Avoiding FCPA Liability by Tightening Internal Controls

Considerations for Institutional Investors and Corporate Counsel

By H. David Kotz and Susan M. Mangiero

In early May of this year, Avon Products, Inc. (Avon) announced that it expected to pay $135 million to end long-standing federal probes of alleged violations of Foreign Corrupt Practices Act (FCPA) provisions relating to books and records, and internal controls. According to its securities filing, the settlement requires the global beauty product company to pay $68 million to the U.S. Department of Justice (DOJ) and $67 million to the U.S. Securities and Exchange Commission (SEC). While this amount is larger than an earlier proposed $12 million settlement, it pales in comparison to the estimated $340 million already spent for an internal investigation and legal fees. Additional costs may arise, depending on the findings of a compliance monitor, who will be installed for at least 18 months.

Avon is not alone in paying big money to settle FCPA allegations with various federal regulatory organizations. This is just another example of a company paying out significant amounts to the DOJ and SEC as part of an FCPA settlement that arose out of lack of internal controls. In April 2014, Hewlett-Packard Company agreed to pay $108 million in fines, penalties, and disgorgements in an FCPA settlement regarding its subsidiaries in three countries allegedly making improper payments to government officials to obtain or retain lucrative public contracts. In January 2014, Alcoa agreed to pay $384 million to settle alleged violations of the FCPA relating to its subsidiaries purportedly paying bribes to government officials in Bahrain to maintain a key source of business.

Anyone expecting a diminution of activity is in for a rude surprise. In 2010, the SEC announced the creation of a specialized unit to police FCPA violations. In 2014 alone, the DOJ has initiated a number of new enforcement inquiries. Concern about illegal payments of bribes to non-U.S. government officials by businesses and fraudulent reporting practices is taking center stage in mergers and acquisitions as well. The last thing a buyer wants is to inherit an expensive FCPA problem that did not show up as part of deal due diligence.

The price tag of non-compliance can be significant. Figure 1 summarizes some recent FCPA settlements. One thing is clear: The amounts of money are large. They are even bigger when related expenses are considered to include in-house analyses, litigation defense, and rehabilitation monies for things such as employee training, improved monitoring systems, and the hiring of a specialized compliance officer to address business development protocols with foreign vendors.

Figure 1: Recent FCPA Settlements

Company	Amount ($ Millions)	Date of Settlement
Hewlett-Packard Company	108	April 9, 2014
Alcoa Inc.	384	Jan. 9, 2014
Archer-Daniels-Midland Company	36	Dec. 20, 2013
Weatherford International	250	Nov. 26, 2013
Diebold, Inc.	48	Oct. 22, 2013
Total S.A.	398	May 29, 2013
Eli Lilly and Company	29	Dec. 20, 2012
Tyco International	26	Sept. 24, 2012
Pfizer Inc.	45	Aug. 7, 2012

Company insiders and corporate counsel are not the only parties tasked with taking action to avoid FCPA non-compliance problems and to correct deficiencies should any occur. As will be discussed in a later section, institutional investors likewise have a need to know whether a company in which they plan to invest or have already invested is exposed to potentially expensive FCPA liabilities that could destroy shareholder value.

FCPA Action Steps

Institutional investors such as pension funds, endowments, foundations, and sovereign wealth funds need to understand the nature of this federal law and what companies should do to stay out of trouble. This section addresses the core elements of the FCPA and offers action steps for any organization that does business outside the United States.

The FCPA has two main provisions, known generally as the "anti-bribery" and "books and records" provisions. The anti-bribery provisions prohibit improper payments of money or "anything of value" to a "foreign official" in order to "obtain or retain business." The books and records provisions require issuers of securities to maintain accurate books and records and ensure that internal accounting controls are in place.

On Nov. 14, 2012, the DOJ and SEC jointly released FCPA: A Resource Guide to the U.S. Foreign Corrupt Practices Act, available at http://1.usa.gov/1uPxdfB. This Guidance provides valuable information concerning how the government interprets the FCPA.

Tightening up internal controls and putting in place an effective compliance program are crucial for lessening or even eliminating FCPA exposure. The primary elements of an effective compliance programs are as follows:

Establishing Written Policies and Procedures

Standards must be put into place in the form of written policies and procedures, such as a code of conduct, to detect and prevent unethical or criminal behavior. The FCPA Guidance also indicates that companies should update compliance policies in light of the constant evolution of

a company's business changes over time, as well as changes in the environments in which it operates.

Establishing Compliance Officers

Specific duties should be assigned to individuals within all levels of the entity with authority for the compliance and ethics programs. The FCPA Guidance stresses the importance of commitment from senior management, noting that compliance begins with the board of directors and senior executives setting the proper tone for the rest of the company.

Establishing Risk Assessment And Internal Audit Procedures

Actions must be taken to assess the risk of improper conduct and to establish procedures for internal examination of an entity's environment to evaluate internal controls, policies, and guidelines, and to ensure that these policies work in an effective manner.

Establishing Continual Training Programs for Employees and Third Parties

All levels of the organization must be trained on its standards, procedures, and other aspects of the compliance and ethics programs.

Establishing Whistleblower Programs

Mechanisms must be put in place to allow employees to confidentially report potential violations or infractions.

Taking the Appropriate Response

Entities must conduct comprehensive and fair internal investigations of allegations of misconduct, and take disciplinary actions against those found to be in violation of company codes and ethical standards. Particular attention should be paid to ensuring that controls are in place in the areas of the greatest exposure. For example, the following accounting controls must be established and tested to ensure that they work efficiently:

Accounts Payable

Controls should be set up to ensure that invoices are legitimate, and supporting documentation corresponds to the amount in the invoices.

Payroll

Responsibilities in this area must be segregated, and the payroll register should be matched with supporting documentation.

Reimbursement of Expenses

Reimbursement should require appropriate approvals and backup documentation.

Petty Cash

Petty cash should be disbursed appropriately, and restrictions should exist on the nature and amount of items that can be paid from petty cash.

Accounts Receivable

Ledgers should be reconciled, and write-offs approved.

Bank Accounts

Bank accounts should be identified, and efforts should be made to verify who is authorized to sign checks.

In addition to accounting controls, the following areas should be closely monitored:

Relationships with Third Parties

Controls must be instituted over the selection and performance of vendors. The Guidance also stresses comprehensive, risk-based due diligence on third parties and transactions.

Gift-Giving

The FCPA's anti-bribery provisions prohibit individuals and businesses from bribing foreign government officials with the "payment of money or anything of value." Accordingly, policies must be established to ensure that gifts are not given for improper purposes.

Charitable Donations

The Guide makes clear that "legitimate charitable giving does not violate the FCPA." But companies "cannot use the pretense of charitable contributions as a way to funnel bribes to government officials." Therefore, processes must be put into place to confirm that donations are legitimate, and not bribes in disguise.

Political Contributions

Controls must ensure that those who receive political contributions are not in a position to benefit the entity in an improper manner.

The Role of Corporate Counsel

The foregoing list is not exhaustive. Facts and circumstances will determine the extent to which a global business must augment its staff, compliance infrastructure, and reporting mechanisms. Corporate counsel can play a vital role in multiple ways. A company's legal officers can mandate FCPA training to be offered on a multidisciplinary and multi-country basis. They can urge the creation of a report card system and the subsequent engagement of an independent party to periodically review the company's success rate in adhering to its FCPA-compliant policies and procedures. In-house counsel can run a mock audit as an offensive mechanism to forestall any regulatory enforcement and/or civil litigation. Good results could be used to negotiate a "safe driver's discount" from underwriters of directors and officers liability insurance. The list goes on.

Institutional Investors As Corporate Watchdogs

As with any other alleged or proven corporate breach of duty to obey the law, shareholders are the ultimate check writers. Their portfolio returns are lowered if one or more of the companies in which they have invested has an FCPA problem. However, economic drains are only one of several motivations for seeking redress. Advancing good governance is another factor. As laid out in the Investor Statement in Support of the U.S. Foreign Corrupt Practices Act, signers that include the then-chief operating officer of the International Corporate Governance Network are aware that "poor control of corruption and bribery can be an indicator of future risk at global corporations and can thereby negatively impact long-term shareholder value." See FCPA Investor Letter for Circulation, June 28, 2012, ICGN.org. Available at http://bit.ly/1oK0EdG.

This focus on FCPA compliance comes none too soon, inasmuch as institutions allocate significant amounts of money to offshore investments, including those in emerging market countries where transparency of process may be limited. See Robert Stowe England, Investors Poised to Boost Emerging Markets Debt, Despite Jitters. *Institutional Investor* (Feb. 25, 2014), available at http://tinyurl.com/kxslevw.

The need to conduct a comprehensive investment due diligence by institutional investors or their consultants or advisers is a familiar concept with respect to selecting, maintaining, or shrinking a position in a corporate-issued stock or bond. Surprising, however, is a dearth of evidence that rigorous FCPA inquiries are being made as part of a request for proposal (RFP) and/or regular reviews of a service provider with worldwide reach. If true, this is not a good thing. Any time an investor or its agent makes a decision based on less than full information, there is a chance that the outcome will be suboptimal in terms of the tradeoff between risk and expected performance. When this occurs, a trustee or other type of investment fiduciary may be accused of breaching his or her duties to be prudent and exercise care and diligence.

Moreover, a failure to gauge the FCPA liability exposure of companies that issue securities that institutional investors purchase is inconsistent with various "pay-to-play" laws. Besides the SEC's adoption of new rules in the municipal securities area, numerous states have established

prohibitions against bribes or seemingly less overt economic incentives that could inappropriately sway public officials. The goal is to avoid further scandals where government executives are induced to let money managers handle a slice of the roughly $2.5 trillion in public pension fund assets. See Rebecca A. Sielman, Milliman 2013 Public Pension Funding Study (November 2013), available at http://tinyurl.com/k4syxbk.

The headlines are replete with independence trouble spots, and "pay to play" is no exception. In 2013, New York Department of Financial Services Superintendent Benjamin Lawsky sent subpoenas to various consulting and asset management firms that handle state and city pension business to better assess "controls to prevent conflicts of interest … " See Mary Williams Walsh, New York Is Investigating Advisers to Pension Funds. *New York Times Dealbook* (Nov. 5, 2013), http://tinyurl.com/k9dydec.

In 2011, it was reported that the SEC had begun investigations as to whether banks, private equity funds, and other types of financial organizations were in compliance with the FCPA as they sought to raise capital and/or manage assets belonging to sovereign wealth funds. See Peter Lattman and Michael J. De La Merced, S.E.C. Looking into Deals with Sovereign Funds. *New York Times Dealbook* (Jan. 13, 2011), http://tinyurl.com/4sfkum9.

Even if an institutional investor has satisfied its need to know about FCPA procedures ahead of investing in a particular company, problems could nevertheless arise. When that occurs, an institutional investor is likely to sue in order to be made whole. Indeed, some pundits suggest that these institutional stewards of other people's money have a fiduciary duty to take legal action. Consider the case of Wal-Mart Stores Inc. (Wal-Mart). Following the news about a bribery faux pas in Mexico, civil litigation ensued. See Mark Friedman, Wal-Mart's Costs Connected to Mexican Bribery Case Reach $400M. *Arkansas Business* (Dec. 9, 2013), http://tinyurl.com/q5cwysa.

Several pension plans, including the $183.8 billion California State Teachers' Retirement System (CalSTRS), were named as lead plaintiffs. See CalSTRS, Investments Overview (2014), available at http://bit.ly/1uSzEy7. In late 2013, Wal-Mart shareholders were told that the company "expects to spend between $75 million and $80 million in FCPA and compliance-related expenses in its fourth quarter alone." See Jacyln Jaeger, Court: Shareholder Lawsuit Against Walmart Can Proceed. *Compliance Week* (Dec. 27, 2013), http://tinyurl.com/lhmnhgu.

In the Wal-mart Global Compliance Report, investors were informed that anti-corruption training was provided to in excess of 100,000 individuals between year-end 2011 and the beginning of 2014. See Wal-mart, Global Compliance Program Report on Fiscal Year 2014 (2014), http://tinyurl.com/lpqkh23.

Conclusion

A company with foreign dealings has a choice. It can implement a robust FCPA compliance infrastructure and follow its rules accordingly, or it can count on being lucky. Corporate counsel has a vital role to play in guiding its internal clients to understand what is expected, advising on

pitfalls to avoid, and recommending action steps such as training and compliance benchmarking by independent outside experts. External attorneys, general counsel, and chief compliance officers for asset managers and institutional investors can similarly advise their respective clients to do whatever it takes to minimize the risks of violating FCPA or failing to carry out comprehensive due diligence of companies with which it deals. FCPA enforcement is not going away, global business transactions are on the rise, and the costs of bad practices are far from trivial.

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