HOW FCPA DUE DILIGENCE

CAN REDUCE OR ELIMINATE COSTLY ENFORCEMENT ACTIONS

By Brian J. Mich and Robert M. Weiner

The decision to not conduct Foreign Corrupt Practices Act ("FCPA") due diligence can have immediate and far-reaching pecuniary effects to a company and its officers and directors. When it comes to enforcing the FCPA, the federal government has been levying severe fines, sanctions and financial disgorgements against companies, and imposing fines and the possibility of imprisonment against individuals.

The FCPA was passed in 1977 in response to the results of an amnesty program set up by the United States Department of Justice, spurred by the shocking disclosures of bribes by scores of prestigious U.S. corporations doing business overseas. More than 400 companies, including more than 100 members of the Fortune 500, took part in the amnesty program and voluntarily disclosed more than $300 million in bribes and other questionable payments in order to get business.[1]

Yet despite these stunning admissions and because there were genuine concerns that any aggressive enforcement of the anti-corruption laws against American companies would put them at a competitive disadvantage vis-à-vis their foreign counterparts, the Department of Justice ("DOJ") and the Securities and Exchange Commission ("SEC") declined to intensify prosecutions under the Act.

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During those earlier times, it might have made sense for companies to look the other way while their officers, employees, joint venture partners and representatives crossed the line between salesmanship and brinksmanship, comfortable in the knowledge that the likelihood of an enforcement action was remote. These days, however, with the SEC and DOJ bearing down, balance sheets in a nosedive and potential for fines and imprisonment, that strategy no longer makes sense.

In the past two years, there has been a marked increase in SEC FCPA enforcement. Since January 2006, the Commission has filed more than 30 FCPA actions, which is more than were filed during the prior 28 years combined. We have also seen a significant increase in the sanctions levied in FCPA cases. Since January 2006, the Commission has ordered the payment of more than $200 million in penalties, disgorgement and prejudgment interest for FCPA violations.[2] The Department of Justice is just as active in this area, having formed a dedicated squad of FBI agents and team of prosecutors who handle only FCPA cases.

Why Now?

Scrutiny of cross-border transactions has reached new heights for reasons beyond the Sarbanes-Oxley Act ("SOX"), which was enacted in 2002 to impede the runaway corporate corruption of the 1990s. Section 404 of SOX and the implementing SEC rules put the onus on CEOs, CFOs and company auditors to certify the accuracy of financial reports, including an annual statement regarding the status of the company's internal controls. Because SOX requires companies to adequately respond to evidence of potential FCPA violations, companies are obligated to investigate and address these matters within a reasonable period of time.

For those companies that do not self-report and are later prosecuted, the penalties can be harsh. In December 2008, Siemens pled guilty to violating the FCPA and agreed to pay $800 million in criminal and civil fines. Other examples of aggressive prosecution involved Baker Hughes, which was fined $44 million; Vetco International, which was fined $26 million; and Chevron's violations, which resulted in a $27 million fine.

Another factor is the increased globalization of anti-corruption enforcement, as witnessed by the Organization of Economic Cooperation and Development's 1997 Convention on Combating the Bribery of Foreign Officials, which has been signed by the US and thirty-six other countries. Each of the signatory nations is required to adopt its own implementing anti-corruption legislation. The enactment of different laws in multiple jurisdictions will likely result in U.S. companies being subject to varying anti-bribery and accounting compliance standards. Moreover, because more and more countries are requiring their companies to follow stringent anti-corruption regulations, U.S. companies can no longer claim, with any credibility, that the enforcement of the FCPA puts them at a competitive disadvantage.

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With this push to put an end to global corruption, FCPA investigations have skyrocketed. Currently, there are 82 companies reporting that they are under investigation for FCPA compliance-related issues.[3]

Another key factor in the increase in FCPA investigations and prosecutions is globalization. The pace at which U.S. corporations have acquired foreign firms in order to gain entry into emerging markets has been remarkable.

Global mergers and acquisitions ("M&A") hit a peak of approximately $2.2 trillion in the first half of 2007, and cross-border M&A activity accounted for 44% of all M&A activity that year, according to Thomson Reuters/Freeman & Co. Although the first half of 2008 experienced a staggering 36% drop-off in global M&A activity, year-to-year, cross-border deals continued to make up 40% of those mergers and acquisitions. And with each one of these cross-border deals comes the potential for post-acquisition successor liability with respect to past FCPA violations.

Risky, Riskier, Riskiest

Historically, some countries around the world, especially those in Latin America, Africa, and Asia, have been doing business with standards different from what is permitted under the FCPA. In some instances, the costs of paying bribes were deemed "allowable business expenses" which could be deducted from a corporation's tax returns. As David Aaron who, at the time, was America's Permanent Representative to the Organization of Economic Coordination and Development, stated in 1996, "It may sound ludicrous to declare a bribe as a tax deduction, but that is simply a measure of how ingrained this habit was."[4]

Nowadays, a prevailing belief that such transactions are just the "cost of doing business" can cost corporations million in fines and disgorgement penalties and can land individuals in jail. As the siren call of emerging markets — and healthier profits — beckons U.S. companies, they will need to examine their due diligence strategy in order to avoid being party to or assuming FCPA violations and undergoing costly investigations and/or incurring staggering fines and compliance initiatives.

A look at Transparency International's Corruption Perception Index, which ranks country-by-country how endemic corruption is in a country's business culture, can help companies gauge the potential threat as they enter a foreign market. At the top of the list—those countries with the least amount of recognized corruption—are the European democracies, Canada, Singapore, Australia, and New Zealand. (The United States ranks eighteenth, tied at 7.7 with Japan and Belgium.) Important emerging markets such as China, India, and Russia are much farther down the list. (China received a 3.9, India a 3.4, and Russia a 2.1—just above several of the world's bloodiest war zones.)

In addition, certain industries historically have been classified as more prone to corruption than others. Industries with major government contracts, such as defense, construction, and aerospace, can especially be problematic. Industries that rely upon government-granted licensing and those that rely on agents or distributors to conduct a majority of its business, including healthcare or pharmaceutical, are similarly vulnerable. These industries are often viewed as the most profitable or attractive to Western investors and businesses. For example, in Russia pharmaceutical sales are expected to surge 20% in 2008 to $17 billion, and 13% in 2009, to $19.4 billion, according to the Dutch research firm, DSM.

Hot Water

FCPA compliance is rendered particularly tricky because the line between a bribe and certain legitimate business practices is not always clear. For example, prosecutors and regulators acknowledge that the giving of a small gift may be acceptable, particularly in non-Western countries, such as China, where the exchanging of gifts is a prevalent social custom, that "shows a relationship is valued and is a means of expressing respect and honor for the person."[5] When gifts are given to officials in exchange for business favors, however, the lines between gifts as part of a social custom and gifts rendered as bribes get blurred.

Similarly, the FCPA contains an exception that allows "facilitating payments," commonly called "grease payments," which are payments to secure performance of a non-discretionary,

routine governmental action that the government official is required to perform. Many other countries that have passed anti-corruption legislation, however, have not treated these types of payments as exceptions to their definitions of bribery. Moreover, like gifts, the line between a lawful grease payment and a bribe is not always easy to discern. Not surprisingly, corporations have gotten in trouble as a result of this lack of clarity. For example, in 2004, the SEC charged Schering-Plough with violating the internal control provisions of the FCPA after the company's Polish subsidiary paid $76,000 in charity payments to a legitimate charity. Because the "donation" was meant to influence a Polish government official who had authority in the health industry to promote the purchase of the company's pharmaceutical products, the SEC required Schering-Plough to pay a $500,000 fine and retain an independent consultant to evaluate its internal controls going forward.

The SEC and the DOJ enjoy broad jurisdiction under the act (the SEC civil, the DOJ criminal), extending even to the prosecution of foreign nationals for violations that occur abroad, as long as they have had some contact with the United States. Mark Mendelsohn, the DOJ's deputy chief responsible for overseeing all FCPA prosecutions, recently promised at the Foreign Corrupt Practices Program in Washington, D.C. that the trend toward more bribery prosecutions is going to continue and that there would be more prosecutions of individuals.

Penalties for Non-Compliance

The penalties for violating the FCPA have been called draconian and can include monetary fines against the corporation, as well as an individual employee. It is important to recognize that, under the Act, companies cannot reimburse employees for fines. In addition, prosecutions can result in jail time and the imposition of court-appointed monitors for protracted periods of time. With the threat of jail time hanging over individuals' heads, Mendelsohn believes executives will think twice before bribing a foreign official. While the threat of enforcement can certainly help curb bribery, companies that adopt a proactive, pre-deal transactional due diligence approach can avoid the risks that come with not knowing.

A prudent attorney will tell you that acquiring a foreign company can be like dancing on a minefield. And like minefields, the accountability provisions in the FCPA are unforgiving, especially because an acquiring firm can be strictly liable for pre-closing FCPA violations committed by the target company. If the acquiring company can prove it took proper steps to uncover any illicit FCPA violations prior to the acquisition, the SEC or DOJ has shown that they will be much more likely to permit a company to enter into a deferred or non-prosecution agreement upon disclosure of such malfeasance.

Such compliance investigations are typically conducted through and in conjunction with counsel in order to maintain the privilege of any due diligence findings. Questions that should be asked include:

- Who are the parties? Are they publicly traded or state-owned?
- What is the corruption risk?
- How is the deal structured?
- What is the marketplace's perception of the company being acquired?
- How did key business relationships come into fruition?
- What percentages of gross sales are made through third parties?
- How are sales transactions conducted and contractual relationships handled?
- Have agents, vendors and other third parties through whom the target does business signed contracts with specific FCPA provisions?
- What background checks were done on key employees, agents, vendors or distributors?

Investigators look for red flags such as:

- Rumors of improper payments
- Undisclosed related-party transactions
- Unreported financial difficulties
- Troubled transactional history or financial reporting issues
- Unusually large or frequent political contributions to an official capable of helping the company
- Retention of unnecessary agents
- Undisclosed legal proceedings
- Criminal or regulatory actions
- Trade with controversial entities or embargoed countries
- Deficient director independence or corporate governance
- Refusal to certify FCPA compliance

The DOJ and the SEC are trying to limit corruption to the greatest extent possible, but perfect compliance with the FCPA may be impossible. The DOJ and the SEC simply do not have the resources to monitor every international business transaction. The DOJ has effectively addressed this issue by publicizing high-penalty, high-profile cases, thereby encouraging companies to self-report FCPA violations and offering deferred prosecutions or non-prosecutions to self-reporters. Although fines are often levied on self-reporters, they can be substantially lower

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than in cases that are prosecuted. Some companies may also be required to implement internal controls and conduct regular testing of those controls to prevent future violations.

SEC Director of Enforcement Linda Chatman Thomsen, in her speech before the Minority Corporate Counsel on March 27, 2008, stated, "Avoiding FCPA pitfalls requires companies to be both proactive and aggressively reactive. Proactively, companies should implement FCPA internal controls which include written policies and procedures, as well as FCPA compliance and training programs. Reactively, companies are well counseled to respond promptly and appropriately to red flags both by conducting internal investigations to identify potential problems and by taking steps to remedy any violative conduct found. Voluntary disclosure is the norm in these cases."

Toward that end, a company should consider:

- Drafting and implementing a corporate anti-corruption policy and/or reviewing an existing policy
- Creating a training and testing program on FCPA requirements and other anti-corruption policies and procedures
- Assessing that program regularly to capture changes in business practices
- Responding to allegations of corrupt activities and investigating them quickly and comprehensively

Such a policy should include disciplinary procedures for employee, agent or representative violations. It should also establish a reporting system so suspected violations can be ferreted out and immediately addressed.

In the end, due diligence is about knowing. Knowing the parties to a transaction, knowing how they conduct business, knowing that certain conduct is more likely to happen than not and knowing that you took the necessary steps to obtain all such information prior to entering the deal. Risk mitigation results in reducing the possibility of a government investigation and subsequent enforcement action. Since the government is still offering some sort of deferred prosecution or workout solution to those companies that self- report FCPA violations, it only makes sense to minimize or eliminate potential risk. Armed with the proper intelligence resulting from due diligence inquiries, companies can avoid running afoul of the law by conducting deals aboveboard, identifying areas of vulnerability and walking away from FCPA problems before they become train wrecks.

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