CORPORATE COUNSEL
An ALM Website
corpcounsel.com | November 3, 2014

How to Conduct Due Diligence With the FCPA in Mind

From the Experts

Thad McBride

FOTOLIA

One of the more difficult issues in anticorruption compliance involves due diligence. It can be vexing even in the best of conditions. But often it is made more complicated by business pressures such those that arise in the context of a merger or acquisition or an urgent sales opportunity, which, of course, drive the need for diligence. Under the restrictions of limited time and money, due diligence generally requires many judgment calls, including identifying which resources to invest, what issues to prioritize and how to respond if a problem is identified.

Anticorruption compliance is always fact-intensive—and due diligence is no exception. Moreover, there is no such thing as perfect judgment. So in our experience, it is essential to develop a framework that ensures a consistent approach to weighting the factors that must be assessed, and the corresponding judgments that must be made, to deliver appropriate advice to your client.

Background

As many readers know, the Foreign Corrupt Practices Act (FCPA) is a U.S. anticorruption statute prohibiting bribery by U.S. persons of non-U.S. government officials. Under the plain language of the FCPA, jurisdiction under the law extends to U.S. corporations and individuals, "issuers" on U.S. stock exchanges, and persons, regardless of nationality, physically located within the United States. In addition to the law's antibribery prohibitions, there are provisions requiring that companies maintain accurate books and records and internal controls adequate to ensure that transactions are entered into only with management authorization, and in accordance with generally accepted accounting principles. While these provisions only apply directly to issuers, any company subject to the FCPA is well-advised to abide by them as a matter of effective compliance.

The FCPA is aggressively enforced by both the U.S. Securities and Exchange Commission and the U.S. Department of Justice. In recent years, monetary penalties for FCPA violations have been severe. Companies have been required to pay tens of millions of dollars or more. In addition, investigation costs—lawyer fees, those of forensic accountants engaged to review books and records, e-discovery costs, and other expenses—may match or even exceed the penalties themselves. Adding to the potential fallout from an FCPA violation, the mainstream press has given significant attention to FCPA investigations and settlements in recent years, resulting in some companies seeing their stock prices plummet or suffering other negative repercussions.

Under the FCPA, criminal penalties may be imposed for "willful" violations, including violations that arise from willful blindness. (Although the term "willful blindness" is not used in the statute, it serves as useful shorthand for the notion that parties may be held liable when they seek to avoid knowledge of an unlawful transaction.) Particularly in the case of engaging a third party, it is important to recognize that FCPA liability can be established in the case of actual knowledge or *constructive* knowledge. In this environment, companies simply have to take steps to identify actual (in the case of a merger/acquisition) or potential (in the case of engaging a third-party representative) corruption violations.

Due Diligence Steps

Notwithstanding the significant penalties that can be imposed for FCPA violations, even the U.S. government recognizes that companies have only a finite amount of time and resources to expend on anticorruption compliance due diligence. The government correspondingly recognizes, and in fact recommends, that companies adopt a risk-based approach. This recommendation is made plain in the FCPA Resource Guide that the DOJ and SEC published jointly in November 2012.

Thus, the first judgment parties must make relates to resource allocation. This in turn should reflect the type of transaction being reviewed and the level of risk posed by that transaction. We recommend reviewing the following factors to assess risk:

- The relevant geographic area (*e.g.*, is the area where the transaction will occur perceived to be particularly corrupt based on the Transparency International Corruption Perceptions Index or some other primary source?).
- The types and frequency of interactions the proposed transaction partner is likely to have with government officials.
- The extent of the compliance program maintained by the potential transaction partner.
- The importance of the prospective partner to the company's bottom line or future development plans. (Depending on the type of transaction on which diligence is to be conducted, other factors may also warrant review.)

Once a general sense of the risk has been established, the next step is to develop a due diligence team. Here again, important judgments must be made. For many companies that have a well-developed legal and/or compliance department, most due diligence can be conducted internally. For these companies, there may be only a limited role for outside counsel or other service providers.

In other situations, however, it may make sense to engage outside counsel to play a significant role in, or even manage, the diligence. For example, some sophisticated companies may nonetheless not have experience in a particular country, and therefore want assistance from outside counsel in conducting a review in that country. Other companies may lack the internal resources to conduct an appropriate due diligence review. There also may be cases that, because of the level of risk involved or the potentially high-profile nature of a transaction, necessitate engaging an independent third party to conduct the diligence. In addition to serving as independent, impartial reviewers, outside counsel can help cloak the diligence review in the attorney-client privilege.

The next step is to develop a plan. This should reflect the risks identified during the first step, as well as the team that will be conducting the diligence. In many cases it will be useful to augment the team with personnel—perhaps from accounting, audit and other groups—who can assist with the diligence. Regardless of the composition of the team, the plan should be clear about the steps needed, with the explicit understanding that additional measures may be required, depending on what is learned during the diligence. The plan is critically important both so team members know what is expected of them, and also as evidence (should it ever be needed) that the company followed a well-defined process to conduct the diligence. That evidence may be the best defense the company has if the U.S. government ever asks why a particular diligence step was or was not taken.

Next is the review itself and, as noted, this should follow the plan. Information about the proposed transaction partner should be collected and analyzed, and that information should be verified based on, for example, public records searches, reference checks, interviews, reviewing the proposed partners' records and other such steps. But not every due diligence step is necessarily productive. For instance, the FCPA guide suggests potentially placing a "pretextual phone call" to a potential third-party agent's offices. The benefit of obtaining information from such a call may be outweighed by the potential offense to the prospective agent.

Troubleshooting Problems

The goal of due diligence is to identify potential red flags, whether violations or simply worrying or notable facts that may be indicative of a violation. Addressing a red flag can be quite easy—in some cases, it's so big and bright that it should cause an immediate halt to the transaction. Alternatively, a red flag can be so benign and easily explained that it need not even slow down a transaction.

In many cases a red flag can create real questions that necessitate yet another judgment call. This is probably the hardest judgment of all to make. In our experience, it is almost always possible to identify a negative or potentially negative fact about a transaction partner if you look hard enough. And conversely, it is *never* possible to prove for certain that a prospective partner will not engage in a corrupt act.

We think analysis of red flags requires a thoughtful, adult analysis about exactly what the risk is and the level of risk tolerance that your company has. For instance, a solitary red flag related to a single transaction may well be an outlier. In such a case, even if there may have been a violation, it is likely that the potential of a future violation can be successfully mitigated through steps such as training, terminating the employee involved, or carving out an asset or business line.

To the extent that a red flag may represent a more systemic issue, it still may be possible to address that issue and proceed with the transaction. (Of course it also is essential to consider whether the benefits of the transaction outweigh its financial and logistical drawbacks.) If the company decides to proceed, or at least considers proceeding, it is important to think about corrective actions to minimize the issues identified through due diligence. First and foremost are measures to ensure that ongoing problems can be stopped immediately after the transaction; if not, we would almost certainly advise that the transaction should not proceed, as problems identified through due diligence that are not subsequently stopped would be the basis for a knowing violation of law.

And stopped means *stopped*. For good. The government has pursued enforcement actions against companies for taking "halfway" compliance measures that did not effectively halt problematic conduct. In addition, activities that continue beyond a merger or acquisition become violations attributable to the buyer's management.

Thus, it is essential to introduce compliance that can comprehensively address compliance issues. And it is crucial to accurately understand the source of the issue so that an appropriate response can be developed. Then, it is important to review whether the compliance measure introduced is in fact effective by conducting a follow-up review or audit. In addition to formal reviews, personnel should be instructed to be vigilant in monitoring that the compliance measure really has worked. Personnel are the best eyes and ears of the company, and they need to be utilized to that end.

Unlike the UK Bribery Act, the FCPA does not include a safe harbor provision by which a company can be insulated from liability if it takes appropriate steps to ensure compliance. However, the U.S. government has suggested that in the event that due diligence misses problems because of willful misrepresentation by the target, but the diligence process is otherwise sound, companies will not themselves be held liable. Similarly, in the context of mergers and acquisitions, the DOJ has suggested that it will not take enforcement action when parties work with it closely and transparently to identify and remediate violations, particularly when these could not be identified prior to the closing of a deal for reasons outside of the buyer's control.

Whatever steps are taken during diligence, whether few or many, they should be documented fully. Accurate and complete records should be maintained, including written information regarding the judgments made. Issues often arise well after the fact of diligence, and personnel responsible for conducting the review may have moved on to new positions or even to a new employer. Reassembling the events from several years earlier is far easier when there are accurate records.

The Bottom Line

Due diligence can be challenging, particularly because it requires personnel to make subjective judgments of risk, and to leverage business decisions that respond to those compliance-based determinations. It is inherent in this exercise that judgment decisions be made. To ensure that those judgments are consistent with those made in other diligence reviews, and to promote sound judgments in all diligence matters, it may be useful to consider the steps outlined in this article.

Thad McBride is a partner in the Washington, D.C., office of Sheppard Mullin Richter & Hampton. His practice involves advising U.S. and non-U.S. clients on understanding and complying with their obligations under the FCPA and other antibribery laws. *He would like to thank his former colleague, Mark Jensen, for his invaluable support in preparing this article—it quite literally would not have been written without his assistance.*