

Venture Capital

Minimizing Anti-Corruption Deal Risk While Maximizing Returns on Venture Capital Investments

By G. Derek Andreson, Thomas M. Shoesmith, Marc H. Axelbaum and Ryan R. Sparacino, *Pillsbury Winthrop Shaw Pittman LLP*

More and more, venture capital firms are investing in start-ups seeking to expand internationally or with nascent cross-border operations in place. Such investments offer opportunities for lucrative returns but also carry significant anti-corruption risk that VC firms are often ill-equipped to manage. For many businesses, managing anti-corruption risk is a necessary cost center. But VC firms are uniquely positioned to use that risk to drive a better deal and gain greater control over management and direction of the business.

The overlapping and increasingly aggressive anti-corruption regimes, including the FCPA, the U.K. Bribery Act, the anti-bribery laws in China, Germany and the newly enacted law in Brazil, coupled with the heightened risk of corruption in emerging economies, can quickly derail an otherwise strong investment. Not only are VC firms subject to fines, penalties and reputational harm through the conduct of the start-up, but the conduct itself may have occurred before the VC firm even considered taking a stake.

This article offers an assessment of the opportunities and risks that VC firms should consider, and concludes with four strategies for maximizing returns while limiting anti-corruption risks.

The Value of Anti-Corruption Analysis Throughout the VC Investment Cycle

Targeted anti-corruption analysis can yield significant value for a VC firm at each stage of the investment cycle – from

the initial due diligence plan, through the various financing rounds, to the sale or IPO of the start-up.

Pre-Investment and Series A Phase

Before the VC firm's initial investment, the firm will engage in extensive due diligence relating to the start-up's business, including the company's business model, industry, growth strategy, market projections, management team, customers, competitors and regulatory environment. If the business has cross-border operations, then the due diligence should incorporate a targeted anti-corruption component to assess that specific risk. See, e.g., "Complying with the FCPA: Mergers, Acquisitions and Investment Transactions (Part One of Five)," *The FCPA Report*, Vol. 2, No. 8 (Apr. 17, 2013).

Doing so can yield immediate advantages for the VC firm during the pre-investment and preferred stock financing phases. First, the firm may assert a stronger position with regard to pre-money valuation – often the most heavily contested issue impacting ROI. Second, the firm might seek more control over certain aspects of the start-up's management and operations. Third, the firm will be able to document its anti-corruption awareness and efforts, which can yield protection as well as credibility should anti-corruption issues arise post-investment.

Pre-Money Valuation Leverage

VC firms can gain negotiating leverage by outlining the anticipated anti-corruption risk relating to that specific

business and its operations, as well as the expense associated with implementing a sufficient compliance program and monitoring that risk through the life cycle of the investment.

Given its unpredictability and the limits of internal controls, anti-corruption risk cannot, and should not, be analyzed dollar for dollar, but rather as a premium for conducting business in regions identified as holding high corruption risk, such as BRIC countries.

That premium should serve as a reduction to pre-money valuation of the business. For businesses that have expanded internationally, the VC firm should identify non-U.S. operations for anti-corruption due diligence to determine whether conduct creating civil or criminal liability has already occurred. If so, that liability risk, as well as the follow-on compliance costs, will directly affect negotiations. It may also be the case that the conduct discovered warrants walking away from the deal.

Enhancing the VC Firm's Oversight and Control

VCs often maintain a hand in the oversight and control of the business. Few start-ups have devoted sufficient time and resources to compliance risks in their initial growth phase, and the prospect of managing those risks internationally while focusing on the business can be daunting.

By identifying anti-corruption risks relating to the start-up, and with the VC firm's ability to limit that risk with appropriate oversight, the VC firm can often compel the start-up to agree to a greater level of organizational control than it would otherwise consider. The most common technique used by VCs to increase their visibility into a portfolio company's operations is the use of a board seat. Placing a representative

of the firm directly into management is not common, but requiring the portfolio company to add an executive with experience in anti-corruption matters may be appropriate in some situations.

The VC firm may also require the implementation of internal controls, an approval right over transactions with foreign government officials, significant third-party contracts or fundamental changes to the company's business model.

Protection through Due Diligence

In virtually every major FCPA matter in which an investor, JV partner or buyer has been the subject of an inquiry, inadequate anti-corruption due diligence was a central factor. See "Strategies for Mitigating the FCPA Risk of Entering into Joint Ventures," *The FCPA Report*, Vol. 2, No. 9 (May 1, 2013).

It is imperative to recognize that targeted due diligence during the pre-investment stage can greatly diminish the firm's exposure in the event that subsequent anti-corruption issues are discovered.

In such circumstances, maintaining thorough documentation of due diligence efforts can mean the difference between government regulators determining that the firm was *willfully blind* – an all too common government theme – or that the company did what was reasonable at the time. Put another way, that difference can drive whether the company faces criminal or civil charges, or whether it receives a pass.

Maintain Compliance During Post-Investment/ Growth Phase

After the investment is closed, ongoing anti-corruption compliance is necessary to maximize value, ward off possible

misconduct and ensure the vitality of the start-up as it grows under the VC firm's watch.

Building a record of compliance during the post-investment/growth phase of the deal cycle adds value that should be recouped upon exit. By creating a strong compliance history, the VC firm will reduce the leverage additional investors may have in the follow-on rounds of investment to drive down the valuation of the company, thereby maximizing the value of the VC firm's initial Series A shares.

On the flip side, if the start-up and the VC firm fail to manage anti-corruption risk during the post-investment/growth phase, the results can be severe. If misconduct occurs, or is suspected, the resulting internal investigation can distract from the core focus of the business, cause vital talent to flee the start-up, and cripple the company's ability to engage in subsequent financing rounds.

Be Vigilant During the Exit Phase

Anti-corruption issues also arise in the exit phase. In most cases, the exit strategy for the VC firm relies on a successful IPO or private sale for the start-up. In either scenario, given the intense scrutiny the investing public now places on anti-corruption issues, the success of an IPO or sale can be influenced by the adequacy of the compliance program.

Even post-exit, an effective anti-corruption program further advances the VC firm's interests by reducing the risk that an undetected corruption problem emerges subsequent to the sale, potentially causing reputational harm to the firm or embroiling it in costly litigation.

Four Anti-Corruption Strategies that VC Firms Should Consider

VC firms should consider targeted strategies that maximize investment opportunity while minimizing anti-corruption risk. Strategies must reflect the specific risks of the investment throughout its life cycle, and may include:

1) Integrate Anti-Corruption Analysis into the Investment Committee Process

The VC firm's Investment Committee should integrate a layer of anti-corruption analysis into its consideration of any investment in a start-up with international operations. This would usually entail assessing risk factors such as geography (e.g., whether the start-up operates or depends on a high-risk country like China or India) and industry (e.g., whether any of the start-up's competitors are under investigation), to name two examples. By effectively and credibly gauging anti-corruption risk, VC firms can drive a better pre-money valuation as well as increase the VC firm's oversight and control – two critical variables in the ultimate profitability of the investment.

2) Execute Targeted Anti-Corruption Due Diligence

The VC firm's anti-corruption due diligence should target the start-up's existing anti-corruption policies and procedures (if any), business relationships, use of third parties, regulatory issues, permitting needs, and other areas that can create anti-corruption risk.

3) Insist on a Tailored Anti-Corruption Policy and Appropriate Anti-Corruption Internal Controls

Effective written policies, tailored to the company and its business, can greatly reduce anti-corruption risk after the VC firm's initial investment. For this reason, the VC firm should insist upon a defined anti-corruption policy, including appropriate anti-corruption internal controls, as a non-negotiable condition of any investment in a start-up.

- **Anti-Corruption Policy.** The VC firm should consider drafting a standard policy that can be quickly tailored to the specific needs of each start-up in which the firm invests. The policy should be written in plain language, accessible to the relevant employees at the start-up, rather than weighed down in legalese. It should clearly spell out the strict prohibitions against bribery and associated misconduct and should emphasize that employees will not be punished for reporting potential wrongdoing in good faith.
- **Internal Controls.** The VC firm should condition its investment on a requirement that the start-up adopt minimal, unobtrusive controls that allow the company (and, perhaps the VC firm) to interdict wrongdoing before it takes root. In our experience, anti-corruption issues are often ignored or downplayed by start-ups that are in growth mode, even when the start-up's business depends on efforts in high-risk jurisdictions such as China.

The VC firm should consider adopting a basic set of internal controls standards that it demands for international investments, which the firm can quickly roll out to the newly acquired company. Striking the balance is critical – while controls are important, the firm should take a realistic view of the capabilities of the start-up and should be mindful of avoiding a scorched-earth approach to internal controls. The

controls required to manage the compliance risks at a Fortune 50 company will be far more intrusive than those necessary for a start-up.

4) Consider Policies that Streamline Internal Investigations

VC firms typically invest in young start-ups with limited cash. The business is generally lean, dependent on a handful of committed employees, and racing to bring their vision or technology to market first. In these circumstances, the start-up is especially vulnerable to an array of compliance risks that could result in a crippling internal investigation.

As a result, it is imperative that the VC firm insist on certain safeguards to ensure that any internal investigation is conducted in a timely and efficient manner. While numerous hurdles, including labor laws, data privacy rules, server locations and local counsel issues can often delay an investigation, most should be anticipated and avoided through the adoption of specific protections at the outset. See “Conflicting Compliance Obligations: How to Navigate Data Privacy Laws While Performing Internal Investigations and Promoting FCPA Compliance in the E.U. (Part Three of Three),” *The FCPA Report*, Vol. 2, No. 3 (Feb 6, 2013).

By planning for contingencies on the front end, the VC firm and the start-up can reduce the risk of a protracted internal investigation, and allow the start-up to focus on growth and earnings.

Conclusion

VC firms considering investments with a cross-border dimension should conduct targeted due diligence to identify and manage anti-corruption risk throughout the investment

cycle. Depending on the region, industry and business model, allowing that risk to remain unaddressed needlessly exposes investors and the business to the costs of an internal investigation, or worse, to regulatory actions by U.S. and foreign authorities.

G. Derek Andreson is a partner in Pillsbury's Washington, D.C. office who focuses on corporate internal investigations, white collar defense, SEC enforcement actions and trial practice. A former federal prosecutor, Andreson leads corporate internal investigations in response to criminal and civil probes by government regulators, including those involving allegations of fraud, bribery, corruption, insider trading, money laundering, criminal antitrust and false claims. He regularly advises the boards of directors of publicly traded companies in navigating parallel investigations by the Department of Justice and the SEC, as well as representing officers and directors during federal grand jury proceedings.

Thomas M. Shoesmith is a partner in Pillsbury's Shanghai and Silicon Valley offices. He specializes in international corporate transactions, with a special emphasis on China. He has handled more than 100 cross-border acquisitions and complex multinational joint ventures

involving more than 50 countries around the world. Since 2003, he has focused most of his efforts on transactions in and with China, including foreign direct investment into the PRC as well as corporate finance and public capital markets transactions for PRC-based companies.

Marc H. Axelbaum is a partner in Pillsbury's San Francisco office. His practice focuses on corporate investigations and white collar criminal defense, SEC enforcement actions, and securities and commercial litigation, representing clients at both the trial and appellate levels in federal and state courts across the country. He has successfully represented individuals and institutional clients in criminal and internal investigations in numerous industries, including banking, hedge funds, pension funds, energy, technology, real estate, construction, life sciences and health care.

Ryan R. Sparacino is Counsel in Pillsbury's Washington, D.C. office who focuses his practice on white collar criminal defense matters, including internal investigations and responses to regulatory inquiries, as well as complex civil litigation. His experience includes representing corporations and individuals in litigation and investigations involving the FCPA, Travel Act, U.K. Bribery Act, criminal antitrust regulation, Sarbanes-Oxley compliance, consumer fraud statutes, intellectual property matters and whistleblower lawsuits.