by the joint venture.

- Require an annual certification of compliance with FCPA provisions.

A company that holds a minority interest in the joint venture may have less power to negotiate these recommendations. Still, the minority interest holder should make every effort to ensure that the joint venture complies with the FCPA, and should take measures to protect itself against liability. Even if the minority interest holder has no opportunity for managerial control, the FCPA requires that the minority interest holder make reasonable efforts to cause the joint venture to comply with the statute. The minority owner should propose controls and compliance policies for the joint venture, and should do so "on the record." If possible, the minority owner should include a unilateral right to terminate the joint venture for non-compliance with the FCPA. If significant red flags are discovered, but the minority owner is unable to achieve reasonable compliance controls over the joint venture's operations, the minority owner should consider walking away from the deal.

Post-Deal Considerations

9. Create a record of due diligence. Due diligence can help shield a buyer from FCPA liability, especially when diligence efforts are reflected in a formal record. While due diligence is not a foolproof guarantee of protection from successor liability, evidence of appropriate, commercially reasonable due diligence will demonstrate to the government that the buyer is serious about FCPA compliance, and may protect the buyer if bribery or corruption is discovered after closing.

10. Continued compliance post-deal. Once the transaction is completed, the buyer should implement an immediate clean-up program to resolve any issues left open after diligence and negotiation. The buyer should terminate any potentially corrupt practices and should implement all additional controls and procedures planned prior to closing. In addition, the buyer should consider the following:

- *Effective compliance program.* The buyer should integrate its own anti-corruption policies, procedures and accounting controls into the former target as soon as possible. In DOJ Opinion Procedure No. 04-02, the DOJ provided the following guidance regarding what constitutes an effective compliance program:
    - Program should contain a clearly articulated policy against corruption.
    - Program should be implemented and overseen by senior executives.

  - Program should be accompanied by regular training and annual certification of compliance.
  - Program should include a hotline for reporting possible violations.
  - Program should be implemented in future business relationships through contractual representations.
  - Program should contain appropriate discipline, monitoring, accounting and reporting procedures.
  - Program should include appropriate provisions regarding audits by outside counsel and auditors.

- *Post-acquisition due diligence.* If the buyer was prevented from conducting thorough pre-acquisition due diligence, the buyer must conduct such diligence post-acquisition. Even if the buyer believes its pre-closing diligence was thorough and commercially reasonable, additional due diligence is advisable.
- *Monitoring.* FCPA compliance requires constant vigilance. Old habits die hard. Even after a buyer has conducted thorough due diligence and implemented stringent anti-corruption policies, non-U.S. subsidiaries, agents and employees may still engage in bribery or corruption. Post-acquisition monitoring is crucial to maintaining FCPA compliance. After the deal has closed, the buyer should continue to conduct random reviews of the target's books and records. The buyer should also ensure that rogue employees, agents and consultants are terminated. Finally, the buyer should encourage self-reporting by implementing employee reporting mechanisms.

Conclusion. Recent trends in FCPA enforcement have made cross-border M&A transactions and joint ventures increasingly risky endeavors. Though no definitive guidance exists, there are useful steps that potential buyers and joint venture partners should take in light of the FCPA. Through comprehensive due diligence, smart negotiation and thoughtful drafting, buyers can improve their chances of avoiding FCPA liability.

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