Investors, Brazil and the FCPA: Minimizing M&A Risk in the Wake of Lava Jato

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The recent uptick in the mergers and acquisitions market in Brazil comes at a time of great upheaval in Brazil. Brazil's sweeping anticorruption investigation, which is more than three years old, has resulted in more than 844 search and seizure warrants, 201 arrest warrants, 158 whistleblower agreements, and 10 corporate settlements (known in Brazil as "leniency agreements") with some of the largest companies in Brazil. Some companies implicated in the scandal have been forced to restructure or file for bankruptcy as a result of their involvement.

Given the active role of Brazilian authorities and the expansive nature of the Foreign Corrupt Practices Act (the "FCPA"), the U.S. legislation that prohibits corrupt payments to non-U.S. government officials, investors need to be mindful of their approach to acquisitions where the targets may be connected to the corruption scandals. This issue is particularly present in "distressed" acquisitions, where one of the sources of distress has been corruption-related terminations of government contracts or other consequences flowing from allegations of corruption.

Fortunately there is a well-worn path, informed by past settlements as well as guidance from U.S. regulators, that helps investors either avoid buying tainted companies or lessen the risk of exposure to corruption-related liability when making investments in tainted companies. To avoid or reduce these risks, investors need to be aware of and plan for circumstances unique to the Brazilian context. Appropriate diligence and early planning can help to minimize the risks and capitalize on the opportunities presented by the Brazil M&A market.

Overview of the FCPA

FCPA

Enacted in 1977, the FCPA is the *most* vigorously enforced foreign anti-bribery legislation in the world. It casts a wide net and can potentially lead to actions by U.S. authorities related to the purchases of targets abroad that have been tainted by bribery. Unlike many foreign bribery laws, the FCPA has two potential sources of liability.

FCPA Sources of Liability

— An anti-bribery provision that prohibits corrupt payments of anything of value to a foreign official in order to obtain or retain business or for an improper purpose. This provision requires that the illicit payment have a U.S. nexus, such as a U.S. person or company making the bribe, the parties acting in furtherance of the bribe within the U.S., or, for U.S. issuers, the bribery occurring in connection with U.S. interstate commerce.

— "Accounting" provisions, which require *any* issuer of securities listed in the U.S. to maintain accurate books and records *and* to maintain a system of internal controls sufficient to provide reasonable assurance that corporate assets are used only for authorized purposes and that an issuer is able to prepare financial statements according to appropriate accounting standards. Importantly, an issuer may be liable under these provisions for inaccuracies in the books and records of a subsidiary and for failing to maintain appropriate internal controls that prevent bribery in a subsidiary.

The accounting provisions, in particular, are often the hook through which foreign issuers are found liable for FCPA violations. A bribe by a foreign issuer is invariably intentionally falsely recorded on its books, leading to accounting provision liability regardless of any U.S. contacts (other than its issuer status) or the materiality of the false record.

The Department of Justice (the "DOJ") and the U.S. Securities and Exchange Commission (the "SEC") are responsible for enforcing the FCPA and have a wide array of tools at their disposal to do so, including fines, disgorgement of ill-gotten gains, and the power to impose non-monetary penalties, such as debarment and the appointment of a compliance monitor. U.S. regulators have also developed programs to encourage the voluntary disclosure of potential corrupt acts, with the promise of lower fines or even the possibility that prosecutors would decline to prosecute the illicit activity, as a reward for cooperating with authorities.

Successor Liability

Generally, under U.S. law buyers are not liable for pre-acquisition crimes of the target, but an acquisition cannot extinguish the pre-close liability of the target.[1]

The standard corporate rules of U.S. successor liability apply in the FCPA context

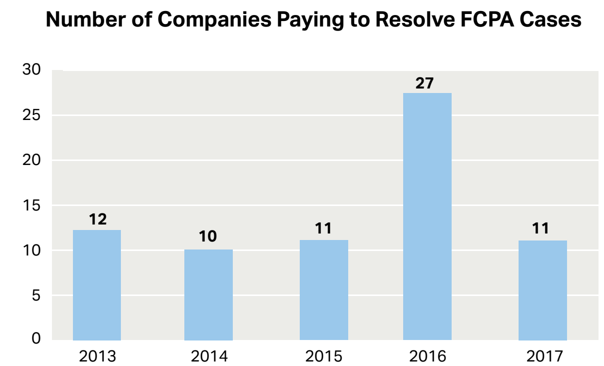
— A purchaser that purchases the stock of another company and maintains such company as a subsidiary does not assume liability for pre-acquisition violations by the subsidiary; liability remains with the newly-acquired subsidiary.

— Absent fraud or an asset sale that is essentially the purchase of an entire company, a company that purchases the assets of another does not assume liability for any pre-acquisition violations by the seller; liability remains with the seller.

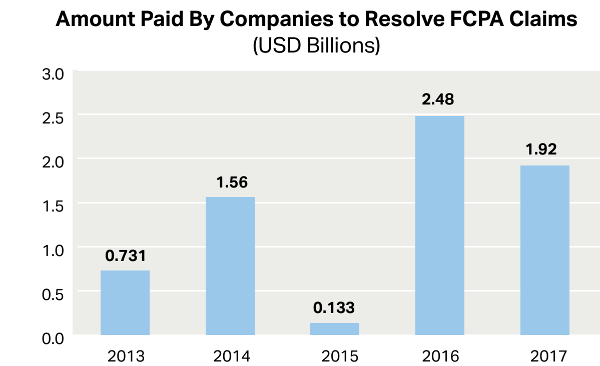
— In a merger between two companies, the surviving entity assumes liability for any violation committed by either company prior to the merger.

If a target committed bribery but there was no FCPA liability at the time the bribe occurred, an acquisition of the target by a U.S. company does not retroactively create FCPA liability for that bribe. As stated in 2012 guidance from the DOJ and the SEC, "Successor liability does not…create liability where none existed before." (Of course, there may be continuing liability for the target under any local anti-bribery law.)

Thus, if there is a concern that a target may be tainted by the recent Brazilian corruption scandals, buying assets is likely the safest approach; and a merger the riskiest strategy. While other business concerns will generally outweigh any corruption issues, in certain transactions, structuring the transaction with these principles in mind may help contain or avoid FCPA liability.



Source: http://www.fcpablog.com/blog/2018/1/2/2017-fcpa-enforcement-index.html



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Mitigating the Risks of Acquiring Assets Tainted by Corruption

The Importance of Effective Diligence

An investor's primary line of defense is due diligence. In addition to protecting a company against risk, effective pre-acquisition due diligence can also ensure proper valuation and post-acquisition planning. Indeed, the DOJ and SEC have consistently advised companies to perform thorough due diligence as a defense against an enforcement action and have declined to prosecute pre-acquisition conduct where the buyer performed adequate diligence, disclosed any violations and took remedial measures post-close.[2] In a 2002 opinion, the DOJ laid out the steps a company should take during its due diligence pre- and post-close:

— conduct thorough risk-based FCPA and anti-corruption due diligence;

— implement the acquiring company's code of conduct and anti-corruption policies as quickly as practicable;

— conduct FCPA and other relevant training for the acquired entity's directors and employees, as well as third-party agents and partners;

— conduct an FCPA-specific audit of the acquired entity as quickly as practicable; and

— disclose to the DOJ any corrupt payments discovered during the due diligence process.

Regarding the last point, actual disclosure to U.S. authorities should only be made after a careful assessment of the risks and benefits associated with any such disclosure.

In general, a diligence plan should be risk-based, with enhanced diligence for higher-risk transactions. For example, deals in which the target is part of a corporate structure in which a related company has been prosecuted or is being investigated for corrupt payments demand more expansive diligence efforts. An enhanced diligence plan could include:

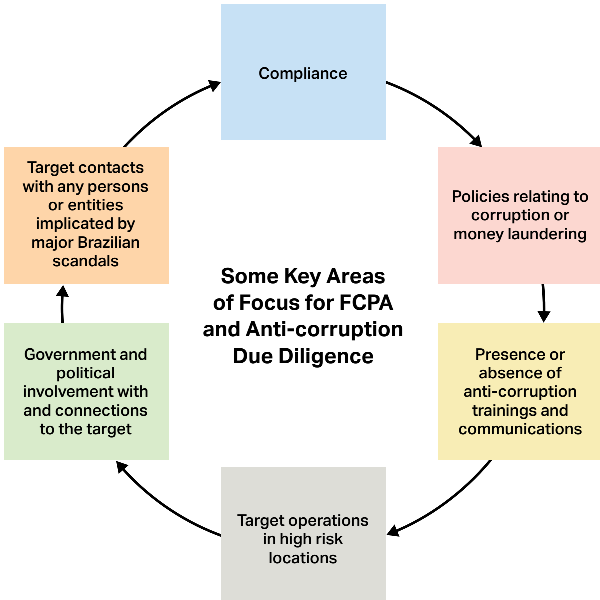
— document requests going back five years (the FCPA statute of limitations);

— interviews of key senior officials with knowledge of the risks and the company's response to such risks;

— an assessment of any existing compliance program; and

— where applicable, updates on the progress and findings of any internal investigations relating to bribery or corruption carried out by the target or seller.

Investors should also consider engaging support firms, such as forensic accounting firms (which can review internal controls and high-risk transactions), reputational diligence firms (which can review sanctions lists, debarment lists, and media reports), investigative firms (which can conduct discreet inquiries), and business intelligence firms (which can examine strategic risk or political concerns). Many forensic accounting firms based in Latin America have developed extensive knowledge of *Lava Jato* and know what to look for, including known intermediaries for corrupt payments.[3]



Minimizing Risks Through the Transaction Agreement
In addition to conducting diligence, an investor should also contractually protect itself with anticorruption contract terms. While even the best contract terms are not a defense to FCPA liability, they can push sellers to disclose corruption incidents or investigations and compliance weaknesses. Typically, these provisions include FCPA-specific representations and warranties in the acquisition or asset purchase agreement. While some terms are relatively common, there is considerable variation in the scope of these representations and they may be heavily negotiated.

Sample Anti-Corruption Representation

"Neither the Company or its Subsidiaries, nor any director nor, to the Knowledge of the Company, any agent or other person acting on the Company's behalf has (i) used any corporate funds for any material unlawful contribution, gift, entertainment or other material unlawful expense relating to political activity; (ii) violated the Foreign Corrupt Practices Act of 1977, as amended, or the Brazilian Clean Company Act or made a material violation of any other applicable anti-bribery or anticorruption law; or (iii) made, offered, agreed, requested or taken an act in furtherance of any material unlawful bribe or kickback or other unlawful or improper payment or benefit. The Company and its Subsidiaries have instituted, maintain and enforce, and will continue to maintain and enforce, policies and procedures designed to promote and ensure compliance with all applicable anti-bribery and anticorruption laws."

Key Considerations For Buyers In Evaluating FCPA Representations In Contracts

— Whether compliance with corruption laws representations are materiality qualified;

— Whether compliance with corruption laws representations are knowledge qualified and, importantly, how "knowledge" is defined (e.g., the knowledge of every employee of the target, the knowledge of a select group of target executives, knowledge of the sellers, knowledge after due inquiry);

— How far back in time a corruption representation covers (the FCPA statute of limitations is five years but U.S. authorities, using conspiracy or other theories of liability, have extended that limitations period considerably); and

— Whether the target has a compliance program or internal controls that will alert them to possible violations (i.e., the representations may be given in good faith by management or the sellers, but may be inaccurate if they have little knowledge of potential bribery by front line employees).

Suggested Enhanced Contractual Protections Where There Is Already Evidence of Corrupt Activity

— Requiring the target to conduct an internal investigation and take remedial action (e.g., repudiate tainted contracts and return tainted profits, fire the employees involved, implement compliance measures that address the misconduct);

— Requiring the target to report any inappropriate conduct to the appropriate authorities and settle with authorities prior to close;

— Insisting on material adverse change or condition precedent clauses, specific to the risks, that allow the purchaser to walk away from the transaction with little to no penalty if the target cannot satisfactorily resolve the matter in a reasonable period or an investigation reveals a material problem; and

— Inserting indemnification provisions that would apply to losses related to potentially corrupt payments that are incurred after the transaction is concluded.

Because provisions relating to FCPA compliance require the counterparty to take on more risk, they are more difficult to negotiate, but acquiring companies have been able to obtain such provisions in past deals. There are, however, downsides to these tactics. For example, further investigations and negotiating corporate settlements can cause delays that could last years; reporting a matter to enforcement authorities introduces uncertainty into a transaction; and an indemnification provision is only as good as the buyer's ability to collect on or enforce the provision.

Planning for and Understanding Continuing Risks

Safeguarding Against Post-Acquisition Violations

It is best to have a post-acquisition compliance and remediation plan in place as early in the process as possible. Generally, if a buyer conducts appropriate pre-close diligence and engages in prompt remediation following the close, U.S. authorities are likely to use their discretion not to bring an enforcement action for any bribes undertaken by the target during an understood grace period. (The length of that grace period is often around six months, though it can vary.) If, however, the buyer is directly involved in the target's bribery (pre- or post-close), the buyer fails to conduct reasonable diligence and post-close remediation, or post-close bribery continues well past the closing, the buyer and/or the target may face liability (depending upon the parties involved in the bribery and the FCPA jurisdiction over that conduct). Indeed, the DOJ and SEC warn that they are more likely to prosecute a successor company where it "directly participated in the violations or failed to stop the misconduct from continuing after the acquisition." In fact, three of the five steps that the DOJ has advised acquiring companies to undertake (from its 2002 opinion and outlined above) relate to *post*-acquisition efforts.

The risks for FCPA issuers are particularly acute. Technically, if a bribe is made by the target on the day after the closing and it is falsely entered into the target's books (e.g., a bribe intentionally mislabeled as a "commission") and the buyer is an FCPA issuer, the buyer would be liable under the FCPA accounting provisions – even if the buyer knew nothing about the bribe. In addition to ensuring no bribery payments are made going forward, an acquiring company should be mindful to remedy possible books and records violations stemming from pre-acquisition conduct.

Continuing Obligations Associated with Pre-Acquisition Violations

Where a target settles with authorities for FCPA violations prior to a transaction, the acquiring company likely will have to assume the obligations associated with that settlement. This does not mean that the buyer assumes FCPA liability but, for example, often requires the acquiring company to undertake any remediation efforts the target company agreed to as part of its resolution. For instance, in 2014, Alstom S.A. entered into a plea agreement admitting to FCPA violations, shortly after General Electric's purchase of the core of Alstom's assets was approved. The agreement required General Electric to undertake certain obligations in the plea agreement, including putting in place a detailed compliance program and complying with specific reporting requirements. Therefore, any investor looking to acquire a target involved in settlement discussions will want to be kept apprised of the settlement negotiations, to understand what obligations it may ultimately have to carry out.

Global Considerations

Global Anticorruption Efforts
While this article is focused on the FCPA, investors should also be aware of the ever-expanding web of anticorruption statutes, including Brazil's anticorruption legislation, the Clean Company Act, which became effective in 2014. In this shifting landscape, regulators are increasingly coordinating across borders to investigate and prosecute corrupt conduct. For instance, in December 2016, Odebrecht and Braskem resolved bribery-related charges simultaneously with authorities in the U.S., Brazil and Switzerland, and in January 2017, Rolls Royce settled charges of bribe payments against it simultaneously with the U.S., Brazil and the U.K. This increased level of cooperation has four primary consequences for any acquiring investor.

Consequences of Cross-Border Cooperation

— It may shift of the calculus further in support of voluntarily disclosing potential misconduct. Self-reporting may, in certain jurisdictions such as the U.S., lead to leniency, and global settlements such as those described above allow the settling companies a degree of finality.

— On the other hand, cross-jurisdictional cooperation increases the risk that authorities in one country will learn about the misconduct from authorities in another country. Thus, the cost of self-reporting may increase as it may create enforcement actions in several jurisdictions.

— It may require interested investors to educate themselves on a larger set of anticorruption statutes and potential exposure related thereto.

— It may result in increased penalties for any corrupt activity, as well as the diversion of resources (and associated financial costs) that necessarily accompany any governmental investigation into the conduct.

The benefits of an effective diligence and compliance plan that addresses anticorruption risks becomes even more critical in the context of cross-border investigations.

Considerations in the Current Brazilian Context

Given the amount of public information relating to bribery coming out of Brazil, U.S. authorities will assume that acquiring companies are on notice about that information and investigating it appropriately. For instance, leniency agreements, guilty pleas and search and seizure petitions are publicly available in Brazil and provide detailed information outlining corrupt conduct. An investor will want to review all public documents to understand what allegations might exist specifically relating to the target. Cooperator statements, which are generally publicly available once a leniency agreement has been approved by the relevant Brazilian court, provide more granular details about the particular contracts or assets that have been tainted by bribery and can help a prospective buyer evaluate which assets are clean and less likely to result in anticorruption liability. A buyer that has not considered these sources of information may be viewed by U.S. officials as having failed to perform adequate diligence.

Given the scope of the Clean Company Act, an acquiring company should first understand whether the target is related to any company that has been implicated in any of the Brazilian anticorruption investigations, including *Lava Jato*, and may therefore have exposure under the Clean Company Act. The Clean Company Act imposes civil and administrative liability on companies operating in Brazil for domestic and foreign bribery. Under the Clean Company Act, controlling, controlled and affiliated companies can be held jointly and severally liable for any fine or damages imposed for a bribe paid by a related company. Therefore, if the target falls within the corporate structure of a company implicated in the Brazilian anticorruption investigations, that target might be financially responsible, even if the target itself has not paid any bribes. Moreover, that liability continues, in the case of a merger, spin-off, change of corporate form or contractual amendment.[4] The law provides limited protection, provided there is no fraud, by capping successor liability at the value of the transferred assets.

The risk of joint and several liability is particularly acute in the current Brazilian market. Given the number of companies subject to leniency agreements or otherwise under investigation that have declared bankruptcy or are restructuring, there is a much higher risk that a potential target may need to pay the financial penalty incurred by an insolvent member of the corporate family that engaged in bribery. For instance, both Odebrecht and Camargo Correa, which entered into leniency agreements, are restructuring and selling their interests in certain of their business units. And both Galvão Engenharia and OAS, which were also implicated in the *Lava Jato* investigation, have filed for bankruptcy.

In spite of the above, transactions have taken place in Brazil, as parties have been able to work around these risks through robust contractual provisions, including strong indemnity clauses and credit protection provisions, such as escrows and collateral.

In addition to contractual protections, Brazilian Federal Decree 8420 allows a leniency agreement to extend to companies within the same corporate family provided that those entities jointly execute the agreement. Therefore a target might receive protections through the leniency agreement of a member of its corporate family that would cabin its damages. For example, some recent agreements have allowed for the sale of assets free and clear of any liabilities.[5] As such, it is also important for an acquiring company to review any related leniency agreement to understand what protections might be afforded the target (and, conversely, what corresponding obligations the target might also be required to undertake).

Regardless of whether a leniency agreement is in place, other Brazilian authorities, such as the Comptroller's Office (*Controladoria-Geral da União* or CGU), the Attorney General of Brazil (*Advocacia-Geral da União* or AGU), of the Court of Accounts (*Tribunal de Conta da União* or TCU), may have ongoing proceedings related to the target or other entities within the same corporate structure. An acquiring company should understand the scope and risks of those proceedings since some of these authorities have continued to pursue actions against companies, even where a leniency agreement has been signed.

Conclusion

The far-reaching investigations in Brazil as well as the country's strict approach to corruption have caused a domino effect of sorts, resulting in anticorruption investigations and prosecutions in other jurisdictions as well. The upside is that as a result of this shift in attitude towards corruption, many companies have begun internal investigations to ensure they have not engaged in corrupt behavior, and many more are implementing compliance programs to map out risks and avoid any such issues in the future.

In the meantime, while there is a lot of opportunity for acquiring companies and assets in Brazil, it is critical to understand those risks and to formulate a plan to minimize them. ■

1. Most recently, on November 29, 2017, the DOJ released a new FCPA Corporate Enforcement Policy in which it stated that there is a presumption that the DOJ will decline to prosecute companies that voluntarily disclose misconduct in an FCPA matter, fully cooperate and timely and appropriately remediate, so long as there are no aggravating circumstances and those companies pay all disgorgement resulting from the misconduct. Dep't of Justice, *United States Attorneys' Manual*, "FCPA Corporate Enforcement Policy," Section 9-47.120, https://www.justice.gov/archives/opa/blog-entry/file/838386/download. The new policy also sets forth reductions on fines *available* to eligible companies. *See* Cleary Gottlieb Alert Memorandum, "DOJ Releases FCPA Corporate Enforcement Policy" (Dec. 1, 2017), available at https://www.clearygottlieb.com/news-and-insights/publicationlisting/doj-releases-fcpa-corporate-enforcement-policy-12-1-17.
2. Criminal Div. of the U.S. Dep't of Justice & the Enf't Div. of the U.S. Sec. and Exch. Comm'n, *FCPA: A Resource Guide to the U.S. Foreign Corrupt Practices Act 29*, https://www.justice.gov/sites/default/files/criminal-fraud/legacy/2015/01/16/guide.pdf (last visited Jul. 21, 2017). *See also* Dep't of Justice, Foreign Corrupt Practice Act Review, No. 08-02, Opinion Procedure Release (2008).
3. The inability to conduct enhanced due diligence does not necessarily mean a high-risk transaction should be avoided. In a 2008 release, the DOJ indicated that it would not take an enforcement action against a company unable to perform pre-closing diligence, provided the company disclosed any identified violations, remediated such violations within the 180-day period and completed its proposed due diligence and remediation by no later than one year from the date of closing. Dep't of Justice, Foreign Corrupt Practice Act Review, No. 08-02, Opinion Procedure Release (2008). More broadly, the 2008 release and other DOJ statements indicate that, particularly when the opportunity for pre-close diligence is limited, the DOJ will allow buyers to act promptly post-close to conduct diligence and institute remedial actions. The standards set by the 2008 release, however, would be quite difficult to meet.
4. The Clean Company Act does not explicitly provide for successor liability in the case of an asset sale.
5. Notably, on August 24, 2017, Brazilian federal prosecutors issued new guidance on the process for negotiating and memorializing leniency agreements. This guidance provides additional transparency about the process and requires, among other things, that the leniency agreement address the obligations of the company, as well as whether the company has authorization to sell its assets. Orientação No. 07/2017, 5ª Câmara de Coordenação e Revisão, *Acordos de Leniência* (Aug. 24, 2017) *available at* http://www.mpf.mp.br/pgr/documentos/ORIENTAO7_2017.pdf.

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