FCPA BEST PRACTICES: IMPLEMENTATION AND UTILIZATION OF THIRD-PARTY AUDITS

As U.S. and foreign law enforcement agencies aggressively pursue companies and individuals for acts of international bribery, third parties continue to present a significant risk. The author, a former U.S. prosecutor, discusses the risks posed by third parties and the importance of properly conducting third-party audits.

By Jason A. Jones *

Since 2010, the United States government has extracted just shy of $5 billion in corporate penalties for violations of the Foreign Corrupt Practices Act (“FCPA”),1 and a significant majority of those cases involved misconduct by third parties such as intermediaries, agents, distributors, brokers, consultants, and channel partners. Global enforcement numbers exhibit a similar trend: three out of four foreign bribery cases involved the use of third parties.2 If you are not worried about what third parties are doing on your company’s behalf, you should be.

It is, of course, often difficult to know with any degree of certainty what a third party is doing, especially in unfamiliar foreign jurisdictions. Obtaining and exercising audit rights over third parties is time-consuming and expensive, especially for companies that have thousands of third parties. Those challenges lead many companies to avoid audit rights altogether. But becoming paralyzed at the enormity of the task is a mistake that could prove exponentially more costly.

So what is a responsible company to do? Audit. How? First, have robust audit rights. Then ensure that contracts with third parties include audit rights provisions that are detailed and enforceable. And once you have those rights, use them. Auditing a couple thousand third parties is unrealistic, but auditing a thoughtfully selected, risk-based sample each year is not. Finally, document everything, from the process to the results. That documentation will be invaluable if and when the regulators come knocking.

This article will briefly explore why companies should obtain the right to audit their third parties, including the civil and criminal liability companies face for third-party misconduct. This article will also discuss


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But under the FCPA, what a company does not know
may still very much hurt it. The FCPA has two primary
prongs: (1) an outright prohibition on foreign bribery
and (2) a sweeping requirement that public companies
maintain accurate books and records, and internal
controls – irrespective of whether there are corruption
issues involved. In the context of third parties, the
enforcement agencies have repeatedly cautioned that a
company may not use a third party to do things that
the company could not do itself, including turning a blind
eye.

In the widely anticipated and well-received A
Resource Guide to the Foreign Corrupt Practices Act
(the “Guide”), jointly issued by the DOJ and the SEC,
the agencies cautioned that “the fact that a bribe is paid
by a third party does not eliminate the potential for
criminal or civil liability.” The statement is accurate
not only because of traditional liability principles, such
as conspiracy and aiding-and-abetting, but also because
the FCPA explicitly prevents companies subject to it
from insulating themselves by using middlemen. Under
the statute, a person or entity acts “knowingly” if she is
aware of a high probability of bribery, unless she
actually believes it is not occurring. Thus, companies
cannot escape liability for the corrupt actions of third
parties simply by avoiding knowledge of what their third
parties are doing or ignoring “red flags” about how they
operate. As the enforcement agencies note, common
“red flags” that could potentially signal wrongdoing are:
excessive commissions to consultants, unreasonably
large discounts to distributors, vague consulting
agreements, close ties to foreign officials, and the use of
offshore accounts or shell companies.

Liability under the books and records provisions of
the FCPA is even broader still. While criminal liability
may be premised only on “knowing” violations, no such
sciener is required for civil exposure. Further, civil
exposure extends not only to the accounting records of
the U.S. company, but also to those of its subsidiaries:
“An issuer’s responsibility thus extends to ensuring that
subsidiaries or affiliates under its control,
foreign subsidiaries and joint ventures, comply with the
accounting provisions.” Recent SEC enforcement
activity suggests that it is embracing strict liability,
which is a powerful tool in the hands of a regulator
whose burden of proof is a simple preponderance of the
evidence.

Take, for example, the recent $12 million settlement
between the SEC and the Mead Johnson Nutrition
Company (“Mead Johnson”). Although the SEC’s
cease-and-desist order is notably light on detail, it
alleges that employees of a Mead Johnson subsidiary in
China used third-party distributors to generate a slush
fund for payments to Chinese healthcare workers. The
settlement papers do not allege – or even imply – that
the U.S. company knew of, or had anything to do with,
the payments. The SEC simply states that because a
subsidiary improperly booked the payments in the
subsidiary’s books, and because those books were
ultimately consolidated into the U.S. parent’s books, the
parent violated the FCPA.

Assuming such sweeping views of their authority,
U.S. enforcement agencies are doubling-down on FCPA
enforcement efforts. The head of the DOJ Criminal

3 DOJ & SEC, A Resource Guide to the Foreign Corrupt
Practices Act (2012) at 22, available at
http://www.justice.gov/sites/default/files/criminal-
fraud/legacy/2015/01/16/guide.pdf.

4 Resource Guide at 43.

Division, Leslie Caldwell, recently told an audience of FCPA practitioners and compliance personnel that the DOJ is “preparing to add 10 new prosecutors to the Fraud Section’s FCPA Unit, increasing its size by 50 percent.”

Andrew Ceresney, the SEC’s Enforcement Director, echoed the sentiment: “the Enforcement Division is committed to aggressively pursuing violations of the FCPA by entities and individuals,” and “looking ahead, I expect FY 2016 will be another active year for FCPA cases.”

International efforts are surging as well. According to Nicola Bonucci, director of legal affairs at the OECD, “for the first time, last year there were more enforcement actions outside the United States for bribery of foreign public officials than there were in the United States.”

In this environment of ever-increasing scrutiny, the importance of managing third-party risks has never been greater. An essential tool in mitigating the risks that a company will be held liable for the actions of a third party is, of course, the process of conducting due diligence of any prospective foreign agents. Due diligence is only a prophylactic, though, and is only as good as the often incomplete information provided before the relationship begins. A robust compliance program pairs pre-agreement due diligence with a thoughtfully designed audit process: predictive analysis plus real-time monitoring.

Having – and exercising – audit rights serves the important purpose of rooting out misconduct before it becomes a much bigger problem, as discussed further below. There are other benefits that are perhaps less tangible but equally impactful. Regardless of the information actually derived from such audits, they provide valuable messaging: messaging to third parties that the company is watching to ensure ethical business practices, messaging to employees that shortcuts will not be tolerated, and messaging to enforcement agencies and regulators that the company is committed to a culture of compliance. A pound of cure and an ounce of prevention.

**WHAT AUDIT RIGHTS SHOULD INCLUDE**

Even if they have never used them, many companies include audit rights in their template contracts for third parties. Often, those rights are too vague to be useful, providing ample ambiguity for third parties to avoid meaningful oversight. In drafting contractual audit rights, it is helpful to remember the purpose of having such rights in the first place: to maintain accurate information about who the third party is and what they are doing. Initial due diligence is an important first step, but the authorities expect companies to continually reassess their third-party relationships, including third-parties’ qualifications, compensation structure, and what services they provide that the company cannot do themselves (or as cheaply).

With those principles in mind, effectively drafted audit rights should include:

*The right to audit the third-party’s compliance policies, procedures and training.* A threshold question is whether the third party has adequate compliance policies demonstrating a commitment to ethical business practices. Audit rights should include the ability to examine all of the third-party’s compliance policies and documentation of the procedures used to implement those policies. The rights should also allow the company to review information on the particulars of how the third party trains its employees (and its own third parties) on compliance issues, including training logs and written training materials.

A robust contract will specify that, in the event the third party does not have policies or training programs that are acceptable to the company, the third party must implement the company’s own policies and accept related training from the company. In either case, the company should require annual written certifications that the third party is aware of the company’s commitment to lawful business practices, making a reciprocal commitment, and certifying that it has done nothing inconsistent with the company’s standards.

*The right to access underlying records and supporting documentation.* A right to audit raw accounting data is essentially useless without a concomitant right to audit the underlying records and supporting documentation. For example, examination of the third-party’s general ledger and trial balances may show some interesting figures regarding gifts, travel, and entertainment, but those figures are impossible to interpret without invoices, requests for payment, and itemized receipts.

A related issue arises when the third party destroys records after a certain period of time. In order to ensure that supporting documentation is available to the company when needed, contracts with third parties

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should include a requirement that the third party maintain related records for a fixed period of time, ideally five to 10 years.

The right to interview. Just as accounting data are often of little use without supporting documentation, documents are often difficult (if not impossible) to interpret without discussing them with relevant personnel. Audit rights should include the right to interview third-party employees selected by the company regarding the documents provided.

A requirement to maintain segregated accounts. One of the primary hurdles encountered by companies attempting to exercise audit rights are accounting records that are commingled by the third party. Imagine, for example, that Company A has a contract with Third Party that includes audit rights, and Company A chooses to exercise those rights. Unfortunately, Third Party also does business with Company B, a competitor of Company A, and all of the accounting information is commingled in the books. Citing local confidentiality and other data privacy rules, Third Party is able to claim that permitting the audit would violate local law. Companies should plan in advance for these types of scenarios by requiring third parties to maintain segregated accounts.

Deadlines for compliance. One of the most effective methods third parties use to avoid compliance with audit rights is delay. Rather than refusing the audit outright, and thereby jeopardizing a valuable relationship with the company, third parties can drag their feet, provide a slow-roll of information, and hope that the company will eventually decide that further efforts are not worth their time and money. Effective audit rights should prevent dilatory tactics by setting forth precise timelines for compliance.

The right to terminate the contract without cause. There will inevitably be those circumstances in which the third party either cannot or will not comply with a demand for an audit, sometimes under the guise of a local law prohibition. The contract should include language permitting termination of the contract without cause, as final protection against such tactics.

HOW AUDIT RIGHTS SHOULD BE EXERCISED

Companies that bristle at the idea of exercising audit rights often do so because of the sheer enormity of the task. Large companies may have thousands of third parties, from the supplier of the paper towels to the channel partner in China. Auditing every third party – or even a small fraction of them – would require a small army of trained personnel and would cost a fortune, with limited upside. Some companies also worry that having audit rights and not using them will look worse to the authorities than not having audit rights at all.

These objections are short-sighted and overblown. The IRS is similarly unable to audit every taxpayer every year, but that reality does not lead them to stop audits entirely. The incapacity to audit everyone is scant justification for auditing no one. Companies developing a third-party audit program should take a page from the IRS playbook: audit a sample of third parties each year, primarily based on the risks of corruption particular to the third party, the industry, and the location of the business activity.

Imagine, for example, that Company A has 2,000 third parties. A robust compliance program should be able to divide that group into three rough, risk-based tiers, including a bottom tier consisting of the significant number of the third parties that are likely to present almost no risk – the paper towel supplier, for instance. Based on their staffing, budget, ability to hire outside experts, and other metrics, Company A decides that a reasonable number of third parties to audit in a given year is 25: 10 from the highest-risk tier, 10 from the medium-risk tier, and 5 randomly selected from the entire pool. Particular red flags or other incidents in a given year would send a third party to the head of the line.

Auditing 25 third parties each year is no simple undertaking and will certainly cost Company A a significant amount of time and money. But neither is it a Sisyphean task, and the prophylactic and optical benefits far outweigh the costs. The enforcement authorities do not “hold companies to a standard of perfection” in designing a compliance program, including audit rights procedures, but they do look at the reasonableness of the design, and “good faith implementation and enforcement.”

Once a routine cadence of exercising audit rights has been established, companies conducting audits should consider the following:

Conducting audits at the direction of attorneys. Sensitive audits should be conducted with and at the direction of counsel, and care should be taken to ensure that all related communications are, to the extent possible, protected by the attorney-client privilege and work-product doctrine.

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9 Resource Guide at 56.
Utilizing forensic accountants with FCPA experience in the relevant jurisdiction. Forensic accountants are often better suited to conducting a targeted sampling of accounting records than over-extended in-house staff. Many outside firms have relevant anti-corruption expertise, including language capabilities, and under proper direction by counsel, the process can be both more efficient and cost effective than attempting the job internally.

Documenting everything. A few years down the road, an issue may arise at a third party with whom the company does business. When the authorities come knocking, the company should be able to quickly pull the records of the risk-based audit process it followed, along with any records relevant to the particular third party at issue. The auditing process may not have caught the issue, but the importance of demonstrating a reasonably robust process and its good faith execution to the authorities cannot be overstated.

CONCLUSION

Companies doing business abroad increasingly depend on third parties to assist their legitimate business needs, sometimes with limited visibility into what those thirds parties are actually doing. Ignoring those risks places companies in jeopardy of devastating consequences, potentially including entanglement in a foreign bribery scandal. To properly manage that risk, companies should take a hard look at their third-party audit programs. Put some thought into tailoring the program, execute the plan with care, and document everything along the way. The efforts will pay dividends.