Emerging risk

For US private equity firms, investing in the emerging markets means increased compliance costs

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THE YEARS SINCE the financial crisis began have seen a significant change in the attractiveness of different markets around the globe. As a result, private investors in search of higher returns are increasingly seeking exposure to emerging markets. While this trend may be an inevitable consequence of slower growth prospects at home, private equity needs to keep in mind that a host of specialised legal compliance obligations accompany investments in most emerging markets, especially in countries perceived as posing corruption risks.

This article discusses the laws presenting perhaps the greatest risks to investors in emerging markets, and proposes some strategies to manage them: the US Foreign Corrupt Practices Act (FCPA) and the US Alien Tort Claims Act (ATS). As described below, a failure to protect against these risks can have dramatic consequences, not just for portfolio companies, but also for funds, fund sponsors and even investment professionals themselves. Successful implementation of well designed compliance strategies, however, can help funds and their portfolio companies manage these risks and avoid the worst consequences.

The FCPA and ATS: Dissimilar statutes posing similar risks

The FCPA criminalises bribery of foreign (non-US) government officials to secure business. It prohibits not only direct bribes to such persons, but also the making of payments to third parties such as agents while knowing that they will be passed through, in whole or in part, to such officials. It also mandates that all companies with publicly traded securities in the United States adhere to prescribed accounting and internal controls standards to ensure that investors can obtain a true and complete financial picture of the company's activities.

The ATS, on the other hand, is a human rights-related law that permits civil lawsuits to be filed in US courts based on alleged overseas misconduct. Although it was originally enacted in 1789, it only began to be used to target corporations in the late 1970s. Since the mid-1990s it regularly has been used to target multi-national corporations, most working in developing countries, for perceived human rights abuses.

Extraterritoriality: Both laws are extraterritorial in nature. The FCPA, by its very title, addresses conduct outside the US, and its provisions can apply to virtually any company or person anywhere, especially in emerging markets where public corruption can be common. The FCPA covers three classes of natural and legal persons: (1) US companies, citizens and permanent residents, who face perhaps the most expansive prohibitions as they can be liable for FCPA violations across the globe simply by virtue of their nationality; (2) issuers of publicly traded securities in the US (whether equity or debt), as long as some act in connection with prohibited payment touches the US in some way or they fail to comply with the accounting and internal controls requirements; and (3) in certain circumstances any person, including non-US nationals and non-US corporations, where some act in furtherance of a payment occurs in the US.

The ATS has a similar, extremely wide jurisdictional scope. Indeed, the law permits actions to be brought in the US by non-US nationals, against non-US nationals and companies, for conduct occurring outside the US. To date, nearly all cases against corporations and corporate officers result from conduct committed in developing countries, and companies in the financial sector are a common target.

Grave consequences: Both laws also can bring potentially grave consequences. Such exposure can arise at any point in the investment cycle, at the portfolio company or fund level, from the initial investment to exit. A dramatic recent example under the FCPA is that of Siemens AG's agreement in 2008 to pay $800 million in connection with a criminal plea agreement admitting billions of dollars in payments to secure contracts to government officials in numerous countries. In addition to the US fines, Siemens also agreed to pay an additional $900 million to German authorities in connection with the same conduct.

Private equity investors have been targeted in landmark FCPA cases as well. For instance, a recent case involved investors in a failed scheme to gain control over the State Oil Company of Azerbaijan during the late 1990s. In so doing, the sponsor, the so-called "Pirate of Prague" Victor Kozeny, made substantial payments to Azeri officials to cause the privatization and his investment fund's participation in it, resulting in FCPA charges. Indeed, Kosmos Energy, a Dallas-based oil exploration company backed by Warburg Pincus and Blackstone Group, currently is being investigated by the DOJ and Ghanaian authorities for alleged corrupt payments in connection with its purchase of development rights to Ghana's Jubilee oil field.

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ATS lawsuits carry similarly large potential liabilities, and often target the financial community. Most recently, in late 2009 a number of Sri Lankan plaintiffs filed suit against Raj Rajaratnam, founder of New York-based hedge fund Galleon Group, alleging his responsibility for human rights abuses in connection with his funding of the Liberation Tigers of Tamil Eelam (LTTE), better known as the Tamil Tigers. Numerous other ATS cases have been pursued against banks, financial institutions, and others in the sector based on their lending practices, employment issues, and other matters. And several ATS cases involving companies doing business in emerging markets have settled for well in excess of $10 million in the past five years, and two courts in 2008 entered judgments against corporate ATS defendants, for $80 million and $7.7 million respectively.

Third parties: Yet another common feature of FCPA and ATS cases is the pervasive involvement of foreign government entities and third parties. The FCPA, of course, regulates interactions with government personnel. Similarly, nearly all viable ATS claims involve underlying conduct committed by or in conjunction with government agents, whether they are security services, regulatory bodies, or others. This is particularly the case in those industries that receive the most foreign direct investment such as extractive, commodities or agricultural industries, or any other emerging markets industry requiring significant security presence, often in rural or unstable areas.

Additionally, non-governmental third parties are also a common source of FCPA and ATS liability, and have resulted in more FCPA enforcement actions that direct dealings with officials. Emerging markets businesses routinely engage a variety of agents, consultants, contractors, joint venture partners, customs brokers and others to navigate non-transparent local business environments. Similarly, most ATS plaintiffs do not contend that the defendant companies themselves committed the alleged human rights violations. Instead, they rely on theories of secondary or vicarious liability (such as aiding and abetting and conspiracy) to attribute the harms committed by those third parties to the corporations.

Effective compliance solutions: Mitigating the risk of successor liability and preserving investment value

As noted above, private equity investors face FCPA and ATS risks on two levels: the fund's own operations, and the operations of their portfolio companies. These risks are exacerbated in emerging markets due to often difficult working environments, a lack of regulatory transparency, the complexities of the FCPA and ATS, and a host of other factors inherent in working in developing countries. They can be managed, however, by adopting compliance solutions to protect the fund itself and/or the portfolio company both from successor liability for past target company actions, and the fund's and portfolio company's actions going forward.

Funds making emerging markets acquisitions face the risk of successor liability for past FCPA or ATS violations of the target. Effective, risk-based due diligence pre-closing and thorough post-closing integration are the principal means of managing this risk. Due diligence should be tailored to the target's specific profile, and focus on the primary risk areas such as the target's core assets (especially those dependent on government licensing or approvals), the strength of its compliance programs, interaction with governments, and third-party relationships among others. Appropriate contractual representations, warranties and safeguards should also be sought from sellers reflecting the results of the acquirer's diligence.

Emerging markets investors also carry the risk of FCPA and ATS violations directly at the fund and portfolio company operations levels. While portfolio company violations may reduce the value of an investment or complicate an exit, violations by the fund or professionals themselves can have worse consequences. There are, however, some practical compliance steps that funds can implement in portfolio companies and their own deal teams to manage these risks:

Adopt FCPA and ATS compliance policies: These can include baseline prohibitions, procedures for making lawful payments to foreign officials, travel, entertainment and hosting guidelines, a facilitating (or "grease") payments policy, policies for engaging security services, governments and other risky thirds parties (including developing specific contract language providing for audit and other rights), "know your customer" policies and others as appropriate. Policies should require due diligence on payments' ultimate beneficiaries, and the avoidance of dealings with politically exposed or other persons with a history of corruption, human rights abuses or other behavior raising "red flags". At a minimum, ATS policies should require adherence to international labor standards, and the use of force under the UN Voluntary Principles on Security and Human Rights.

Ensure strong financial controls: Finance personnel should be trained to identify problematic payments, unclear records, ensure all payments comport with applicable laws, and know when to raise issues arising under the company's policies and procedures. This is particularly important for issuers due to the FCPA's accounting requirements.

Effective policy implementation: Train key employees, including all who interact with foreign government personnel, security services, labor unions, and those who make financial decisions, to recognise common FCPA and ATS risks. Consider including third parties in training as well. Ensure knowledgeable personnel are available in real-time to provide guidance when questions arise.

Reporting, investigation and remediation and testing: Create mechanisms for employees and third parties to report problems. Foster an atmosphere that encourages such reporting, and when FCPA or ATS concerns arise, investigate and address immediately. Develop capacity internally and externally (through internal audit and outside counsel) to periodically test FCPA and ATS compliance.

Of course, private equity funds will need to adapt these compliance measures as the requirements of their portfolio companies and their own operations will be markedly different. While these measures cannot prevent every potential violation or address every risk, they can equip funds and their investments with the tools to manage FCPA and ATS risks in even the most difficult emerging markets. This in turn will protect the value of their investments, the funds and the investment professionals themselves as they divert ever more attention to investments in emerging markets. ■

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