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# Q&A on the Foreign Corrupt Practices Act for private equity firms

Agencies charged with enforcement of the US Foreign Corrupt Practices Act (**FCPA**) have broadened their traditional focus, recently bringing the investment management industry within the scope of their scrutiny. In particular, the US Securities and Exchange Commission's (**SEC**) current investigation of private equity firms' and banks' dealings with sovereign wealth funds, combined with the ongoing investigation involving the private equity arm of Allianz SE, have spurred private equity firms to introduce or enhance anti-bribery controls. But what risks do they need to address, and what are the particular implications of the FCPA for private equity firms?

## A brief overview

The FCPA applies to US persons and companies, any stockholder, officer, director, employee, or agent acting on behalf of a US company, and to any company in the world that has a class of securities registered pursuant to Section 12 of the Securities Exchange Act of 1934 (**Exchange Act**) or is required to file reports with the SEC pursuant to Section 15(d) of the Exchange Act. The FCPA also can apply to any non-US company or individual if prohibited acts are taken within the United States. The FCPA has two separate sets of provisions, the anti-bribery provisions and the accounting provisions. It carries both civil and criminal penalties, enforced by the SEC and the US Department of Justice (**DOJ**).

The FCPA broadly prohibits bribery of non-US government officials by US issuers,[1] domestic concerns,[2] and certain other persons, and requires US issuers to maintain accurate books and records and reasonable accounting controls.

## 1. Can portfolio companies be exposed to enforcement actions under the FCPA?

Portfolio companies are subject to the FCPA for acts anywhere in the world if they are US issuers or domestic concerns. In such circumstances, the FCPA would not only apply to the portfolio company, but also to any stockholder, officer, director, employee, or agent acting on its behalf, including, in some circumstances, a joint venture partner. Moreover, US citizens and residents employed by non-US companies are also subject to the FCPA


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[1] An "issuer" is a corporation that (a) has issued securities that are registered in the United States or (b) are required to file periodic reports with the SEC under Section 15(d) of the Securities Exchange Act.

[2] A "domestic concern" is a US citizen (wherever located) and any business entity (such as a corporation, partnership or unincorporated organization) organized under the laws of a US state or which has a principal place of business in the United States.

even if the offence took place entirely outside the United States. Thus, a US employee or director working within a portfolio company may be held independently liable for making a corrupt payment to a foreign official and thereby provide the basis for US jurisdiction over the non-US company as well.

A non-US portfolio company affiliated with a US fund can be subject to the FCPA if it uses "instrumentalities of US commerce,"[3] such as the mails, phone lines, or internet, or if it takes any action within the United States in furtherance of a corrupt payment. It does not matter if the use of the interstate facility is only "incident to an essential part of the scheme." Accordingly, such a jurisdictional nexus may be readily established in the context of the relationship between a non-US portfolio company and a US fund monitoring and managing its investment.

## 2. Does bribery at the portfolio company level put the private equity firm (the **Fund**) at risk under the FCPA?

Under the anti-bribery provisions of the FCPA, the extent to which a Fund could be at risk for prohibited activities conducted by the portfolio company is a fact-specific analysis that depends on multiple factors. For example, the US government would scrutinize the Fund manager's degree of involvement in the portfolio company as well as whether the Fund invested with the knowledge that this portfolio company might make illicit payments to foreign public officials. Recently, the US government has found "knowledge" in circumstances constituting "wilful blindness" toward and conscious disregard of prohibited conduct.

As noted above, the FCPA, under the books and records provisions, makes US issuers, including non-US companies, responsible for maintaining accurate financial records and for adopting internal controls that ensure such records are complete. These provisions apply to a foreign subsidiary of a US issuer to the extent that the subsidiary's books are consolidated with those of its parent company. Moreover, parent companies can be held responsible for the FCPA books and records violations of their non-US subsidiaries, even when they had no actual knowledge of the corrupt payment if they should have known.

In this regard, the SEC and DOJ have held a parent company liable even without showing that it directed, controlled, authorized or even knew of the improper payment where it "*failed to ensure that the [non-US subsidiary] conducted due diligence on agents hired through the joint venture in which [it] participated."* This reasoning may extend to a Fund investing in a portfolio company (for instance, as part of a capital contribution) or a venture with the knowledge that this affiliate, venture or its partners may make illicit payments to foreign public officials. Knowledge, for these purposes, includes circumstances constituting wilful blindness toward, and conscious disregard of, the affiliate's prohibited conduct.[4]

## 3. What degree of control over the portfolio company is necessary to put the Fund at risk?

If the portfolio company is a US issuer, the portfolio company can be held liable under the FCPA's accounting provisions, for any improper accounting entries that are consolidated and included in the Fund's financial statements.

Under the anti-bribery provisions, the FCPA does not define the degree of control that a parent company must have over a non-US company to trigger liability. Nor are there clear cut judicial standards as most FCPA cases are settled with the DOJ and the SEC before trial. Based on these settlements, parental liability most often occurs when the subsidiary that made the improper payment is wholly or majority owned. Accordingly, when Funds purchase a majority stake in a portfolio company, and thereby gain a high degree of control of the company, the Fund is also exposed to a greater level of FCPA risk.

However, the notion of control under the FCPA is not exclusively based on the size of the stake; US enforcement authorities also take other indicia of influence, such as managerial and operational control, into

[3] Diagnostics Products Corporation (Tianjin), a Chinese subsidiary of a US company, was found subject to US jurisdiction because it caused a budget to be sent from the United States to China by phone, fax and email, and sent an email from China to the United States with a monthly report that included the improper payments.

[4] An investor was sent to jail for "wilfully disregarding" evidence that his investment in a venture might be used by another investor to bribe foreign public officials, such as the co-investor's questionable background, the high risk country (Azerbaijan) and industry sector (oil and gas) of the investment.

account when evaluating whether the Fund actually "directed, controlled or authorized" the improper payment made by the portfolio company.

Recently, in the Alcatel-Lucent case, the DOJ looked beyond the minority 43% stake that the Malaysian government held in a company to find that the degree of actual control that the government exercised in the company made it a government "instrumentality" such that its employees were government officials under the FCPA. A similar reasoning may also be used to analyze the nature of the relationship between a Fund and a portfolio company.

In practice, private equity firms usually rely on local partners to pilot day-to-day operations, but retain a number of contractual rights, such as veto rights over major corporate decisions, which may amount to a significant degree of control. FCPA-related risks are likely to increase in proportion to the degree of effective control ceded to the Fund.

### Additional risks

Bribery in a portfolio company creates significant risks to the value and marketability of the investment. These risks include the unenforceability and/or termination of revenue-producing contracts procured by bribery, debarment from public procurement contracts, and imposition of large fines and costs following criminal or regulatory investigations. Bribery at the portfolio company level may also have a negative impact on the Fund manager's reputation.

Further, Fund documentation may require that the manager ensure that the FCPA is not breached by investee companies. Bribery at portfolio company level could result in investors withdrawing investments early.

## 4. Is successor liability a potential concern?

The US enforcement authorities have taken the position that a company may be held criminally liable for the actions of an acquired company, even if these actions were committed before the date of the acquisition or merger and were unknown to the acquiring company. The fact that the acquiring company has carried out anti-corruption due diligence is likely to mitigate the risk but does not constitute a legal defence if a previously unidentified FCPA compliance issue arises.

In a 2008 FCPA Opinion Release, the DOJ confirmed this position and advised the requesting company to carry out exhaustive post-acquisition due diligence (as pre-acquisition due diligence could not be undertaken in this particular case) addressing in particular "the use of agents and other third parties; commercial dealings with state-owned customers; any joint venture, teaming or consortium arrangements; customs and immigration matters; tax matters; and any government licenses and permits."

In a recent and illustrative example of an enforcement action based on the successor liability theory, Alliance One, an American tobacco company formed in 2005 from the merger of Dimon Incorporated (Dimon) and Standard Commercial Corporation (SCC), entered into a non-prosecution agreement with the DOJ for FCPA violations committed by subsidiaries of Dimon and SCC before the 2005 merger.

## 5. What are the risks for the private equity managers?

The FCPA applies to the officers, directors, employees, agents, or stockholders of domestic concerns or US issuers engaging in prohibited conduct on their behalf. As a result, the Fund's partners who may serve as directors in a portfolio company or who may otherwise authorize or direct activities of the portfolio company may face individual liability.

## 6. Examples of FCPA application in the private equity context

To illustrate the risks explained above, imagine a private equity Fund, headquartered in the US, with investment activity in Asia. The representatives of the Fund, both US and non-US nationals, are employed by a locally incorporated adviser to the Fund. The Fund invests into a portfolio company, specializing in construction business, also locally incorporated. An employee of the portfolio company makes an improper payment to a government official to secure a government tender. As mentioned above, the extent of potential FCPA liability of persons and entities involved in this scenario requires a very fact-specific analysis.

Under the recent FCPA cases, the Fund itself, as a domestic concern, can be subject to FCPA liability if it either had actual knowledge of the violation, or should have known that the violation could have occurred. Because of the broad concept of "knowledge," the Fund can be found liable, if, for example, it ignored certain red flags, *e.g.* that the construction business in this country is known for its notorious bribery activities or that their local adviser has no established anti-bribery policies. The Fund can also be liable based on a theory of control, which takes into consideration the actual control the US Fund has over a foreign portfolio company, such as the ability to nominate board directors or exercise veto power. The portfolio company may be found liable if it used instrumentalities of US commerce to further the illegal act, *e.g.* by sending an email with a report including improper payments. The US national employees may face individual liability, if they were engaged in the prohibited conduct; however, it is unlikely that the US authorities could assert jurisdiction over the Fund or portfolio company based on this fact alone.

## 7. Recommendations

### Pre-deal anti-corruption due diligence

The recent increase of FCPA enforcement actions has added an incentive to conduct anti-bribery due diligence on investee companies, co-investees and managers and to include anti-bribery representations and warranties in investment agreements.

In order to identify the potential risks associated with a transaction, Funds should conduct in-depth anti-corruption due diligence at the pre-deal stage. Such due diligence would include identification of a company's interaction with government agencies, its business partners, its use of intermediaries and any anti-bribery internal controls currently in place at the company. At the same time, the pre-deal due diligence should be carefully tailored to the dynamics of the deal, so as not to impair the relationship established between the parties.

Any red flags should be carefully identified, investigated and properly addressed before the final investment decision is made. Examples of red flags include the absence of a proper anti-corruption policy, lavish entertaining of government officials, unusual contract terms or payment arrangements with intermediaries, excessive commissions or fees, and lack of due diligence practices.

### Post-deal preventive actions

The actions that the Fund may take to prevent illicit payment at the portfolio company level will depend on the nature of the relationship between the two entities and on the Fund's involvement in the portfolio company's business. However, even where the Fund's control over the portfolio company is low, the Fund can take steps to prevent the portfolio company from engaging in corrupt practices.

In particular, the Fund should ensure that portfolio companies implement and comply with anti-corruption policies. Such policies and practices should include strict books and records obligations and due diligence requirements when working with intermediaries. Strong gift and hospitality controls, particularly with regard to public officials, are also critical.

The Fund should never remain passive once it identifies FCPA red flags. The Fund should ensure that proper investigations are carried out and express clear disapproval of any conduct violating the FCPA. The absence of reproval is more likely to be interpreted as passive acquiescence if the Fund is deeply involved in the management of the portfolio company.

## Clifford Chance's Asia anti-corruption group

Clifford Chance's on-the-ground anti-corruption team in Asia combines litigation and M&A specialists. Our team advises on a range of issues including upstream (risk management and front-line compliance, advisory, M&A due diligence, in-house training workshops) and downstream (investigations, crisis management, advising on remedial actions and defense work) legal support.

Our team boasts Wendy Wysong, a specialist in white collar crime and ex-US federal prosecutor, with expertise on the US Foreign Corrupt Practices Act, export controls, and economic sanctions. Wendy is adding an Asian office to her regular desk in Washington DC.

On-the-ground anti-corruption lawyers with local Hong Kong and PRC capabilities backed by US expertise mean our offering is second to none. In addition, we have strong resources among our global network with very recognized capabilities in the US (FCPA practitioners), London (UK Bribery Act) and Europe and are able to manage the multi-national and complex anti-corruption enforcement risks.