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WHAT TO DO IF YOUR THIRD PARTY IS EMBROILED IN A CORRUPTION SCANDAL

Multinational companies may suffer severe reputational and legal risks if third parties with whom they deal become embroiled in corruption scandals. To address this situation, the author describes seven steps companies should take to mitigate potential damage. She closes with tips for companies to minimize future issues with third parties.

By Brigida Benitez *

Corruption continues to dominate worldwide headlines, and many national authorities have enacted anti-corruption laws and implementing regulations. Latin America is a prime example. Brazil's unprecedented "Operation Car Wash" (*Lava Jato*) and Argentina's more recent "Notebooks" (*Cuadernos*) scandal have led to scores of indictments and subsequent prosecutions. Brazil has also passed a Clean Company Act and shifted the focus of local prosecutors toward corruption. Multinational companies may be caught in the cross hairs when they are doing business with implicated parties in those countries, even if the third party's actions have nothing to do with the company's business.

Local procurement laws, as well as complex regulatory environments among other factors, often lead multinational companies to rely on third parties, such as contractors, distributors, consultants, sales agents, deal brokers, and legal advisors, to provide services and supplies within the region. When one of these third parties is accused of corruption, a company can find itself potentially tainted by association. In these cases, there are certain steps a company can take to address the issue and mitigate potential damage to the company.

This article provides practical guidance on how to address this type of situation.

ASSESS THE RELATIONSHIP

The first step is to assess the company's relationship with the third party. Among the factors to examine are the size and scope of the contract, the nature of the contracting process, and the timing of the contract. All of this will help in assessing the potential risk and exposure from the relationship and any changes to it. For example, is the third party a major vendor that solely supplies a key product to the company? Is it a distributor upon which the company is very dependent? This will help determine how easily the third party can be replaced if there is a change in the relationship. Also, is the contract amount in the tens of thousands or in the millions of dollars? Larger contracts have a higher-risk profile and thus may trigger further inquiry, even in the absence of other risk factors.

Even more importantly, how was the third party hired? It is critical to understand whether there was a competitive bidding process, who was involved in

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contracting the third party, and whether the company's standard approval process was followed. In some smaller markets in Latin America, for example, vendors are often contracted directly, and there may be a familial or other personal or business relationship between a company employee and the vendor. It is important also to consider the timing of the contract. Was a third party hired immediately after a local or national election? Has the contract been extended without a competitive bidding process without justification? These are all questions that should be answered to determine the risk level of the relationship with the third party. Indications that a third party may have been contracted outside of proper channels will assist in deciding whether to take a closer look at the relationship.

It is also essential to understand the terms of the contract. Is it an ongoing contract for a specific period of time or one that is project-based? How near is it to completion? Does the company have the right to cancel the contract and under what terms? If the company ultimately decides that it is best to sever the relationship with the third party, then it must assess its potential legal exposure under the contract, discussed further, below.

CONSIDER THE SOURCE

A company's response will also depend in part on the nature and credibility of the source of the information about the third party's alleged involvement in corruption. Was this an allegation made by a competitor, perhaps someone who lost a valuable contract in a bidding process, or even an internal whistleblower? Is this a press article by an investigative journalist (and where has it been published)? Or has the third party actually been indicted in a criminal proceeding? If the allegation is not yet public, or has not been widely publicized, then there may be more time to assess the information and take action. Also, if the source is not particularly credible – such as a tabloid newspaper – then the reaction can be more measured. But, of course, if there has been an indictment, then the level of seriousness increases and the response should be proportionate.

EXAMINE THE CONTEXT AND EVALUATE THE REPUTATIONAL RISK

As part of this initial inquiry, it is worth considering the current environment at the company, and assessing

recent changes or contemplated actions. Have there been recent additions (or resignations) on the board of directors? Is there a pending transaction, such as a merger or acquisition? Is there an upcoming shareholder meeting, in the case of a public company? Has there been any other public controversy that has affected the company? These types of factors should not dictate the company's response, but they have to be considered, particularly in developing and implementing the company's communications and media strategy. All of these factors can come into play and the company's reaction may have significant implications on the business side.

Indeed, one of the company's key concerns will be the potential reputational risk of being associated with a third party that is caught up in a corruption scandal. This is why it is critical to understand the facts surrounding the third party. As the company is determining its steps from a legal perspective, there should be a parallel track preparing a communications and media response to the situation.

CONDUCT AN INTERNAL INVESTIGATION

If the allegation is raised by a credible source and/or the vendor at issue has a significant contract with the company, a company must consider launching an internal investigation. Internal investigations can be done in-house, generally through the legal or compliance team, or can be done together with outside counsel and/or an external auditor. In order to maintain the privileged nature of an investigation, it is safest to have the investigation conducted by outside counsel, especially in jurisdictions outside the US.

With any investigation, the essential first step is to determine the scope. With a specific allegation, it is easier to accomplish this, as any investigation would be focused on the third party. But once you make some initial determinations about how the third party was hired, any unusual steps in the process or other areas of concern, that scope should probably expand so that a company ensures that it is addressing what may be a larger problem. Scope is important because the investigation has to be sufficient to identify potential issues without turning the company upside down.

An internal investigation would include collecting documents, such as e-mails, accounting documents, and

records of meetings and approval processes, interviewing employees involved in contracting or managing the third party, and auditing the payments made to the third party. This step may not only provide further clarity of risk and bring to light potential misconduct within the company, but is also a valuable step in creating a defense should a government regulator enter the picture. Ultimately, an important goal of the internal investigation – no matter the size or length – is to establish a basis of facts that will allow the company to determine how to move forward with the third party.

COMMUNICATE WITH THE THIRD PARTY

At some point, the company will likely have to address the issue directly with the third party in question. The timing will depend on a number of factors, including the source of the allegation. In the face of an indictment, for example, the company would be justified in immediately contacting the third party for information. In the context of other allegations, it may be best to do so as part of the investigation, where the company could interview key personnel and request documents that would help complete the findings of the internal investigation. For example, it might be helpful for establishing the ownership structure of the vendor, or for clarifying the relationship between the vendor and any potential agents. The third party could be asked to provide official documents, such as ownership records or contracts, which are verifiable and would provide additional support for findings. It may even be possible to do a full or partial audit of the vendor's books and records, especially if such a right is provided for in the contract.

There may be situations in which it may not be necessary, or even in the company's best interests, to communicate directly with the third party. If the internal investigation has uncovered strong evidence of misconduct, a company may make the judgment that interviews of the third party are not necessary or would not be helpful.

ANALYZE THE CONTRACTUAL RISK

In the event that there is strong evidence of misconduct or high risk of reputational harm, termination of the contract may be the best option on the table. Of course, the benefits of the termination must outweigh the downsides of any potential contractual liabilities. Before terminating a contract, a company should take into account both financial and reputational

consequences. If terminating the contract would lead to expensive, prolonged litigation, or a high settlement, consider whether there are alternative ways to mitigate the risk of maintaining the vendor rather than immediate termination. Additionally, a contract that is due to end soon might be best to leave untouched, unless there is clear evidence of misconduct. It may be possible to phase out the third party and ensure it is not invited to participate in further bidding process with the company or its contractors.

On the other hand, once a third party is mired in a high-profile corruption scandal, there may be intense pressure from both the government and the public to disassociate from it. Cutting the contract and taking the loss may be well worth the savings in reputational harm, especially in industries already struggling with a negative public image and in countries where there may be a higher perception of corruption.

ASSESS POTENTIAL CIVIL AND CRIMINAL LIABILITY

The Department of Justice and the Securities and Exchange Commission continue to actively pursue charges against companies and individuals under the US Foreign Corrupt Practices Act ("FCPA"), not only for bribery and corruption, but also for violations of the books and records, and internal controls provisions. Under the FCPA's accounting provisions, a company under US jurisdiction can be held liable for failing to (1) maintain complete and accurate books and records and (2) maintain a system of internal controls, which is construed to include a compliance program. A corruption scandal indicating that funds paid to third parties were improperly booked may trigger an investigation. If proper records and controls were not maintained, a company may be charged even without evidence that certain payments constituted bribes. Launching an internal investigation and properly addressing risk and evidence of misconduct can serve as a critical defense to a government investigation.

A company will also need to consider the laws of the jurisdiction where the third party provided services, including, of course, national anti-corruption laws and regulations. The conduct may also fall within the scope of local laws and regulations. And if the company is involved in any public projects, such as those involving financing by international financial institutions, such as the World Bank, those entities may also begin separate (though often coordinated) investigations. With increased anti-corruption efforts and cooperation among

regulatory authorities, a company must be prepared to coordinate a multijurisdictional response.

TIPS TO MINIMIZE FUTURE ISSUES WITH THIRD PARTIES

Conduct Robust Due Diligence

Given the common risks associated with third parties, the best strategy is for companies to have a robust due diligence system at the front end, especially for high value contracts. This will not only help to protect the company from getting unknowingly wrapped up in a corruption scandal, but also provide a credible defense should the preventive action fail.

Due diligence should be a systematic process built into the contracting process. It can take place before bidding for the contract begins or before the contract is awarded. Conducting due diligence earlier in the contracting process may decrease the chances that the system is manipulated to benefit third parties later in the process. Due diligence should include review of official ownership records to identify owners and searches in databases, such as World Check, to identify potential Politically Exposed Persons (“PEPs”), or sanctioned entities or individuals. Potential contractors should be asked to identify relationships with PEPs through anti-corruption questionnaires, and employees should run searches on social media platforms as an extra check.

The contracts with third parties should also provide another layer of protection. These should ideally contain anti-corruption provisions and required certifications by third parties, audit rights, and training.

It is important to bear in mind that corruption schemes often operate through straw persons (*testaferros* in Spanish) and even with these processes in place, well-concealed relationships with government officials might still exist. And in some jurisdictions, those ownership records are challenging to obtain and the ownership structure of entities is often not transparent. Strong policies, however, help ensure that the company’s internal controls are aligned with the expectations set under US rules and regulations.

Create Controls for High Risk Vendors

Not all contracts create equal risk. Certain contracts, by the nature of the activity involved or the amount of the payments, are inherently high risk and benefit from a system of controls even after the contract has been awarded. This is particularly true for services that involve direct interaction with government officials; for

example, certain legal advisors, agents who assist with obtaining permits, and government relations consultants. Risk can also increase where companies have connections to government officials through labor parties or due to the reliance of a town on employment provided by the company. Contracts with high value amounts are also high risk and may require more controls, even without other risk factors being present. Additional controls should include mechanisms for ensuring legitimate services were provided and a system for identifying red flags through the course of the relationship with the vendor, such as frequent extensions of the contract or increases in contract value.

Enforce Policies on Interactions with Government Officials

Remember that a company can require vendors to adhere to its policies, and having clear policies with respect to interactions with government officials that apply to third parties should be a given. Policies should specifically address meals, gifts, and other entertainment, and should set guidelines regarding the agreements and representations the third party is permitted to make. These can be included in anti-corruption provisions set forth in contracts or a separate agreement signed by the third party. Consider, furthermore, providing training to third parties on the FCPA and local anti-corruption laws. This educates third parties on the reasons behind the policies and demonstrates that the company is serious about compliance by third parties.

Refresh Due Diligence

While a robust due diligence process at the front end is necessary, it is critical for companies periodically to refresh the due diligence on third parties. In addition to any regular certifications, it is often helpful to conduct some basic due diligence on third parties to confirm that there have not been any significant changes in ownership or that no issues of concern have arisen, especially in the public sphere. This is particularly important to do at the time of any contract extension or renewal. How often due diligence must be refreshed depends on the risk profile of both the company and the third party, the relevant industry, and the geographic location of the company’s operations.

Implement Functional Reporting Mechanisms

The lynchpin of the above risk mitigation options is an effective system for reporting potential violations of anti-corruption policies and laws, and investigating those reports. It is best to have multiple streams for reporting

concerns, and at least one should be anonymous – for example, an anonymous hotline. The reports should go to legal, compliance, or an ombudsperson, rather to anyone working in the company’s operations. A company’s employees, who are generally the ones working directly with third parties, should feel empowered to report potential issues to the company and know that those issues will be taken seriously.

CONCLUSION

Anti-corruption risk, especially arising from third-party relationships, cannot be eliminated altogether, but there are steps that a company can take to mitigate those risks at the front end and hopefully avoid having a third party get caught up in a corruption scandal. But even if risk mitigation has not prevented that situation, a company can still recover if it takes thoughtful, deliberate, and quick action in response. ■