Quinn Emanuel Private Equity Litigation Practice Alert

Mitigating Risks from Today's Investments in China: Due Diligence Practical Pointers for Private Equity Firms

In spite of the challenges, private equity investment activity in Asia remains strong, setting new records the past few years in total deal and exit value. Meanwhile, as the competition for quality investments has intensified, deal schedules have been compressed, causing some private equity firms to cut back on their compliance due diligence.

At the same time, recent developments in the policies and enforcement actions of the U.S. government demonstrate a priority of targeting China-based companies, an appetite to go after private equity managers for the misconduct of their portfolio companies, and thus a more compelling need for robust due diligence. In this Client Alert, we share our observations on the changing compliance risk landscape in China and offer some practical suggestions for conducting effective due diligence.

I. The "China Initiative" and the Risk It Creates

In November 2018, then-Attorney General Jeff Sessions announced the "China Initiative" with the aim of "countering Chinese national security threats and reinforc[ing] the President's overall national security strategy."[1] Attorney General William Barr further declared in June 2019 that the U.S. Department of Justice ("DOJ") must "continue to pursue, and indeed step up, our China Initiative."[2] The two objectives of the China Initiative that are particularly relevant here are: 1) "Identify[ing] priority trade secret theft cases, ensur[ing] that investigations are adequately resourced"; and 2) "Identify[ing] Foreign Corrupt Practices Act (FCPA) cases involving Chinese companies that compete with American businesses."[3]

So far, the DOJ has brought over 20 criminal cases pertaining to economic espionage, trade secret, and export controls under the China Initiative. It was not uncommon in recent years for Chinese companies, especially start-ups that rely on attracting private equity and venture capital investments, to be embroiled in intellectual property disputes with U.S. companies. Under the China Initiative, such risk is heightened with the added weight of criminal investigations and prosecutions by the U.S. government and needs to be carefully evaluated during due diligence.

As to the FCPA, a substantial number of FCPA enforcement actions have always involved alleged misconduct in China, although the targets have traditionally been U.S. companies and non-Chinese U.S.-listed companies, who have subsidiaries and/or operations in China. That is changing.

First, the U.S. government has demonstrated an interest in investigating and prosecuting parties who are neither operating in the U.S. nor traded on a U.S. stock exchange but are otherwise subject to U.S. jurisdiction because of conduct that occurred in U.S. territory. For example, in the *U.S. v. Patrick Ho* case, where a Chinese individual was found to have bribed officials of African countries for the benefit of a Chinese company without any operations in the U.S. or securities traded in the U.S., the U.S. government asserted

[1] Department of Justice China Initiative Fact Sheet, https://www.justice.gov/opa/page/file/1122686/download.
[2] Attorney General William P. Barr, Opening Remarks at the U.S. Attorney's Conference (June 26, 2019), https://www.justice.gov/opa/speech/attorney-general-william-p-barr-delivers-opening-remarks-us-attorneys-conference.
[3] Department of Justice China Initiative Fact Sheet, https://www.justice.gov/opa/page/file/1122686/download.

jurisdiction mainly on the basis that one of the alleged bribes was transmitted via wire transfer through New York.[4]

Further, consistent with the DOJ's policy of focusing on individual accountability in the context of FCPA enforcement, the U.S. government has actively prosecuted individual executives of China-based operations instead of only seeking settlements with companies. In 2018 and 2019, for instance, two Chinese individuals, Ng Nap Seng (chairman of the Macao Sun Kian Ip Group)[5] and Patrick Ho (secretary-general of an NGO funded by a Chinese company)[6], were sentenced to prison terms for FCPA violations and other related crimes. Just last month, the U.S. government unsealed charges against two Chinese individuals, who were former executives of a U.S. company's Chinese subsidiary, for bribing Chinese government officials, among other offenses.[7] The prosecution of individual corporate executives and the resulting reputational damage and operational interruption to a prospective portfolio company make it more difficult to quantify the true exposure under the FCPA.

Both of the scenarios above highlight the increase in DOJ enforcement activity under the China Initiative and the importance of targeted due diligence when contemplating an investment in China.

II. Potential Liability from Portfolio Company Misconduct

In addition to diminished investment value and reputational risk, recent case law suggests that private equity managers should also be mindful of potential liability attributed to them from the misconduct of their portfolio companies. The recent case of *United States ex rel. Medrano v. Diabetic Care RX, LLC ("Diabetic")*, No. 15 Civ. 62617 (S.D. Fla.) demonstrates the U.S. government's willingness to, under certain circumstances, hold private equity firms liable for the misconduct of their portfolio companies. In *Diabetic*, the U.S. government charged a pharmacy, Diabetic Care Rx, LLC d/b/a Patient Care America ("PCA"), and a private equity firm whose fund invested in PCA, for allegedly engaging in an illegal kickback scheme that violated the federal False Claims Act.

According to the U.S. government's theory, the private equity firm was liable for PCA's misconduct because, as manager of the private equity fund that invested in PCA, it "controlled and directed" the conduct of PCA on behalf of the fund. Specifically, the U.S. government alleged that:

- The firm controlled a majority of the board seats of the portfolio company;
- Two partners of the firm became officers and board members of the portfolio company and were aware of certain facts underlying the illegal scheme from serving those roles;
- The firm "initiated" the portfolio company's entry into a new line of business, which it "anticipated could result in a 'quick and dramatic' payback" on its investment;

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[4] https://www.justice.gov/usao-sdny/pr/patrick-ho-former-head-organization-backed-chinese-energy-conglomerate-sentenced-3.

[5] https://www.justice.gov/opa/pr/chairman-macau-real-estate-development-company-convicted-all-counts-role-scheme-bribe-united.

[6] https://www.justice.gov/usao-sdny/pr/patrick-ho-former-head-organization-backed-chinese-energy-conglomerate-sentenced-3.

[7] Two Former Executives of the China Subsidiary of a Multi-Level Marketing Company Charged for Scheme to Pay Foreign Bribes and Circumvent Internal Accounting Controls (Nov. 14, 2019), https://www.justice.gov/opa/pr/two-former-executives-china-subsidiary-multi-level-marketing-company-charged-scheme-pay.

- The firm was heavily involved in the portfolio company's new CEO's recruitment and compensation structure's design, and obtained the new CEO's agreement to get the firm's approval "for key decisions affecting the [portfolio] company."
- The firm (and the portfolio company) "failed to implement any compliance measures" over the new line of business.

The *Diabetic* defendants eventually settled with the U.S. government for $21 million (in USD) before the court ruled on the private firm's liability.

While the *Diabetic* case may have presented a unique set of facts, such as the private equity firm's alleged specific knowledge of the portfolio company's illegal scheme,[8] it is notable that the U.S. government charged the private equity firm, which did not directly invest in the portfolio company (but managed a fund that made the investment), for the conduct of the portfolio company.

III. Recent Changes to the FCPA Corporate Enforcement Policy Further Encourage Thorough and Timely Due Diligence

Earlier this year, Assistant Attorney General Brian Benczkowski of the Criminal Division of the DOJ announced certain changes to the FCPA Corporate Enforcement Policy,[9] which were later codified in a revised Policy in the Justice Manual. They offer important guidance on preventing successor-liability. This updated Enforcement Policy provides further clarity that if a private equity firm or other entity "uncovers misconduct through thorough and timely due diligence or, in appropriate instances, through post-acquisition audits or compliance integration efforts, and voluntarily self-discloses the misconduct and otherwise takes action consistent with" the Enforcement Policy, it would receive *a presumption of a declination*.[10] Further, "even if aggravating circumstances existed as to the acquired entity," the acquirer may still be eligible for a declination in appropriate circumstances.[11]

Whether to self-report issues identified in an acquisition are always a fact-specific, carefully-balanced judgment call, but the updated Enforcement Policy intends to provide more certainty and thus potentially stronger incentives to investors who timely uncover issues through careful due diligence.

IV. Suggestions for Conducting Due Diligence on Targets in China

We offer below some suggestions to consider in conducting due diligence. This is by no means an exhaustive list, but is rather meant to address selective issues we see repeatedly in conducting due diligence on, and in representing, China-based investment targets. We organize them under the various stages of typical compliance due diligence:

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[8] Of course, the U.S. Court of Appeals for the Second Circuit has held that the lack of direct evidence of an investor's actual knowledge of the invested company does not prevent the finding of the investor's FCPA liability. *U.S. v. Kozeny*, 667 F.3d 122 (2d Cir. 2011).
[9] Assistant Attorney General Brian A. Benczkowski, Remarks at the 33rd Annual ABA National Institute on White Collar Crime Conference (Mar. 8, 2019), https://www.justice.gov/opa/speech/assistant-attorney-general-brian-benczkowski-delivers-remarks-33rd-annual-aba-national.
[10] JM § 9-47.120(4), FCPA Corporate Enforcement Policy, https://www.justice.gov/jm/jm-9-47000-foreign-corrupt-practices-act-1977#9-47.120.
[11] *Id.*

Questionnaire & Document Request

- Confirm whether the target may have engaged in business activities in the U.S., even if the target does not have formal operations and securities traded in the U.S. This could include meetings, other business trips, banking transactions (including settlement accounts), and even email servers.
- Understand the target's third-party agents and intermediaries, regardless of whether there are written contracts with them and how they are regarded and described by the target. Understand the nature of their work and how they are compensated. The majority of FCPA enforcement actions, including in particular those concerning conduct in China, involve improper payments through third-parties.
- Understand the target's potential "touchpoints" with government officials and how the target interacts with government officials under such various circumstances. This should not be limited to official interactions with government authorities, such as clearing through customs, applying for permits and licenses, etc. Rather, the inquiry should also cover business transactions with government entities and state-owned companies, who may be the target's customers, suppliers, shareholders, etc.
- If the investment return is substantially dependent on the target's technology and/or intellectual property, make sure to cover their origin and IP protection mechanism. Sometimes it could even be advisable to conduct an independent assessment of the target's exposure to IP infringement claims and trade secret theft charges.

Sample Testing of Transactions

- If allowed by deal schedule and dynamics, targeted, risk-based sample testing can be very effective in uncovering issues otherwise not reflected in the policy documents and questionnaire responses. If it is not feasible to conduct pre-closing sample testing, it is often advisable to include the sample testing in the post-closing diligence.
- Sample testing should focus on higher-risk transactions identified from background research and answers to the questionnaire. Some of the higher-risk transactions typically come from payments to third-party agents/intermediaries, government relations & public relations expenses, marketing expenses, and high-value promotional expenses, but sample size and selection are ultimately a case-by-case judgment call based on the target's business model and answers to the questionnaire. We often identify improper transactions and other inconsistencies with the target's written policies from very manageable, tailored sample sizes.

Management Interviews

- To better leverage the often-limited interview time with senior managers, interview questions should be tailored based on the target's business model, higher-risk areas, and questionnaire responses.
- Use real life scenarios to test the target's compliance procedure – invite the target's executives to walk through what would happen if an issue is identified, such as when there is an anonymous whistleblower allegation or a sales expense exceeded the target's policy limit.
- On the other hand, for critical issues, it is sometimes worth raising the exact questions answered in the questionnaire with the executives again, as quite often the written answers were not prepared by the executives, who might have knowledge and perspectives different from those who prepared the answers.

Remediation

- Consider the actions necessary to address the compliance risks identified from the due diligence early on and build the cost into the return on investment analysis and price negotiations.
- If not taking a controlling stake, consider having the target agree to the contemplated remediation steps as part of the investment agreement and describe them as specifically as possible. Despite the target's willingness to cooperate with the investor in ramping up its compliance infrastructure, its priorities and incentives may change after the deal closes.

Of course, an effective and efficient due diligence plan and the practical evaluation and remediation of risks greatly depend on the specific facts and circumstances of each situation. There are many factors and details to be considered beyond those that can be addressed in this brief Client Alert. We would be happy to consult with you regarding your approach to conducting due diligence or issues you may encounter with particular investment targets.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned in it, please do not hesitate to reach out to:

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