FTI JOURNAL

June 2014

Let the Brazilian Compliance Games Begin!

Eduardo Sampaio
Senior Managing Director
Forensic & Litigation Consulting
FTI Consulting

As Brazil prepares to host the June 2014 World Cup and the 2016 Summer Olympics, the country's recently enacted anti-corruption law presents a host of compliance challenges to domestic and foreign businesses participating in the preparations. In an environment as volatile as Brazil's, navigating and mitigating these challenges and risks will mean the difference between scoring a success and losing the match.

It is hard to overestimate the financial and reputational resources Brazil has invested in order to host the June 2014 World Cup and the 2016 Summer Olympics. Mounting either of these events in the spotlight of international media attention would be a difficult undertaking for any country. Attempting both within a span of two years is placing an unprecedented strain on Brazil's economy, government, legal system and infrastructure, as well as testing the country's national character and will. And as the World Cup matches get under way this June, it remains to be seen whether Brazil — and the domestic and multinational interests that have joined it to help make these events go smoothly — will succeed.

A key step Brazil took to help ensure that both the World Cup and the Summer Olympics would be successful was the signing of a new anti-corruption law, the Clean Companies Act, by President Dilma Rousseff in August 2013, which went into effect January 2014. Prior to Brazil's commitment to hosting the Cup and the Games, the law had been languishing in the legislature despite Brazil's reputation as a country in which the payment of bribes has long been an everyday cost of business. But the effort required to mount these events demanded the country harmonize its regulatory environment with the rest of the developed world in order to be perceived as a safe place for business and investment. The pressure cooker of the Cup and the Olympics may not be the easiest or fairest crucible in which to test the efficacy of this law, but that is the challenge confronting Brazil right now. The success or failure of the World Cup and the Olympic Games will be viewed not only as a judgment on the new law but as a signal to international business going forward and as a sign as to whether Brazil truly has joined the ranks of modern economies.

Risky Fun and Games

Estimates for the projected total budget for the World Cup vary from $10 billion at the low end to more than $14 billion on the high end. According to the Tribunal de Contas da União, the Brazilian Court of Audit, the projected budget amounted to $12.5 billion in mid-2012. The projected budget for the 2016 Summer Olympics currently is $18 billion. But all these numbers are suspect given the lack of transparency and precision in Brazil. For example, in a document drafted by Brazil's Public Olympic Authority in January 2014, only 24 of the 52 projects listed had been accounted for in the expenditure estimate, and the total included neither the necessary infrastructure investments nor the operating expenses for organizing the Games.

Furthermore, it is a given that whatever the estimate, it will be too low. According to a 2012 University of Oxford study, "Olympic Games overrun budget with 100 percent consistency." Russia, for instance, estimated its budget for the 2014 Winter Olympics at $12 billion. The lowest estimate for the ultimate cost of the Sochi Olympics is double that, and some forecasts run as high as $50 billion.

Budget overruns already are making headlines in Brazil and worldwide. The cost of the renovation work to prepare the Mane Garrincha Stadium in Brasilia (one of 12 stadiums hosting Cup matches) was estimated in 2012 at $312 million. By March 2014, the cost had risen to $614 million. According to an investigation conducted by the Court of Accounts of the Brazilian Federal District, the construction work alone was overpriced by $196 million.

Brazil's public works and construction sectors are considered extremely hospitable to both petty and grand

Clearly, corruption has been a problem in Brazil and a costly one, too.

corruption due to the size of infrastructure and construction contracts and the large sums of money involved. The uniqueness of each project makes benchmarking and estimating real costs as difficult as it is easy to inflate the costs of hard-to-track on-the-ground expenditures while combating the universal problem of materials disappearing during projects. Further complicating an already complex system is the participation of scores of subcontractors of varying sizes and widely differing ethical and accounting standards, not to mention basic safety practices. Indeed, in November 2013, a crane collapsed at the Arena Corinthians in São Paulo, killing two workers. They had been hired by subcontractors of Odebrecht, a major Brazilian construction company.

Since these stadium projects were not governed by public bidding processes and regulations (an invitation to corruption) and because the starting date of the World Cup was immovable, extraordinary charges had to be assumed. The option of halting construction was not on the table. Even so, six of Brazil's stadiums did not meet the International Federation of Association Football's Dec. 31, 2013 deadline for completion. As of April 2014, three World Cup stadiums remained under construction as the starting date of the first match, June 12, looms.

Missed deadlines, cost overruns, headlines shouting corruption, and questions about the wisdom of Brazil's decision to invest billions to host the Cup and the Summer Games have led to riots in the streets in several Brazilian cities. These protests are expected to continue during the Cup matches. This has raised security issues and damaged Brazil's reputation internationally. All these factors have cast doubt on the ultimate success of both events and on the path the country is treading.

Corruption, Cost and the Law

A 2009 World Bank survey of more than 1,800 Brazilian firms found that almost 70 percent identified corruption as a major constraint to doing business. Nearly half of these firms pointed to the corruption of Brazilian courts as a major block. Not surprisingly, Brazil ranked 72 out of 177 countries on Transparency International's 2013 Corruption Perceptions Index.

Clearly, corruption has been a problem in Brazil and a costly one, too. The Federation of Industries in São Paulo estimates the annual cost of corruption in Brazil varies between 1.4 percent and 2.3 percent of gross domestic product (GDP). In 2013, that would have amounted to about $34 billion-$56 billion. And perhaps not coincidentally, the Brazilian economy lately has turned sour. GDP growth declined from a high of 7.5 percent in 2010 to 2.3 percent in 2013. At the same time, litigation has skyrocketed, and the length of court actions can be extreme, lasting from six to 10 years.

Not only does corruption levy a national tax on Brazil's economy, it slows the modernization of key infrastructure. For example, Germany's Siemens has about $1.6 billion in infrastructure project orders related to the World Cup and the Olympic Games, including building systems for the national stadium in Brasilia and an energy management system for the national grid operator. Siemens also is part of a consortium of foreign contractors refurbishing and extending the São Paulo metro system. However, in January 2014, Siemens was banned from bidding on any new public contracts due to a long-running bribery case. Siemens reported the bribery attempt itself and is awaiting penalties, but the company's further involvement in Brazil's Olympic plans is limited to contracts already signed, even in the face of Siemens' relative stance against corruption.

Before the passage of Brazil's anti-corruption law, corporations had no liability for corrupt acts committed by their employees or agents acting on a company's behalf. Only individuals could be punished for corrupt acts. The Clean Companies Act makes both individuals and corporations liable and subject to punishment, and the penalties can be severe, rising up to 20 percent of a company's gross revenues for the previous fiscal year.

While well-intended and certainly long needed, Brazil's law has certain inherent problems. It is very broad: Unlike the U.S. Foreign Corrupt Practices Act (FCPA) and the UK Bribery Act, Brazil's anti-corruption law holds parent and affiliated companies, subsidiaries and members of the same consortium in a given public contract all jointly liable. And there is no clear-cut statutory limit to that liability.

Most problematic, however, is the fact that, unlike the Justice Department or the Securities and Exchange Commission in the United States or the Serious Fraud Office in the UK, no central Brazilian office is charged with enforcing the anti-corruption law. Not just Brazil's 27 states but its 5,570 municipalities can interpret the law, launch investigations, bring charges against companies, and impose penalties and sanctions. In fact, any entity within Brazil's executive, legislative and judicial branches may bring an action against a company. This, undoubtedly, will lead to inconsistent standards, practices, rulings and penalties being applied and will make compliance an ever-shifting target for companies.

Frighteningly, courts with no experience in anti-corruption actions could be in the position to determine corporate culpability and liability, and unethical judges might use the law to extort bribes from a company to prevent prosecution based on dubious or trumped-up evidence.

Like the FCPA and the UK Bribery Act, Brazil's anti-corruption law states that a comprehensive, transparent and clearly enforced corporate policy of compliance — including internal controls and written codes of conduct — will be taken into account and should be a mitigating factor when penalties are considered. But if various local authorities adopt differing definitions of what constitutes adequate controls and codes of conduct, it will be very hard — if not impossible — for companies to design programs that will be in compliance.

These difficulties and nightmare scenarios leave investors asking if the new law will encourage (as intended) or discourage business. And it leaves companies conducting business in Brazil or contemplating entering the market, asking what they can do to mitigate the risks of this law.

Risk Mitigation in Brazil

The greatest burden of the anti-corruption law will fall on those firms that have not invested in compliance programs. That would include the majority of Brazilian firms. To begin shouldering this burden in a responsible way, companies must take the following steps:

Assess

Given that the law specifically states that penalties in corruption cases will be mitigated by the evidence of adequate processes to guard against bribery and corruption in the conduct of business, companies must assess both their own organization's processes and their industry sector's. In truth, one-size compliance programs do not fit all. Depending on the degree of exposure to government contracts, the number of offices maintained and the subcontractors employed, each company must develop its own approach.

Investigate

Companies should investigate their own internal processes and practices to eliminate those that are non-compliant. A good place to start is by seeking local advice since compliance with the FCPA or the Bribery Act does not assure compliance with the anti-corruption law in Brazil, which differs in reach and in respect to where, to whom and in what way irregularities, once discovered, should be reported.

Companies must perform a risk-based assessment of what parts of the business likely would be most affected by the law's strict guidelines. For instance, facilitation payments as small as $250, which routinely are requested by government officials and are so ingrained

in the Brazilian culture that many representatives consider these payments as part of their salaries, no longer are permitted. (Indeed, a 2009 World Bank study found 16 percent of surveyed firms reported that they were expected to give informal "gifts" to tax officials.)

Investigations also should include the practices of Brazilian companies doing business abroad, especially in jurisdictions with weaker anti-corruption laws since Brazil law now holds affiliated companies and members of the same consortium jointly liable for the acts of any individual person or company. These investigations certainly should be a part of due diligence in the pre-transactional phase of all mergers and acquisitions, and these deals should continue to be monitored after a transaction has closed.

Before the new law, companies could acquire businesses with checkered histories and believe that the rewards outweighed the risks and that any follow-on problems could be fixed by implementing an upgraded code of conduct. Now, however, the acquirer also inherits the liabilities of the acquired company: The acquirer is responsible for the acquired company's malfeasances from the past, and, as noted earlier, there is *no clear-cut statutory limit to that liability*.

Conduct background checks

It is critical to conduct background checks on both employees and subcontractors even though access to firm and individual credentials is more limited in Brazil than in the United States or the Eurozone due to bureaucratic bottlenecks and the extreme fragmentation of Brazilian business databases and commercial boards. Each Brazilian state has its own commercial board, and each has a different search tool. Plus smaller subcontractors often employ persons for whom obtaining background information practically is impossible. Therefore, to reduce exposure to off-the-radar bribe offerings, it is advisable to employ on-the-ground investigators and advisors to obtain information about employees and stakeholders. For example, Coca-Cola was in business with Brazilian bottlers that (like many smaller Brazilian businesses) avoided taxes. Coca-Cola, after investigating its bottlers, cracked down on some and forced them out of their network, thereby limiting the company's own exposure.

Balance the investment

The huge increase in penalties under the anti-corruption law (which, as stated above, can be up to 20 percent of a firm's previous year's gross revenues) should be taken into account when conducting a cost-benefit analysis of a Brazilian investment. The cost of engaging in corrupt acts inevitably will be greater than that of implementing almost any compliance program and certainly more than conducting business-as-usual in Brazil. For example, train-making conglomerate Alstom has been charged with paying more than $20 million in bribes to São Paulo officials to secure contracts. Now São Paulo's public prosecutor is asking that all Alstom operations in Brazil be shuttered. In February 2014, a criminal lawsuit was opened against 11 persons accused of participating in the bribery. Subsequently, in the last year, Alstom has lost a quarter of its market value as its shares have declined 40 percent.

Harder to estimate, but equally destructive, is the reputational damage these actions cause. Almost every day, Brazilian newspapers delight in featuring corruption stories on the front page.

Get commitment at the top

Chief executive officers (CEO) must get out in front and take a strong stand against the payment of bribes as a way to get or facilitate business, no matter the cost to company growth, revenues or operations. However, a strong executive stance will ring hollow if the company persists in engaging in dubious deals or maintains relationships with questionable players in pursuit of fleeting opportunities. In short, boards and CEOs must walk the talk.

Train

Compliance is not only a top-down affair, it must permeate the organization. To create a compliant organizational culture, there must be regular, continuing and clear communications to and with all employees about a firm's ethics and code of conduct. Companies need to formulate written policies for reporting suspicious acts and should publish and disseminate (with the help of legal counsel) the details of what constitutes violations of the new law. This strategy should be designed with the character of the workers in mind, as well as scenarios that might arise. In Brazil, it is important not to overlook any segment of the workforce, from C-suite executives at headquarters to laborers at construction sites. For example, a manager on a loading dock can be asked for a bribe to get a truck unloaded as easily (if not more so) as a white collar employee who may be asked for a facilitation payment in a government official's office to get a permit stamped.

In Brazil today, the only effective policy for compliance is zero tolerance.

The Kickoff

Brazil's recently enacted anti-corruption law will continue to mature and evolve. One hopes that enforcement of the law eventually will be run centrally by the national controller's office (the Controladoria Geral da União). That would end the autonomy of local judges and prosecutors in the municipalities and help bring about standardization in the application of the law. Until then, businesses and wise investors must familiarize themselves with the law's (and the nation's) idiosyncrasies even as steps are taken to demonstrate a firm commitment to compliance.

By becoming educated with the intricacies of the law and by following the recommendations in this article, companies and investors can minimize the risk of running afoul of the law, with its consequent severe financial and operational penalties. Then — and only then — Brazil will have a chance for a happy World Cup and a successful Summer Olympics. ■

Eduardo Sampaio
Eduardo.Sampaio@fticonsulting.com
Senior Managing Director
Forensic & Litigation Consulting
FTI Consulting

Eduardo Sampaio is based in São Paulo, Brazil and has more than 15 years experience in risk and business consulting firms.

For more information and an online version of this article, visit ftijournal.com.