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Managing Corruption Risk in Mergers and Acquisitions: Why Pay Good Money for Someone Else's Problem?

Allegations of bribery of foreign officials are receiving attention from the general media as never before. Now headlines such as "SEC Charges Alcoa With FCPA Violations", "The Bribery Aisle: How Walmart Got Its Way in Mexico", or "S.E.C. Asks if Hollywood Paid Bribes in China" are almost commonplace. This is in large part because enforcement agencies such as the US Department of Justice (DOJ) and the Securities and Exchange Commission (SEC), and counterparts in other countries such as the Serious Fraud Office in the United Kingdom and prosecutors in Germany, are stepping up enforcement of their anti-foreign-corruption statutes. In the United States in particular, the bounty provisions of the Dodd-Frank Act have provided a powerful additional incentive for would-be whistleblowers.

Because of its early enactment and strong enforcement over the past couple of decades, the US Foreign Corrupt Practices Act (FCPA), enacted in 1977 and last significantly amended in 1998 (in large part to make it consistent with the OECD's 1997 Convention on Combating Bribery of Foreign Public Officials in International Business Transactions), has played a unique role in cross-border transactions with respect to corruption risk. The FCPA, however, is not the only anti-corruption statute a company must keep in mind as part of a cross-border merger and acquisition transaction. Recent years have seen significant legislative activity in this area in other countries, such as the Bribery Act that the United Kingdom enacted in 2010 with much fanfare, and Germany's Act on Combating the Bribery of Foreign Public Officials in International Business Transactions of 1998, implementing the above-referenced OECD Convention. Germany also amended its Penal Code in 2002 by providing that commercial bribery that impacts competition constitutes a criminal act (rather than just being a form of unfair competition) and also extended the prohibition to bribes that impact competition with foreign competitors (rather than just domestic, i.e., German, competitors).

Regardless of how an M&A transaction is structured, the acquirer will likely inherit liability for any corrupt conduct of the target, whether under general principles of successor liability or otherwise. When enforcing the FCPA, the DOJ and SEC for the most part do not recognize any concept of "your-watch/my-watch" when it comes to these issues, and so acquirers are required to pay assiduous attention to pre-closing due diligence and post-closing remediation. Particularly problematic is the situation where pre-closing violative conduct continues past closing.

That raises the real question of what alternatives an acquirer has when it discovers a corruption issue in an acquisition context. This article will discuss four alternatives in turn (i) ignore the problem; (ii) protect against the problem; (iii) investigate and fix the problem; and (iv) self-report the problem.

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1. Ignore the Problem (and Hope It Goes Away or is Never Discovered)

We can deal quickly with the one option that is a bad choice – to ignore the problem in the hope that it will either go away or never be discovered. This is not really even an option. Once the acquirer learns of a possible corruption issue, it must take action – it would be playing with fire if it decides to do nothing. In fact, its obligations go beyond that – in *A Resource Guide to the U.S. Foreign Corrupt Practices Act* (2012) (the "Guidelines"), the DOJ and SEC confirm that an entity may not be "willfully blind" to transgressions. So purposefully choosing to ignore an issue by not looking for it in the first place also does not qualify as an option.

2. Protect Against the Problem

In general terms, the earlier in the process a potential problem is discovered, the better the range of protective options that are available to the acquirer.

During Due Diligence/Pre-signing

The most meaningful action an acquirer can take is to conduct appropriate due diligence. From a general standpoint, due diligence has several major purposes: (i) to identify issues that should cause the acquirer to walk away from the deal (so-called "deal-killers"); (ii) to identify issues that should cause the acquirer to re-price the deal or seek other pre-closing remediation; (iii) to identify issues that are meaningful from an integration standpoint; and (iv) to identify issues that may affect the definitive agreements.

The first three are closely related, and operate in tandem. Whether an issue is a deal-killer or an issue that causes the acquirer to seek to re-price the deal, and whether the issues require a specific remedy or other treatment in the definitive agreements, really are matters of degree. The major focus of this diligence is on conduct that affects the target's value as a going concern post-closing, such as:

- loss of projected revenues that were generated from or that are attributable to bribery;
- business changes such as the need to terminate particular distributors or suppliers (with the resulting disruption to the business);
- costs associated with investigating problematic conduct;
- costs associated with remedying problematic conduct (e.g., training or implementing a new compliance framework);
- loss of internal employee time and external resources to remediation rather than to developing the core business; and
- reputational harm resulting from association with an allegedly corrupt enterprise.

With that in mind, the definitive documents offer an opportunity to acquirers to seek potential remediation by including appropriate anti-bribery language therein. These mechanisms include representations and warranties (to confirm the acquirer's due diligence findings with respect to potential corruption issues, hopefully underlining that that it did not have knowledge of any corruption infractions at the time it consummated the acquisition), and shifting the burden of any damage (at least internally) onto the seller or target. The burden shift may be effected by indemnification language that provides for the acquirer to be indemnified in the event of any breach of the underlying anti-corruption representations and warranties. To provide the maximum protection to the acquirer, it may want to provide that violations of the anti-corruption representations are not subject to the indemnification de minimis, basket, and cap. Similarly, acquirers should consider seeking a longer period in which to make a claim for a corruption violation than for other types of indemnification claims. Finally, if the acquirer is paying the purchase price in installments, or by way of an earn-out, the buyer should be able to withhold payments if it makes a good-faith corruption claim against the seller or target prior to the due date of any such payments. These items are all subject to negotiation, but with the understanding that the acquirer's leverage increases if the diligence identifies actual or potential issues.

The anti-corruption representation and warranty language should specifically refer not only to the FCPA, but also to any other local anti-bribery statutes that apply to the target. Otherwise, a target that is a non-US entity may be able to claim that it was not subject to the FCPA prior to closing of the acquisition and, therefore, there was no breach of the FCPA (as well as the more practical argument that it cannot be expected to know what types of activities are prohibited by a U.S. statute). Non-U.S. targets also often find anti-bribery representations and warranties more palatable if reference is made not only to the FCPA, but also to local anti-bribery laws. An example (simplified for illustrative purposes) follows:

> The Company has not, directly or indirectly, violated or is violating any provision of, or any rule or regulation issued under, (A) the US Foreign Corrupt Practices Act of 1977, (B) the German Act on Combating the Bribery of Foreign Public Officials in International Business Transactions, (C) any other applicable law enacted in any applicable jurisdiction in connection with, or arising under, the OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions, or (D) any other law, rule, regulation, or other legally binding measure of any foreign or domestic jurisdiction of similar effect or that relates to bribery or corruption.

Beyond representations and warranties and indemnification, in the period before signing the acquirer can also insist on other contract-based mechanisms to address corruption issues. These include pre-closing covenants, for example to remedy specific issues (e.g., termination of a distributor found in the diligence to have been complicit in corrupt behavior, or even more generalized covenants requiring adoption of a compliance program). The protective impact of these can be enhanced substantially if they are elevated to the status of conditions to closing, which means that closing cannot happen unless the target or seller (as applicable) complies with the covenants – though a savvy seller will resist these as they reduce certainty of closing or at the very least give the acquirer another legitimate ground on which to resist closing the transaction.

Between Signing and Closing

The inter-party dynamic changes between signing and closing, and mostly in favor of the seller and against the acquirer. At that stage of the process, the acquirer is essentially bound to close unless a condition to closing is not met. At the same time, the acquirer does not control the target business and has a limited ability to remedy the issue itself and so is reliant on the seller or target to take necessary remedial action.

If a new or aggravated corruption issue comes to light after signing but before closing, the acquirer may have the opportunity to revisit its willingness to conclude the transaction:

- In an ideal situation for the acquirer, the purchase agreement will include a condition to closing that no new corruption issue arises. Accordingly, if a third party asserts a claim or if an enforcement agency provides notice that it is investigating potentially violative conduct, the acquirer might be entitled to walk away entirely, or at least seek a revised transaction price or structure. This would be relatively uncommon to see in a purchase agreement because of the impact that closing conditions have in terms of reducing certainty of closing.
- In what is a more common situation for the acquirer, the purchase agreement will provide a condition that there would be no major change in the accuracy of representations and warranties between signing and closing, and the new or aggravated issue is such that the acquirer can claim such a change. In that situation, the acquirer might seek to delay the closing until the seller resolves the issue or possibly even walk away if the issue or delay is such that it materially affects the value of the transaction to the acquirer.
- In what is the least optimal situation for the acquirer, the purchase agreement either contains neither of the above provisions or conditions their application on a high standard of materiality. In that case, the acquirer must show a material adverse effect (or "MAE") from the new development. Typically the standard of materiality for an MAE is high, as it requires some kind of a material and permanent impact on the target's business or revenues. The bottom line is that it is rare for an acquirer to assert an MAE successfully.

Post-Closing

If a problem comes to light after closing, even though the acquirer's situation is arguably worse in that it is now firmly "stuck" with a problem, in some ways the acquirer's position has improved in that it is now in control of integration and fixing the problem. Upon a problem arising, the acquirer's obligation - and possibly the best way to mitigate its own risk – is first and foremost to investigate the issue and seek ways to fix the problem. More on this below.

If the purchase agreement permits, the acquirer could also look at the possibility of seeking a remedy against the seller. This is where the scope of the representations and warranties comes into play, as well as the scope of the indemnification clauses. These interplay to a significant degree. Thus, for example, there may be a clear breach of the representation and warranty, but if a time or monetary limit precludes a recovery under the indemnification provision, then the acquirer will be left without a remedy. This is clearly a situation where a focus on securing appropriately written protections up front will be important and potentially make the difference between having recourse and not having recourse.

3. Investigate and Fix the Problem

An investigation can occur at any stage of the transaction process. It may be used pre-signing, to run to ground the implications of a problem that has manifested itself during diligence. It is an almost mandatory part of any risk assessment and mitigation plan for an issue that has come up after closing. It can even be used between signing and closing with the consent of the seller or target to help both parties assess their respective risk profiles in that situation. As such, it is a powerful tool in the "what-to-do" arsenal.

An investigation is typically broken down into several parts: (i) selecting outside counsel, (ii) reviewing documentary evidence, (iii) interviewing witnesses or other individuals involved with the bribery scheme, and (iv) depending on the outcome of the investigation, implementing remedial measures.

A company conducting an investigation is not required to engage outside counsel, but for a number of reasons it might be well-advised to do so. First, outside counsel will generally have more experience with the finer points and nuances of corruption investigations than will in-house attorneys. This detailed experience can make or break an investigation. Second, engaging outside counsel will allow the company to assert the attorney-client privilege more easily. This is particularly true outside the United States, where the attorney-client and similar privileges are often recognized only with respect to outside counsel and not for in-house counsel. Finally, it may also be necessary to hire local counsel that has expertise in foreign laws – most likely those of the country in which the alleged conduct occurred. It should be self-evident that this local counsel should have experience not only with its local laws, but also with the FCPA.

When reviewing documentary evidence, the acquirer's diligence team should look for red flags such as service agreements involving "consulting fees" at an inflated rate or even service agreements where no services were actually provided. Accordingly, it is important to review not only the terms of agreements, but also whether the performance of these agreements matches up to the terms thereof. The red flag is that the parties may have concluded agreements or arrangements with the understanding that a portion of the proceeds will end up being paid as a bribe to a foreign official. Another common red flag in some countries might include heavy-handed "invitations" to contribute to "charities".

In relation to documents, it is also important for the investigating counsel to ensure that they have a legal right to review the documents – most commonly problematic being employees' correspondence (such as emails). Unlike the United States, a number of countries (primarily in the European Union) have stringent data privacy laws that prohibit, or at least severely restrict, third parties – including management and their advisors – from reviewing email correspondence of employees without the employees' individual consents. Employees must "freely" consent to have their documents reviewed, even though created in the course of employment. Whether a consent has indeed been given "freely" hinges on large part whether it includes an unequivocal statement that if the employee refuses to give the consent, the employee will not suffer any consequences. The consent should also inform the employee as to how the employer will use the data, e.g., local counsel will review it, the employer will transfer it to outside counsel in the United States for analysis, it will be forwarded to the SEC and DOJ, etc.

Document review can be done more efficiently by engaging a document review service provider than a gaggle of contract attorneys. The document review service providers help create custom searches to identify more easily key emails, rather than reviewing each email manually. Data mining technologies generally have evolved substantially in recent years in response to burdens imposed by e-discovery. Just like any other process, the more structure that is in place at the beginning of the document review stage, the more efficient – and productive – will be the entire process.

For the foregoing reasons, it is usually not a good idea in more serious cases for companies to engage in an internally-driven fact-gathering process, even if led by in-house attorneys and even if only as an initial matter, as this may jeopardize the attorney-client privilege, as well as thwart the outside attorneys' investigation that follows by putting employees on notice that something is awry. Additionally, employees will have had a chance to "rehearse" their answers for the next round of questions from outside counsel. A company may, of course, subsequently decide to waive the attorney-client privilege, but this should be by choice rather than inadvertently.

Interviews are often the most crucial aspect of an investigation as they allow the investigators not only to confront individuals with written evidence, but also to read interviewees' body language. Counsel conducting interviews needs to make clear that it is the company that is being represented, not the interviewee, and that it is the company that holds the attorney-client privilege, again not the interviewee. One issue that almost always arises is whether the interviewees should have their own personal counsel present. The answer to this question is rarely a simple "yes" or "no"; both local laws and the specific allegations that are being investigated will play a role in answering this question. Language may also be an issue. If the interviews are conducted by US counsel that is not fluent in the foreign language or the person being interviewed is not fluent in English, the availability and/or use of translators is a must. Finally, at the end of the interview, the interviewee should be reminded not to discuss the interview with colleagues or any other third party. Whether the interviewee will actually observe this request is an entirely different issue.

Finally, though it sounds obvious, management needs to understand that it cannot panic when it first learns of a possible corruption violation. Panicking includes destroying evidence (emails or other documents), asking employees or other staff to keep the matter quiet vis-à-vis investigators, or contacting the recipients of allegedly improper payments to inform them that trouble may be brewing and asking them to keep the matter confidential. Any action along those lines will not help matters and could have serious consequences for the investigation (and could be an aggravating factor if sanctions should subsequently be imposed).

Depending on the outcome of the investigation, remediation measures may be in order. Remediation measures might include: (i) disciplining the employees involved as well as their supervisors or managers, (ii) revising or supplementing employee training to make clear that such actions will not be tolerated, (iii) revising company policies to clearly set forth that such actions are not acceptable, and (iv) in the context of pre-acquisition diligence, introducing or revising language in acquisition agreements to protect the acquirer. Regardless of what remedial measures the company implements, they need to come straight from upper level management. Nothing sends a stronger message of indifference than handing this off to lower level employees. On top of that, to ensure future compliance, management should monitor compliance directly or, in the alternative, appoint an oversight committee of sufficiently high-level employees to undertake this responsibility.

Disciplining employees, including managers, may involve financial disciplining, placing a record in an employee's personnel file, or even terminating the employee. In these instances, local employment law will govern – and in this regard, it is important to bear in mind the significant differences between US employment laws and the employment laws of many foreign countries. Not all countries observe the employment at-will doctrine. In some countries, an employer cannot dock an employee's pay without the employee's consent (which the employee is unlikely to provide). In some countries, an employee may challenge in court a record in an employee's personnel file that the employee violated company policy. The same applies in some countries if an employer decides to terminate an employee – in some cases to the point that such challenges are almost standard procedure. As a matter of common sense, an employee who is terminated will be less inclined to cooperate with the investigation, regardless of whether the investigation is being conducted by the company, the government, or both; and in these cases, the risk of a terminated employee turning into a whistleblower increases.

Fortunately, both the SEC and the DOJ appreciate that foreign employment laws may hamper an employer's ability to terminate an employee, even for actions as egregious as the bribery of foreign government officials. Both the SEC and the DOJ also appreciate that a company may have rogue employees, meaning if certain employees violate a company's anti-bribery policy, this does not necessarily mean that a compliance program is deficient. The government does not expect perfection: as stated in the Guidelines, "no compliance program can ever prevent all criminal activity by a corporation's employees."

One way to help ensure that such violations are not repeated is by providing suitable anti-corruption training to employees. As the Guidelines note, "suitable" means (i) in the local language of the employees, and (ii) the training is updated regularly to ensure that it is current. The most effective method of driving the message home to employees that a company will not tolerate bribery is to go through hypothetical situations that the employees may actually face on the job. Just as importantly, the possible disciplinary measures employees may face if they should violate the company's bribery policies need to be highlighted – not as a scare tactic, but as a clear message that the company's culture is not one of bribing officials to retain or maintain business.

One common mistake in training is to focus exclusively on the FCPA and largely ignore local anti-bribery laws. Merely pointing out the "do's and don'ts" of the FCPA to overseas employees is not an effective method of training these employees. It would be prudent to ensure that training includes instruction on local anti-bribery laws *in addition to* the FCPA as all of these laws apply to local employees.

Written company policies will also ensure that employee are constantly reminded that bribery is not part of company culture and that employees who violate this policy will face disciplinary measures – regardless of their seniority. The SEC and DOJ will look for whether a hotline is in place, or some other means for employees to notify management (including anonymously) of potential violations of the company's anti-bribery policy. Just as foreign employment laws need to be observed when disciplining employees of a foreign subsidiary, US employers also need to be aware of foreign laws that may restrict their ability to establish a hotline. Under German law, for example, hotlines are generally subject to approval by a works council, meaning that if the works council does not approve the hotline, the US entity may not force a hotline to be established at a subsidiary in Germany. Other countries may have other restrictions regarding hotlines. In France, for example, hotlines may be used only for particular purposes, such as to collect tips regarding bribes or corruption; the same is true in Sweden except that hotlines in that country may be used to give tips only on senior personnel. It is essential to obtain advice before setting up an anonymous hotline in a foreign jurisdiction.

4. Self-Report the Problem

If the investigation reveals a violation, in addition to remedying the issue it is necessary to consider whether to self-report the violation. The self-report-or-not decision needs to be made quickly as the SEC and DOJ will give "credit" for a self-report only if they hear about the violation directly from the company itself or from its attorneys. If the government first learns about a violation from a whistleblower or another third party, then much of the benefit of self-reporting goes away.

Whether to self-report is a complicated decision. The advantage is that, as discussed above, the entity will ostensibly get credit for making the voluntary disclosure. The downside may be significant. Even with a self-report, the US government may nevertheless seek a criminal indictment, and heavy fines, self-monitoring and external monitoring are also real possibilities. Monitoring in any form is an expensive and time-consuming proposition, including extensive time commitments from management. Accordingly, management must be actively involved in the investigation and the defense of any corruption claim, as well as strategic decisions in respect thereof.

Whether it makes sense to self-report to non-US authorities may involve a different analysis. For example, German law does not expressly provide "credit" for self-reporting a bribery violation (unlike tax evasion or antitrust violations); moreover, Germany does not provide for criminal prosecution of corporations (only natural persons may be prosecuted for crimes). So a German corporation would be less inclined to self-report a bribery violation to German authorities except in the most egregious of cases where it is almost a given that German prosecutors will become aware of bribery violations. One notable exception includes where a company has decided to self-report to US authorities; it would then make sense also to self-report in Germany with the hopes that the German prosecutors take this into consideration during the investigation and possible prosecution phases.

Conclusion

The follow-up headlines to the headlines mentioned at the beginning of this article are sobering: "Alcoa to Pay $384 Million to Settle Bahrain Bribery Charges", and "After Bribery Scandal, High-Level Departures at Walmart". These headlines make clear that if corruption issues are ignored or given only scant attention during due diligence, they can be a real game changer for the company involved, thus heightening the risk for an acquirer in an M&A transaction. Companies are well-advised to keep the FCPA – and its foreign counterparts – at the forefront when conducting due diligence as part of an M&A transaction. The key is to pursue the transaction with an "eyes wide open" approach and a willingness to make the difficult decisions along the way. Even if no red flags surface during the due diligence phase, acquirers need to ensure not only that the target has proper policies and training in place, but also that any problems that arise post-closing are tackled swiftly and completely. A combination of the techniques described above can significantly mitigate the risks; but ignoring the problem is never an option.