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ARE YOU PAYING TOO MUCH? HOW SMART COMPANIES USE FCPA AND UK BRIBERY ACT DUE DILIGENCE TO ENSURE THEIR DEALS ARE VALUED CORRECTLY

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There is a global focus on corruption that shows no signs of abating and in fact, is intensifying. Beginning with the adoption of the Sarbanes-Oxley Act in 2002, we have seen an increase in regulation designed to put the brakes on clever accounting and even cleverer "innovative" banking products. Society – and in response government – wants its pound of flesh for the practices of the large corporates like Enron and large financial institutions like Lehman Brothers. Punishment is exacted in the form of increasingly large penalties, occasional jail sentences and ubiquitous demands for ever stricter corporate governance and compliance programs. The most common and effective tools for exacting punishment are the U.S. Foreign Corrupt Practices Act ("FCPA") and its souped-up sidekick – the UK Bribery Act.

The Foreign Corrupt Practices Act

In 1977, in the wake of the Watergate scandal, the U.S. Congress enacted the FCPA to halt the bribery and corruption of foreign officials. In addition, it was hoped that the FCPA would lead to more integrity and accountability in business and more efficient and equitable distribution of economic resources. The FCPA created criminal and civil penalties for payments, or the promise of anything of value, by U.S. corporations or U.S. nationals to foreign officials for the purpose of gaining an improper advantage or obtaining or retaining business. The FCPA also applies to foreigners who take part in furthering such bribes while in the United States.

The U.S. Department of Justice ("DOJ") has made prosecuting violations of the FCPA one of its top priorities in recent years. FCPA enforcement is now viewed as a national security issue. The DOJ is focusing its efforts on "industry sweeps" of those sectors it considers to be at high risk of corruption, including energy, mining, banking, insurance, telecommunications, pharmaceuticals, gaming and manufacturing. From 2004 through 2009, the DOJ brought more FCPA prosecutions than in all of the previous 26 years combined since the act was passed. In 2010 alone, the DOJ resolved more than 50 FCPA enforcement actions, with 35 defendants currently awaiting trial on FCPA charges. In November 2011, the DOJ secured a 15-year prison sentence in an FCPA case – the longest ever imposed.

Foreign companies are increasingly a target of FCPA enforcement actions, as the United States attempts to pressure foreign governments into being more proactive in the anti-corruption arena. Under the theory of "correspondent bank

account" jurisdiction, the DOJ need only establish a tenuous connection to the United States in order to bring a prosecution under the FCPA. It is enough for U.S. dollar funds to have cleared overnight in the U.S. branch of a bank with no other connection to the United States. Eight of the 10 largest FCPA actions of all time were against foreign corporations, and in 2010 the six largest actions, accounting for 80% of the fines, were against foreign companies.

The UK Bribery Act

As of July 1, 2011, companies with any tie to the United Kingdom's stream of commerce — and not just those with share listings in London — are subject to the tough new UK Bribery Act. Its scope is similar to the FCPA, with three important distinguishing features. First, accepting a bribe from or paying a bribe to any individual is prohibited, no matter where it occurs. For instance, a bribe paid to an employee of a private company is illegal. This is a much broader prohibition than the FCPA, which makes it illegal to offer anything of value only to foreign government officials and employees of international public organizations. Second, a company can be held strictly liable for bribery if the company fails to put in place procedures to prevent corruption. Third, there is no limit on the size of fines, and the potential prison sentences are longer than under the FCPA. Unlike the FCPA, the UK Bribery Act does not have an exception for facilitation payments, such as those used to speed up the process for obtaining a building permit or import license.

Impact on Deal Price

When you mention the word "compliance" to almost anyone working in capital markets, be they bankers, lawyers or accountants, you almost immediately lose your audience. Compliance is just a cost center, right? Just another hurdle in the way of getting deals done efficiently and cost-effectively, right? Wrong! In the new era of compliance-hungry regulators, who are fighting corruption Clark Kent style, it pays to put these issues at the forefront of every deal.

FCPA and UK Bribery Act investigations can have an immediate impact on share price. For example, on March 1, 2011, the Las Vegas Sands Corporation announced that the Securities and Exchange Commission ("SEC") and the DOJ were investigating its FCPA compliance. By the end of the trading day, its share price had dropped 6.3%, which represented a shrink in market capitalization of $1.67 billion in a single day. Examples of this kind, showing a marked drop in share price and value in response to announcements of alleged corruption, are prevalent among the small- to mid-cap companies. The large-cap companies tend to be hit less hard and to rebound more quickly. Among the possible reasons for this phenomenon are the stronger reputation in the market of many large cap companies and the less significant impact any ultimate fine will have on the market capitalization of such companies.

FCPA fines are steep and are on the increase. In 2010, companies paid in penalties an average of $2.14 per U.S. dollar gained from FCPA violations. This is an 1800% increase from penalties of just $0.11 per dollar in 2007. In 2010, corporate fines and disgorgements for FCPA violations amounted to over $1.7 billion, which exceeded all previous years. And, the six largest actions in 2010 accounted for $1.36 billion of this total.

There are also significant "downstream effects" that can far surpass the cost to companies of FCPA fines and drops in share price. These include securities class actions, disbarment from foreign government contracts and restrictions on the ability to import or export goods and services. Corruption has a big impact on the cost and sometimes even the ultimate viability of a deal.

The discovery of FCPA and UK Bribery Act violations can unravel potential merger discussions. In 2003, Titan Corporation entered into merger discussions with Lockheed Martin for $1.8 billion. Titan represented in the merger agreement that neither it nor any of its subsidiaries had taken any actions to violate the FCPA. When it was later revealed that Titan had funneled more than $2 million through an agent in Benin toward the election of that country's president, the merger with Lockheed Martin collapsed.

Top Ten Regulatory Settlements

	FCPA Fines ($M)	Home Country
1.	800	Germany
2.	579	U.S.A.
3.	400	U.K.
4.	365	The Netherlands/Italy
5.	338	France
6.	218.8	Japan
7.	185	Germany
8.	137	France
9.	81.8	Switzerland
10.	70	U.S.A.

"Successor Liability" Approach to Enforcement

Increasingly, the U.S. government has wielded the enforcement powers of the FCPA in a manner that casts the specter of "successor liability" on acquirers for historical violations of acquired companies, even when the acquirer played no role in the pre-acquisition conduct. This approach to successor liability is frequently invoked when the acquirer is seen to have failed to undertake adequate due diligence to inform itself about the violations and allows the prohibited conduct to continue post-acquisition after the acquired business has been consolidated with that of the acquirer. For example, in September 1998, Halliburton, through a series of corporate transactions, acquired KBR. It was later revealed that from 1994, prior to its acquisition by Halliburton, and continuing through 2004, KBR and its partners in the TSKJ joint venture had paid bribes to a wide range of government officials in order to obtain contracts worth more than $6 billion to build the Bonny Island liquefied natural gas facility in Nigeria. The SEC subsequently accused KBR of violating the anti-bribery provisions of the FCPA and aiding and abetting Halliburton's violations and accused Halliburton of conducting insufficient due diligence and failing to design and maintain adequate internal controls when it consolidated KBR's false financial statements into its own. In enforcing the books and records violations against Halliburton, the SEC used those alleged failures, along with Halliburton's own lack of post-acquisition vigilance and alleged misconduct, to force a sizable penalty. Halliburton and KBR agreed to pay $177 million in disgorgement to settle the SEC's charges. KBR also agreed to pay $402 million to settle the DOJ's parallel criminal charges, $382 million of which was paid by Halliburton under contractual indemnification arrangements with KBR as part of KBR's spin off as a separate public company in 2006. In addition, as part of the resolution of the SEC investigation, Halliburton agreed to retain an independent consultant to perform a review of its internal controls and record-keeping policies and to adopt any necessary improvements.

The idea of successor liability is troubling to many legal practitioners, particularly those practicing in jurisdictions outside of the United States. For instance, in the UK, successor liability is limited to certain torts, such as product liability and environmental breaches, situations involving express or implied assumptions of liability, de facto mergers where the successor is a continuation of the predecessor, or mergers done as a pretext to defraud creditors. In contrast, the U.S. government's approach to successor liability has become a primary enforcement feature of the FCPA in any type of acquisition, and because the vast majority of cases settle, its legality has not yet been challenged in a court of law.

Prophylactic measures

To avoid a loss in deal value, an acquirer must conduct careful anticorruption due diligence that is specifically tailored to the company being acquired. First, however, the level of risk should be assessed through a series of key questions. These questions include:

1. Are any employees, owners, or principals current or former government employees or closely affiliated with one?
2. What practices and safeguards are there regarding gifts, entertainment, hospitalities, charitable contributions, sponsorships, donations and other benefits?
3. What is the target's relationship with intermediaries (distributors, agents, consultants, etc.)?
4. Have there been any past investigations/violations?
5. Does the target operate in a high-risk industry/high-risk country?
6. What is the target's association with foreign governments? Does it provide them with goods and services? Is it government owned or controlled? Does it rely on government-issued licenses or permits?
7. Does the target have clear policies and procedures in place to detect, report and manage FCPA and UK Bribery Act violations?
8. Is there any suspicion of FCPA or UK Bribery Act violations in the target?
9. What does the Transparency International Corruption Perception Index reveal about the target?

Second, the target's systems and controls should be evaluated in the following areas:

1. Use of agents and outside consultants
2. Expense claims, payments and petty cash disbursements
3. Contracting/contact points with government bodies
4. Fraud response procedures/mechanisms
5. Entertainment and gift practices
6. Record-keeping practices and accuracy of books and records
7. Relationships with state-owned enterprises

Coordination with accountants and auditors in conducting pre-merger anticorruption due diligence is vital. Cash is the most prevalent form of bribery worldwide, particularly disbursements to sales people, and so these professionals have a critical role to play in their review of books and

records. They should report back regularly to the legal experts, who can make an informed decision on the likelihood of FCPA violations based on what is unearthed by the accountants. In the United States, it is sometimes possible to extend attorney-client privilege to an accountant's findings, if the accountant is acting as an agent for the attorney or is retained directly by the attorney to provide services to the attorney's client. This would, of course, be the best possible outcome.

In order to reduce the risk of potential FCPA and UK Bribery Act liability, every acquirer should consider (1) encouraging the target to undertake a compliance investigation prior to any potential investment; (2) insisting on the right to audit the books and records of the target; (3) insisting on anticorruption and compliance representations and warranties; and (4) requiring execution of FCPA and UK Bribery Act compliance certifications.

If the due diligence reveals FCPA or UK Bribery Act issues, a buyer has several options available, including (1) negotiating specific indemnification provisions; (2) self-reporting to the DOJ or SEC; (3) adjusting the deal price or walking away from the transaction; and (4) allocating potential fees and fines in the merger agreement.

If there is not time to conduct adequate anticorruption due diligence prior to closing, then the acquirer could consider requesting an advisory opinion from the DOJ. Halliburton did this in connection with its recent proposed acquisition of a British company operating in the oil and gas industry in more than 50 countries, some of which were high risk, to ensure that it would not incur any FCPA liability. The target was accepting closed bids with a very limited amount of due diligence allowed in accordance with London Stock Exchange rules. The DOJ advised Halliburton that the transaction itself would not create any FCPA liability and that it would not be prosecuted for any of the target's pre-acquisition conduct, provided that it disclosed any questionable conduct discovered during a 180-day post-closing period, and that it completed a detailed post-closing due diligence plan.

If, on the other hand, due diligence is conducted but potential issues do not arise until after the merger, then the acquirer should seek thoughtful and expert legal advice as to whether to make a voluntary disclosure of its findings to the DOJ. In addition, if a company agrees to develop evidence against others and provide it to the DOJ and SEC, as many have done, this can mitigate liability. This so-called "cooperation credit" can be very expensive, because it requires a comprehensive internal investigation and then full remediation.

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Compliance Programs

Because of the significant risk corruption poses to the success and cost of a deal, it is prudent for companies to establish a "best practices" compliance program to mitigate potential damage from hidden corruption. The UK Bribery Act contains an affirmative defense that allows a company to avoid strict liability only if it can demonstrate that it had in place "adequate procedures" designed to prevent bribery. Although the FCPA does not contain an analogous provision, the United States considers good compliance programs to be an important mitigating factor. In fact, recent amendments to the U.S. Sentencing Guidelines include "monitoring and auditing to detect criminal conduct" and "evaluat[ing] periodically the effectiveness of the organization's compliance and ethics program" as essential elements of an effective compliance program.

Conclusion

There can be no doubt: corruption is expensive, it damages corporate and individual reputations, and it can seriously impair – if not kill – a deal. Smart companies, however, turn those negatives to their advantage. They recognize that by performing meaningful anticorruption due diligence they can protect themselves from overpaying for key acquisitions; avoid costly diminutions of share value; and mitigate the risk of successor liability that surely follows a post-acquisition discovery of corruption. These companies put into practice the sage and oft-quoted advice that "the best defense is a good offense," and by so doing, position themselves to reap the benefits of their best practices compliance efforts for years to come. ◎