

The Foreign Corrupt Practices Act

US legislation with global implications

The recent investigation into the UN Oil-for-Food Programme has highlighted the need for multinational companies to be aware of the US Foreign Corrupt Practices Act and the negative consequences that can result from failure to comply with this legislation. Dick Thornburgh, Michael Missal, Edward Fishman and Jonathan Young explain the key provisions of the Act and outline steps that companies can take to promote compliance.

In late October 2005, the Independent Inquiry Committee examining alleged corruption in the United Nations Oil-for-Food Programme (the Volcker Committee) concluded that more than 2,000 companies from around the world had paid the Saddam Hussein regime over US\$1.5 billion (about EUR1.26 billion) in illegal “kickbacks” to obtain contracts to sell humanitarian goods to Iraq. The companies implicated in the final report issued by the Volcker Committee (the Volcker Report) included several well-known US and European multinationals, including Daimler Chrysler, ABB, Siemens, Eli Lilly and Eastman Kodak (*see box, The Volcker Report*).

The companies named in the Volcker Report now face more than negative publicity. Some of the companies have received inquiries from the US Department of Justice (DOJ) and the US Securities and Exchange Commission (SEC) about possible violations of the US Foreign Corrupt Practices Act (FCPA). The FCPA prohibits both US companies and their foreign affiliates, as well as foreign companies that issue securities registered in the US, from making or offering to make corrupt payments to foreign government officials. It also requires those companies to maintain accurate “books and records” and to have a sufficient set of “internal controls” to prevent corruption and other unethical behaviour.

Incidents such as the above highlight the FCPA risks faced by companies that conduct business in the global arena, while recent prosecutions



and settlements strongly suggest that enforcement activity and penalties for breach of the legislation are on the rise and will only increase in the future. If the necessary steps are not taken to promote compliance with the FCPA, companies and individuals can face serious penalties.

In view of these developments, this article:

- Details the recent rise in FCPA enforcement activity.
- Explains the key provisions of the FCPA.
- Outlines the steps companies can take to minimise FCPA risks.

The rise in enforcement activity

The DOJ and the SEC have dramatically increased their FCPA enforcement in the last few years, which has resulted in numerous settlements and significant penalties. A criminal violation of the anti-bribery provisions of the FCPA could result in prison terms of up to five years and monetary penalties of up to US\$100,000 (about EUR82,074.9) for individuals, and fines of up to US\$2 million (about EUR1.64 million) for corporations, per offence. In July 2005, two US business executives were sentenced to multi-year prison terms for bribing Haitian officials to reduce duties on imported rice. In the same month, Swiss industrial giant ABB Ltd agreed to pay US\$10.5 million (about EUR8.6 million) in fines to the DOJ in exchange for a deferred prosecution agreement on criminal FCPA charges.

In addition to significant monetary fines, the potential civil penalties imposed on a company for violation of the FCPA could include disgorgement of all revenues earned from the business associated with the corrupt payment. Last year, US defence consulting firm Titan Corp agreed to pay the SEC over US\$15 million (about EUR12.3 million) in disgorgement and interest penalties regarding illegal bribes to government officials in Benin, Africa. The SEC may also appoint an independent compliance monitor to examine a company's ongoing internal FCPA compliance programme.

FCPA compliance and enforcement remains a top priority for the DOJ and SEC, as recent prosecutions, settled cases and increased enforcement budgets make clear. In addition, the DOJ and SEC rou-

tinely co-operate and share information in investigations and enforcement actions. Given the US's continued efforts to pressure the Organisation for Economic Co-operation and Development and other regions to adopt and enforce anti-corruption legislation, as well as a heightened focus on corporate governance in the post-Enron era, the level of FCPA enforcement activity will likely remain strong for the foreseeable future.

The potential harm from an FCPA violation transcends government enforcement activity. A recent high-profile merger between US defence contractors Lockheed Martin and Titan Corp was aborted because of the discovery that Titan had made illegal payments to government officials in Africa. The discovery of an FCPA violation also could lead to class action litigation by US shareholders or wrongful termination litigation by affected employees.

FCPA: key provisions

The FCPA was enacted in 1977 following a series of admissions that large US companies paid bribes to foreign government

officials, politicians and political parties.

The FCPA applies to US issuers, meaning:

- Any US company and its foreign affiliates.
- Any foreign company issuing securities registered with the SEC.

The FCPA has two primary components: the anti-bribery provisions enforced by the DOJ, and the "books and records" and "internal controls" provisions enforced by the SEC.

Anti-bribery provisions

The FCPA prohibits US issuers and their officers, directors, employees and agents from offering "anything of value" to a foreign government official, foreign political party or candidate for foreign office to influence an official act or secure an improper advantage. An employee of a state-owned corporation qualifies as a government official under the FCPA.

The anti-bribery provisions contain an exception for making small "facilitating payments" to induce low-level foreign government officials to perform ministerial or routine acts. For example, paying a small sum of money to a foreign customs agent to expedite the paperwork necessary to receive a shipment of imported goods would most likely qualify as a "facilitating payment". However, making payments to influence a discretionary function (such as awarding a contract for supplying goods under the Oil-for-Food Programme) most likely would not fall within the exception.

Under the vicarious liability standard of the anti-bribery provisions, a US issuer may be liable for corrupt payments made by foreign affiliates or third party agents if the US issuer knew, or should have known, of the "high probability" that such payments were made. This standard was enacted to prevent companies from adopting a "head in the sand" approach regarding the activities of their foreign affiliates and agents. The DOJ has identified a number of "red flags" that may provide sufficient notice to the US issuer of corrupt conduct by its affiliates or agents (*see box, Red flags*).

Accounting provisions

The FCPA's accounting provisions generally require US issuers to maintain accu-

The Volcker Report

In April 2004, United Nations Secretary-General Kofi Annan announced the formation of a high-level Independent Inquiry Committee, now known as the Volcker Committee (named after its Chairman, former US Federal Reserve Chairman Paul Volcker). The Committee was appointed to conduct an inquiry into allegations of impropriety in the operation and management of the UN Oil-for-Food Programme.

The Committee's final report (the Volcker Report), published in October 2005, alleges that over 2,000 companies from the chemical, pharmaceutical, food and other global industries disguised payments to the Iraqi regime through improper service and transportation fees. According to the report, these arrangements enabled companies or their third-party agents to obtain reimbursement for kickbacks from the UN escrow account that had been established to pay for humanitarian goods. In other words, the Volcker Report claims that these companies used money from the UN programme itself to make illegal payments.

rate “books and records” and to establish and maintain an effective system of “internal controls” to account for transactions and assets. These requirements are designed to ensure the integrity and transparency of financial information presented to the investing public and to prevent foreign bribery and other improper financial activity. The SEC is the primary enforcer of these FCPA accounting provisions.

The “books and records” provision requires US issuers, and their foreign subsidiaries and affiliates, to maintain “books, records and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer.” The “internal controls” provision requires US companies and US issuers to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that:

- Transactions are executed in accordance with management’s general or specific authorisation.
- Transactions are recorded as necessary:
 - to permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements; and
 - to maintain accountability for assets.
- Access to assets is permitted only in accordance with management’s general or specific authorisation.
- The recorded accountability for assets is compared with the existing assets at reasonable intervals and appropriate action is taken with respect to any differences.

The US issuers covered by the above provisions must ensure that their wholly-owned subsidiaries comply with them.

In a case involving improper foreign payments, the SEC typically charges a company with violating both the “books and records” provision and the “internal controls” provision of the FCPA. The SEC takes the position that the use of funds for a purpose other than that recorded on its books is sufficient to support a “books and records” violation. In other words, an improper payment to a foreign govern-

Red flags

US issuers can be held vicariously liable for their affiliates’ and agents’ conduct. As a result, they should develop effective internal controls and monitoring policies to help avert any Foreign Corrupt Practices Act (FCPA) violations.

In particular, US issuers should look out for the following “red flags”, which have been identified by the US Department of Justice as potentially providing sufficient notice of corrupt conduct:

- Unusual financial arrangements.
- A pattern of corruption in the country.
- A refusal to provide FCPA compliance certifications.
- Abnormally large commissions.
- Lack of transparency in expenses and accounting records.
- An agent’s reputation for unethical business practices.
- Whether any transactions have been recorded as cash.
- Unnecessary third parties or multiple intermediaries performing similar functions.
- Requests for payments to a third party rather than the intermediary.
- Requests for reimbursements that are poorly documented.

ment official that is not described as a “bribe” on a company’s books and records is a violation (in the SEC’s view) of the “books and records” provision. Based on recent practice, the SEC usually finds an “internal controls” violation if it has concluded that a “books and records” violation occurred.

The SEC has emphasised that it will enforce the FCPA accounting provisions even when there is no jurisdictional basis for an FCPA bribery case. In other words, the SEC may find a books and records violation even where no one in the US was aware of any misconduct and even where there were no “red flags” that might have alerted US personnel to misconduct. The

SEC may find a books and records violation simply because a US issuer’s books and records do not fairly and accurately account for improper payments.

Minimising FCPA liability

Multinational companies can take several steps to minimise their potential FCPA exposure as they expand global operations and increase contacts with foreign governments. Some of the more significant steps include:

■ **Strengthening internal compliance programmes.** A robust and comprehensive internal compliance programme is the cornerstone of any strategy to minimise FCPA risk. An adequate compliance programme must, at a minimum, include the following components:

- a clearly defined corporate policy that prohibits any employee or agent from giving or offering to give anything of value to a foreign government employee or engaging in other conduct that could violate the FCPA, unless specifically approved in advance by the company’s legal counsel after full disclosure;

- an effective process by which the company’s FCPA policy is disseminated and explained to all employees (and, where appropriate, translated into foreign languages);

- an effective process by which all employees, or an expansively defined subgroup of management, finance, sales and all other employees that handle cash or interact with third party customers, agents or government officials, are required to provide annual certifications of compliance with the company’s FCPA policy; and

- periodic training and emphasis on the requirements of the FCPA policy and associated controls and procedures, either through internal meetings, external trainers or web-based programmes.

■ **Internal audit testing of all business locations.** It is not sufficient to have a comprehensive FCPA compliance policy without adequate and frequent testing of its effectiveness. As a result, all companies should endeavour to conduct full scope audit work (through internal audit staff or outside auditors) at all business locations within a specified time frame (for example, no later than every three years).

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This audit work should include testing in high-risk areas such as cash handling, third-party agent transactions, customs compliance and tax settlements. The audit coverage schedule should be based on a risk assessment that adequately considers, among other factors, any material management or system changes, the relative size of the business unit, and the time since the last audit at that location.

■ **Oversight of sales agents and other consultants.** The unsupervised use of sales agents, tax consultants, lobbyists and other third party consultants is a breeding ground for potential FCPA problems. A company should require legal counsel approval of any contracts or other arrangements with such consultants. Company management should also perform thorough due diligence on these consultants. In addition, consultants should be required to abide by the company's

FCPA policy and to indemnify the company for any breach of that covenant.

■ **Effective management and "tone at the top".** One of the best tools for managing FCPA risk is to have effective management in place at the corporate and oversight levels for any local subsidiary. In addition to setting the proper tone about the importance of ethical conduct, good managers often make frequent visits to local operating units and communicate directly with local employees. This level of interaction can facilitate the dissemination of company rules and policies and can encourage early disclosure or detection of potential FCPA problems.

■ **Sensitivity to business transactions in command economies.** Companies doing business in areas where governments still own or control many of the industrial production facilities and public service in-

dustries should be particularly vigilant to potential FCPA liability. Such high-risk areas include China, India and most parts of Africa and South America. US enforcement agencies have made it clear that the FCPA prohibits cash payments to employees of state-owned businesses (such as payments made to doctors at state-owned hospitals in China to induce them to buy certain pharmaceuticals).

■ **Due diligence in M&A transactions.** It is common for companies to inherit FCPA successor liability as a result of an M&A transaction. Potential FCPA liability should be considered prominently in due diligence activities, particularly when the company to be acquired has multiple operations in foreign locations. If a potential FCPA issue is identified, experienced FCPA counsel should be consulted about the implications and the available options regarding the proposed transaction, public disclosure and dealings with the regulatory agencies.

■ **Swift and thorough response to possible FCPA violations.** If a potential FCPA violation comes to a company's attention, it should conduct a prompt and thorough investigation to determine the nature of that potential violation, the adequacy of the controls in place to prevent such occurrences, and the steps necessary to remedy control deficiencies. In certain circumstances it is preferable to have outside counsel and forensic accountants conduct such an investigation to maintain independence from management. In addition, experienced FCPA counsel should be consulted about attorney-client privilege, document preservation and other issues that are likely to arise in the course of such an investigation.

Counsel should also be consulted about whether to make voluntary disclosure of an FCPA violation to the US enforcement agencies. This is typically a complex strategic decision that involves various considerations, including the impact on public disclosure obligations and the risk of third party litigation.

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