# Anti-corruption considerations for private equity firms

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# Anti-corruption risks to private equity

## Financial risk

- Impaired value of the acquired company where value was based on revenues generated from bribe-paying
- Significant expenses associated with conducting an internal investigation, responding to regulatory inquiries and, payment of significant fines and penalties for those issues identified post-close and related litigation costs
- Loss of expected revenue due to segment/specific operations inherited where problem is concentrated
- Loss of key customer and associated expected sales revenue due to relationship built on side deals and/or kickbacks
- Loss of key supplier/supplier discounts due to improper relationship or relationship built on bribe paying

## Operational risk

- Delays in closing due to identification of a problem at the last minute
- Successor liability for PE firm and directors due to violative activity performed by the portfolio company — even prior to ownership by the PE firm
- Difficulty attracting funding from certain SWF investors if benefits, gifts, travel and entertainment are not be provided at expected levels
- Inability to divest or exit from investment if problem is inherited and not remedied
- Difficulty engaging upstanding, qualified suppliers, consultants and placement agents due to requiring third parties to sign anti-corruption due diligence certifications
- No knowledge of potential books and records issues due to denied access or inability to audit

## Reputational risk

- Difficulty attracting capital for future investments due to negative reputation driven from prior bad acts
- Liability exposure for directors, fund managers, executives or other associated individuals charged with management or guidance responsibilities over the portfolio company

# Anti-corruption considerations

The FCPA, enacted in 1977, prohibits US companies, their subsidiaries, officers, directors or employees from bribing foreign officials, either directly or indirectly through intermediaries, for the purpose of obtaining or retaining business.

The Foreign Corrupt Practices Act (FCPA) has become an enforcement priority for regulators and a major compliance issue for US companies with overseas operations. The US Securities and Exchange Commission (SEC) and the US Department of Justice (DOJ) have stepped up efforts to investigate and prosecute business corruption, significantly raising the reputational and financial risks to companies. The FCPA, enacted in 1977, prohibits US companies, their subsidiaries, officers, directors or employees from bribing foreign officials, either directly or indirectly through intermediaries, for the purpose of obtaining or retaining business. It also requires companies registered with the SEC to keep accurate records of all business transactions and maintain an effective system of internal accounting controls.

During 2010 and 2011, we saw a continued surge in corporate cases against large corporations by the US authorities. In 2010, the DOJ and SEC together charged or otherwise alleged violations of the FCPA against 47 companies and levied more than $1.7 billion in total penalties.[1] In 2011, US authorities imposed fines, penalties and disgorgement amounting to more than $509 million in 16 corporate cases, demonstrating that the US enforcement authorities are continuing to pursue FCPA cases aggressively.[2] During 2011, 31% of enforcement actions targeted non-US companies, and record number of charges were against non-US individuals (12 of the 18 individual cases) leading many to believe that the US government will continue to use its expansive view of jurisdiction under the FCPA.[3]

Anti-bribery enforcement is continuing to be a priority outside the US as well. The UK Bribery Act of 2010 (the Act), which went into effect on July 1, 2011, has attracted the most attention on the international front. The Act poses a host of new challenges, including potentially broad grounds of jurisdiction, reaching companies and partnerships established outside the UK but that "carry on" a business in the UK.[4] The expansive statute covers commercial bribery and does not have an exception for facilitation payments, going beyond the provisions of the FCPA. In addition, the Act contains an affirmative defense that will allow a company to avoid liability if it demonstrates that it had "adequate procedures" in place designed to prevent such bribery.[5] However, as with the FCPA, there is no requirement of actual knowledge — what is known and what you should have known are equally important.

[1] Shearman & Sterling LLP, *FCPA Digest*, January 2011, p. 8.

[2] Shearman & Sterling LLP, *FCPA Digest*, January 2012, pgs 5–7.

[3] Shearman & Sterling LLP, *FCPA Digest*, January 2012, p. 5.

[4] Shearman & Sterling LLP, *FCPA Digest*, January 2011, p. 25.

[5] On March 30, 2011, the UK Ministry of Justice issued the implementation guidance as to what constitutes adequate procedures and announced that the Act will be effective on July 1, 2011.

# Anti-corruption regulation effects

The current SEC focus appears to be on improper payments or conferred benefits to obtain or retain business and relationships with sovereign-wealth funds. FCPA penalties are significant and include criminal and civil penalties for the company and individuals.

Private equity firms should be aware that the SEC appears to be focused on enforcing the FCPA in the financial services industry. The SEC and DOJ investigations have targeted industries in the past (e.g., oil and gas, pharmaceuticals, freight forwarding), and they are likely to continue to expand. In early 2011, the SEC began to make initial inquiries regarding FCPA practices at certain banks, private equity firms and hedge funds, specifically regarding their interactions with sovereign wealth funds (SWFs). The SEC appears to be focused on and is actively investigating fundraising and investing activities. SWF advisors, private equity firms and hedge funds have been on the anti-corruption radar for several years, and SWF employees are considered "foreign officials" by US regulators and therefore within the FCPA's scope. The current SEC focus appears to be on improper payments or conferred benefits to obtain or retain business and relationships with SWFs. FCPA penalties are significant and include criminal and civil penalties for the company and individuals.

Mark Mendelsohn, former Deputy Chief of the DOJ Fraud Section and partner of law firm Paul, Weiss, Rifkind, Wharton & Garrison LLP, told *The Wall Street Journal* that, "Financial institutions, private-equity funds, hedge funds have historically paid less attention to FCPA risks than industrial companies have. That's changing. It's not a straight-forward issue because these institutions all have different investment strategies. There are some very real issues about where responsibility for compliance lies. The private-equity fund often will have some of their partners or business leaders sitting on the boards of the investment companies. So in a very simple way they are going to have exposure."[6]

Additionally, UK authorities have made clear that the level of control over entities will affect the enforcement of corporate offenses under the UK Bribery Act; for private equity firms, this means the level of control in their portfolio companies.[7] In a recent meeting with the clients of the law firm Debevoise & Plimpton LLP, Serious Fraud Office Director Richard Alderman warned that even if they aren't aware of the bribes, private equity firms are responsible for the actions of their investee companies.[8] Alderman also stated, "it may even be that it is a condition of investment by fund managers allocating funds to you to invest that you invest only in companies that are FCPA and Bribery Act compliant. This is something you will need to bear in mind. You may also need to look at your exposure if you are directors (whether executive or non-executive) in the companies in which you invest."[9]

Although the SEC is yet to formally charge a private equity firm based on the conduct of a foreign private company in its portfolio, during 2011, the SEC investigated the actions a joint venture of one of Europe's largest insurers for possible bribery. Although the SEC reportedly decided to drop its charges due to lack of access to documentation held by the insurer's joint venture partner, the action certainly suggests that the SEC is taking corruption at the investment company level seriously.[10]

Furthermore, private equity continues to seek deals overseas and sees emerging markets as a "hot ticket."[11] Potential investors should be aware of the corruption risks present in many developing nations, particularly in the "BRIC" countries of Brazil, Russia, India and China. While the developing nations promise strong growth opportunities, high costs to clean up those operations, even within an outsourced distributor or sales office, may present enough cause for walking away. According to a survey of corporate executives, investment bankers,

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private equity executives and hedge fund managers conducted by Mayer Brown, LLP, "63 percent of respondents reported that the FCPA and anti-corruption issues caused their companies to renegotiate or pull out of planned business relationships, mergers or acquisitions over the last three years."[12]

As all of this information suggests, understanding the corruption risks specific to private equity is extremely important given the current regulatory environment. For instance, broad successor liability for the prior actions of an acquisition, which applies when one corporation acquires another, does not apply in the context of an equity investment. However, two features remain central to any legal claim of responsibility imposed on private equity firms — how much you control and how much you know.

[6] Dionne Searcey, "Former Enforcer Sees Looming Fights," The Wall Street Journal Online, March 17, 2011.

[7] Debevoise & Plimpton LLP, "UK Bribery Act Enters Into Force," June 30, 2011.

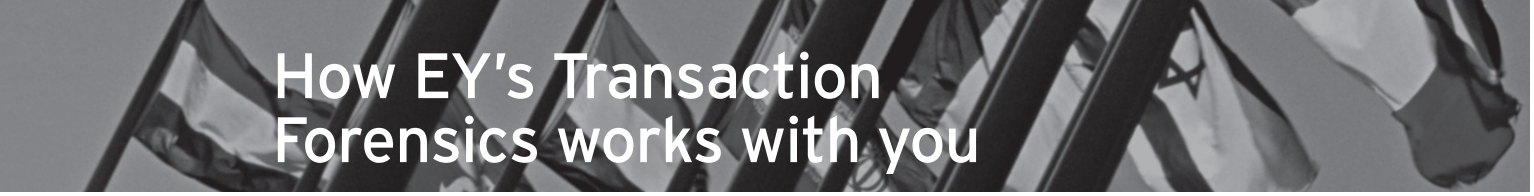
[8] Lindsay Fortado, "Private Equity Firms May Be Covered by Bribery Law, SFO Says," Bloomberg, June 23, 2011.

[9] Norton Rose Group, "The impact of the UK Bribery Act 2010 on the private equity industry," August 2011.

[10] "SEC to limit charges against Allianz," Thompson Reuters, http://newsandinsight.thomsonreuters.com/Securities/News/2011/11_-_October/SEC _to_limit_charges _against _Allianz/, October 14, 2011.

[11] Jason Kelly, "Private-Equity Managers Aim for Emerging Markets as Deals Shrink", Bloomberg/Businessweek, May 3, 2011.

[12] Mayer Brown, LLP, "Anti-Corruption Compliance for Private Equity and Hedge Funds," November 8, 2011.



# How EY's Transaction Forensics works with you

Would-be buyers should perform anti-corruption due diligence as a first step in considering deals abroad — before, not along with or after traditional due diligence, particularly given the potential for successor liability.

## Pre- and post-acquisition anti-corruption due diligence of a target company

Would-be buyers should perform anti-corruption due diligence as a first step in considering deals abroad — before, not along with or after traditional due diligence, particularly given the potential for successor liability. Successor liability means that the acquiring company bears responsibility for the people, practices and activities brought along with a purchase, regardless of when and where questionable action occurred. The DOJ's 2008 "Halliburton Opinion" (OPR 08-02) set forth the DOJ's view on the importance of FCPA due diligence and the high standards it expects. The Opinion demonstrates the need for companies making global acquisitions to have a robust FCPA and anti-corruption due diligence process, including the analysis of company financial and accounting records for at least the last three years.

Anti-corruption due diligence can be performed in a phased approach. Typically, the first phase includes performing background checks on target companies, including key individuals at the target such as owners and executives, and may extend to identified third parties and agents acting on the target company's behalf. This phase also includes interviewing key executives (e.g., legal, compliance, ethics, business development and finance), reviewing anti-corruption policies and procedures, and performing a high-level risk assessment. Any potential red flags identified could highlight the need for a second phase, which could include transaction testing, electronic document review, site visits and additional interviews. A third potential phase relates to assisting with the implementation and monitoring of a post-closing anti-corruption compliance program, including assisting in the development or enhancement of existing anti-corruption policies and training.

## Anti-corruption risk assessments at the fund and portfolio company level

Recent developments in anti-corruption enforcement highlight the need for PE firms to consider their anti-corruption compliance programs at the fund and portfolio company levels to understand where potential risks could be lurking. The phases of conducting a risk assessment at the fund or portfolio company level are similar to the phases of anti-corruption due diligence described previously.

**Phase 1** relates to obtaining a high-level understanding of fund-level or portfolio company operations. One key is evaluating corruption risks of portfolio companies and funds based on the location and nature of operations. Many firms use the Corruption Perception Index issued by Transparency International, a nonprofit organization long recognized for ranking countries by corruption risk metrics.[13] The Index can help companies by heightening awareness of the potential corruption environment based solely on the location of their own operations as well as that of their customers. Obtaining an understanding of the sales strategy, key customers (particularly those that are government owned or affiliated) and the use of third-party sales agents, consultants or distributors is also of primary importance.

**Phase 2** includes performing forensic research, site visits, interviews with key executives, testing and documentation. The key here is to use local EY Transaction Forensics resources who understand local practices in addition to US Transaction Forensics professionals who understand the implications of the results.

**Phase 3** includes distilling acquired insights and assisting in the development or enhancement of existing anti-corruption policies and training — locally and globally — to help eliminate future risk.

[13] Corruption Perceptions Index 2011, *Transparency International website*, http://cpi.transparency.org/cpi2011/results/, accessed January 6, 2012.

## Anti-corruption risk questions for private equity firms

- Are you aware of the requirements of the FCPA, the UK Bribery Act and other country-specific anti-corruption laws?
- Do you currently do business with foreign government customers or state-owned enterprises, including SWFs? Do you intend to pursue this business going forward?
- How confident are you that business developers, sales personnel, placement agents, investment advisors and portfolio companies understand and comply with the FCPA, the UK Bribery Act and other anti-corruption laws?
- Are your anti-corruption policies, procedures, monitoring programs, training and financial controls executed on a consistent and effective basis across the enterprise?
- Do your employees have a clear understanding of the broad definition of a government official? Do your employees understand what is considered appropriate versus excessive spending on gifts, meals and entertainment-related business procurement and retention?
- Do your financial reporting and travel and entertainment expense reporting systems provide sufficient transparency and information details to identify and review potentially violative payments or activities?

# Why Transaction Forensics?

- Deep anti-corruption and FCPA due diligence, investigative and compliance experience coupled with global capabilities and resources, specifically focused on potential issues with cross-border transactions
- Understanding and experience in helping financial services firms identify and measure corruption risks in various industries
- Experience assisting private equity clients with anti-corruption risk assessments and pre-acquisition anti-corruption due diligence
- Experience assisting companies in their response to industry-wide corruption initiatives
- Experience supporting clients responding to DOJ and SEC inquiries and investigations
- Experience assisting companies in pre-acquisition contractual language assessments and pre-arbitration dispute analysis
- Experience in providing post-acquisition assistance with preparation of accounting mechanism and post-closing arbitration and dispute services

**Transaction Forensics is a separate service line in Ernst & Young LLP's Fraud Investigation & Dispute Services practice. The practice focuses on due diligence services (primarily related to anti-corruption and other forensic due diligence) and disputes and investigations that stem from contemplated and completed merger and acquisition transactions**

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