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Briefing note
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Q&A on the Bribery Act for Private Equity Firms

The UK Bribery Act 2010 has been made effective as of 1 July 2011 . The Ministry of Justice's final guidance on the adequate procedures commercial organisations is in place to prevent bribes being paid on their behalf is still expected to be published shortly. Private equity firms are among those currently introducing or enhancing anti-bribery controls, but what risks do they need to address, and what are the particular implications of the Bribery Act for private equity firms?

1. Will portfolio companies be exposed to prosecution under the Bribery Act?
Portfolio companies will be subject to the Bribery Act in respect of active or passive bribery anywhere in the world if they are incorporated in the UK, or, for non-UK companies, if they participate in an act of bribery that involves a UK element. Additionally, a portfolio company which has an office in the UK (even if not incorporated here) is at risk of prosecution under the Bribery Act for the corporate criminal offence of failure to prevent bribery where the bribery was committed on its behalf anywhere in the world (even without its knowledge) and without regard to whether that conduct could be prosecuted under the law of the jurisdiction in which it occurs.

If the portfolio company is not incorporated in the UK or does not have an office in the UK, it is presently unclear exactly what level of connection with the UK will amount to carrying on business in the UK so as to trigger exposure. In the context of a portfolio company and private equity manager relationship, there is a risk that activities being performed by a UK manager on behalf of the portfolio company might lead to the portfolio company being categorised as carrying on business in the UK.

2. Does bribery at the portfolio company level put the private equity manager or the owning fund at risk under the Bribery Act?
We consider that the Bribery Act does not generally put funds and their investors or the managers of the fund at risk of criminal prosecution for failing to prevent bribery by the portfolio companies. This is because liability only arises for an organisation, under the associated person test, where a third party is performing services for or on behalf of that organisation. Generally, a portfolio company will not be performing services for or on behalf of either the fund, its investors, or the manager and will therefore not be an associated person. However, bribery in a portfolio company does create significant risks to the value and marketability of the investment. Examples of how value can be impacted include the termination of revenue producing contracts procured by bribery, debarment from public procurement contracts, and the large fines and costs that may result from criminal or regulatory investigations. Clearly bribery at portfolio company level may also have a negative impact on the fund manager's reputation.

Further, it is not unlikely that the fund documentation will require the manager to ensure that the US Foreign Corrupt Practices Act and/or the Bribery Act are

Key issues

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not breached by investee companies. Bribery at portfolio company level could therefore result in investors withdrawing funds early.

Additionally, if the manager were to be complicit in acts of bribery by the portfolio company, it would run the risk of prosecution as an accessory or co-conspirator to the portfolio company's crime. Where a portfolio company had committed a bribery offence, a director put on its board by the private equity fund could also be at personal risk of being prosecuted for the offence if he was considered to have consented to or connived in the bribery.

3. Will bribery at the portfolio company level create a money laundering issue for an FSA regulated private equity manager?

Money laundering issues follow bribery as night follows day. As UK private equity managers operate in the regulated sector and are therefore subject to the UK's onerous money laundering obligations, knowledge at the private equity manager level of bribery by a portfolio company may give rise to a need to report the suspicion to the Serious and Organised Crime Agency in the UK.

Where a private equity manager knows or suspects that part of the value of an investment results from an act of bribery, it may need consent under the Proceeds of Crime Act 2002 to deal with the investment and the revenue stream it produces. For this purpose, a broad view is taken by the law to proceeds of crime. For example, the long-term revenue stream flowing from a contract that was secured through the payment of a bribe can be viewed as the proceeds of crime such that any dealing with that revenue stream or property representing its conversion risks being characterised as money laundering.

Even if knowledge of bribery does not percolate from the investee company, it may still give rise to money laundering risks for the private equity manager's employees or partners who sit as non-executive directors on the board of a portfolio company. If a private equity manager has to report bribery by a portfolio company in a Suspicious Activity Report under the money laundering legislation, it would be naive to think that there will be no risk of prosecution for bribery for the portfolio company itself if it is within the jurisdictional reach of UK prosecutors.

In January 2011, the Serious Fraud Office (SFO), the UK's lead agency for the prosecution of bribery, announced that it had neglected money laundering as a criminal charge and would now give it a higher priority. Even where a portfolio company is not within the reach of the SFO under the Bribery Act, it may still be caught by the UK's money laundering laws if it passes revenue under a contract tainted by bribery through the UK. Handling dividends and sale proceeds resulting from such an investee company will also present a money laundering risk for the private equity manager.

4. What are the risks in relation to hospitality, gifts and corporate entertainment?

Although many of the scare stories in the press are extreme, corporate hospitality is an area where there are real risks that need to be addressed.

Much of the confusion arises because there are different offences which apply depending on whether you are entertaining foreign public officials or private sector investors. The offence of bribing a foreign public official (section 6 of the Bribery Act) was drafted deliberately broadly so that prosecutors would not need to look into difficult questions as to whether the officials were acting improperly. This means that any hospitality involving foreign public officials that could be described as in excess of common courtesy risks being categorised as a bribe.

Private sector entertainment would be prosecuted under the main offence of bribery (section 1 of the Bribery Act), which requires some form of improper performance of a function or duty. For this offence, the prosecution would need to show that the hospitality was so lavish that it could be inferred that it was being given in order to induce or reward the recipient for improper performance of his or her duties. Under an additional quirk of the Act, someone offering or providing entertainment may also be at risk of prosecution where he knows or believes that it would be improper for the other party to accept it, for example, because it is contrary to the recipient's company policy on gifts and hospitality.

The areas of highest risks for private equity managers are likely to be in relation to hospitality and travel expenses for investors in their funds. When the hospitality is directed at officers of sovereign wealth funds the risks are particularly high. However, even investors who are themselves fund managers will owe fiduciary duties and many pension funds have strict rules on acceptance of hospitality. Prosecutors may argue that hospitality which is lavish by reference to the standards of the industry and timed around particular decisions by the individuals enjoying the entertainment carries an inference that it is linked with an expectation of improper performance by the individual being entertained.

5. What must private equity firms do in relation to bribery outside of the Bribery Act framework?

There are already regulatory controls in place which require FSA approved firms to have systems and controls in place to prevent bribery. These will continue whether or not the Bribery Act comes into force in April this year or later, and they are potentially wider in some respects than the controls required under the Bribery Act (for example, they would include systems to prevent passive bribery).

The FSA sent a clear message on this two years ago when it fined Aon £5.2 million for having inadequate anti-bribery systems and controls. More recently, the FSA published a report on its thematic review of insurance brokers' systems and controls to prevent bribery highlighting good and bad practices. The FSA has made it clear that approved firms should already have the necessary systems and controls in place.

6. Who will enforce the Bribery Act?
You may until now have seen the FSA as the principal point of engagement in relation to issues of financial and economic crime, and the FSA will still be looking for quick wins in the form of fines against authorised firms for poor anti-bribery systems and controls. But you can no longer ignore the SFO. Under its new Director, Richard Alderman, the SFO is no longer the lonely prosecutor. It wants to be a major enforcement player that engages with industry in crime prevention as well as playing its traditional role of prosecutor. It wants businesses to approach the SFO with their problems in preventing bribery and to discuss with firms how these problems could be tackled. The structure of the organisation that will replace the SFO is still unclear, but the message at the moment is ignore them at your peril.

Even as the UK authorities limber up to enforce the Bribery Act, it seems that US authorities are staying one step ahead. Shortly before Christmas, it was reported that the US Department of Justice and the Securities and Exchange Commission were investigating a German financial services provider (not currently listed in the US) in relation to bribery at a European printing systems manufacturer in which the financial services firm's private equity arm has a majority share. The portfolio company itself appears to have no connection with the US other than that the manager is within a group that at one time had an SEC listing.

Conclusion

To conclude, private equity firms are already expected to have anti-bribery controls in place for the purposes of FSA regulation. The Bribery Act has added impetus to the culture change in the financial services community in respect of bribery and corruption, with anti-bribery due diligence on investee companies, co-investees and managers becoming standard, and anti-bribery representations and warranties viewed as increasingly important. Although portfolio companies will not put the private equity manager or the owning fund at risk under the Bribery Act corporate offence, corruption in a portfolio company carries inherent commercial and reputational risks, as well as money laundering implications. And yes, tightening up controls and procedures around gifts and hospitality, particularly where entertaining public officials, is definitely a good idea. In the context of transactions, due diligence on corruption issues will be of increasing importance, particularly in relation to businesses operating in riskier countries and industries. Investment agreements will need to provide for a compliance policy and warranty protection will be sought from sellers and consortium partners.