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Practicing the Law of the World from New York

TRANSCRIPT:

ARTICLES:

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PRACTICUM: FORM AND POLICY

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Living with the U.S. Foreign Corrupt Practices Act (FCPA) in an Era of Enhanced Enforcement

[Editor's Note: There follows an edited transcript of the program of the International Law and Practice Section of the New York State Bar Association (NYSBA) held on 28 January 2009 at the New York Marriott Marquis during the NYSBA's Annual Meeting.]

I. Introductory Remarks

MICHAEL GALLIGAN: Ladies and gentlemen, good morning and thank you for coming. We are very pleased to welcome you to this morning's program of the International Section, which is taking place in connection with the annual meeting of the New York State Bar Association. The focus of our program is on enforcement of and compliance under the United States Foreign Corrupt Practices Act.

I am very grateful to Ollie Armas for the tremendous job he has done in assembling the program today: in conceiving it, in coming up with innovative ways of presenting the material, and for gathering a tremendous array of speakers from here in New York, as well as from Washington, D.C., England, and elsewhere.

During the year, there are many smaller programs that our committees individually offer. I can give you a sample of some that took place last year: we had programs on Sharia law and on Russian law, and Jane Wexton, who is participating in this session, was part of a panel on corporate compliance programs. For those of you who want to take part in a more extended program and also like to get out and travel abroad and meet and network and interact with lawyers from other countries, we have our annual fall seasonal program, which, this year, takes place in Singapore, between October 26th and October 29th. The theme of that program will be "New York and New Asia: A Partnership for the Future."

For those of you from abroad, I note that we have chapters around the world. I see some members and chapter chairs here from India, Germany, Colombia, and many other countries. As you can see, there are many ways you can become involved in our section—whether you are an associate just starting in international practice, a young partner who is just now reestablishing your base for marketing, networking, or a senior partner who wants to share all the experience you have so as to pass on some of that knowledge, experience and wisdom to others. There are a tremendous number of opportunities to be active, become committee or chapter chairs and even officers of this section, in ways that are perhaps not true of some of the other international groups.

Ollie, I give the platform to you.

OLIVER ARMAS: Thank you, Michael, and my thanks to all of you. Let me make some brief introductions before I hand the podium over to our fine first panel. We have an interesting program today as we try to break open the topic of the Foreign Corrupt Practices Act for you in ways that you will hopefully find instructive and enjoyable.

The first panel will provide a broad overview of the statute and aspects of the FCPA that we think are necessary for any practitioner, whether a U.S.-based practitioner or a lawyer outside the U.S., to be knowledgeable about the FCPA. We intend for this morning's program to convey a good basic understanding of how the law works and how it has been recently enforced.

Our first panel is comprised of three excellent experts in the field. I am not sure if, under New York State Bar Association advertising guidelines, I am allowed to say this, but they truly are experts in the field and they will give you an overview from different perspectives.

Kevin Abikoff is a partner at the prestigious firm of Hughes Hubbard & Reed. He is a white-collar-crime specialist and does a lot of work in his field. He will be our first presenter and will give you FCPA 101 or 102, if you will, so as to set the stage for the remainder of the program.

We will then hear Jane Wexton, who runs her own national advisory consulting group, assisting multinationals and U.S. domestic concerns with compliance issues, including the FCPA. Jane is a former prosecutor with the District Attorney's Office here in New York. She used to be a chief compliance officer at GE Capital and has also served as chief global anti-money laundering officer at Citibank, N.A. She will develop the dialogue further so that you can start understanding concepts of the FCPA from different perspectives.

And then we will leap over the pond, as they say, to introduce aspects from Europe, principally the U.K. Lisa Osofsky is with Control Risks Group and duly qualified both in the U.K. and here in the U.S. Lisa is also a former prosecutor, a former assistant U.S. attorney out of Chicago. She will give you yet a third perspective, principally with respect to investigations that she or Control Risks Group has handled, introducing a European angle into the dialogue.

We will then move on to the second panel, which will take the form of a mock presentation. We have our actors here. I will give you a more specific introduction when we get to that part of the program. And with the mock presentation, our goal is to bring certain aspects of the FCPA to life, if you will.

We will conclude today with Carole Basri's panel. We will have in-house counsel from different companies who will give you their perspective on the FCPA and what it means in terms of the practical reality of having to deal with this broad statute and the heightened government enforcement in the area relating to it.

Thank very much. I hope you enjoy the program.

II. Latest Developments in Enforcement of and Compliance with the FCPA

A. Overview of FCPA

KEVIN ABIKOFF: Thank you and welcome. As Ollie said, I have the distinct pleasure of presenting FCPA 101 or 102. This usually takes me between one and three hours to do. I think I have just a small fraction of that time here, so I am going to be skipping over a few things. But I think it will enable you to approach the next sessions with an understanding of the elements of the FCPA, and at least—in the way I think about this statute—some of the critical issues that arise under it. Briefly, I will give first an overview addressing the legal and regulatory context, and then I will turn to the specific elements of the FCPA.

First, let us look at the enforcement environment, generally—and this is not just the U.S.; this applies to overseas, and it has specific application both to the FCPA and the other anti-bribery statutes around the world. I do not want to steal anybody else's thunder, but there are lots and lots of penalties involved, including big ones. We will hear about some of those very soon. Why are these penalties there? It is anybody's guess. I have written a book on corporate governance, and one of the things I suggest is that there is just a broad-based perception that corporate executives are bad guys. There is also a widespread loss of confidence in the public markets. If you combine that with enhanced enforcement resources and maybe just a tiny bit of opportunism on the part of our regulators to make a name for themselves, you get a pretty difficult environment.

I do not think you can look at the FCPA in isolation. It is a statute created in 1977, initially after examinations that related to the securities laws. Various people who were at the U.S. Securities and Exchange Commission (SEC) at the time take credit for having written it, but it emerged as a securities statute. You really have to put it back in that context, at least to some extent, to understand it.

The sources of duties and responsibilities for corporate executives under the FCPA are much the same as they are under those other statutes and rules. Thus, you have to look at the common law duties, the SEC statements, statements from deputy attorneys general at the U.S. Department of Justice (DOJ), and the federal sentencing guidelines, especially those related to corporations.

Those topics require a whole other lecture, but let us look at the key takeaways for companies wanting to comply with FCPA. They need to have an effective system in place to deal with risks. The system has to be managed by appropriate people with effective reporting to the board of directors. They have to react to red flags, and that is key. There have been decisions out of Delaware, out of Chicago, that say that, if you do not react to red flags, your conduct is not in good faith, and that, when your conduct is not in good faith, you face personal liability. Of all things, this tends to get the attention of boards and senior executives. Companies also have to be proactive: they must conduct their investigation, and, while the new DOJ guidance does not state that any privilege must be waived, companies must be prepared, most likely, in appropriate circumstances, to turn the information they uncover over to the government.

What is the FCPA? It consists of six basic elements. Various people organize these differently. This is how I do it:

The FCPA has as its focus the (i) payment, offer, or promise of (ii) anything of value to (iii) certain people—who include not just foreign officials but also candidates for political office and others—(iv) with corrupt intent (v) for the purpose of influencing that official to act or not to act or to influence somebody else (vi) to assist in obtaining or retaining business.

Those are the elements. It is a fairly complex and relatively confusing statute. I am going to make it easy. This is what I call the FCPA-sensitivity analysis. If you face any of the following issues, you need to be real careful. If you are corporate counsel or a private practitioner who does not regularly practice in this area and you hit these things, you should take a deep breath and start thinking real hard. What are they?—A payment, offer, or promise of anything of value to a foreign official or any of the other named people. Again, it would not be per se illegal, but great caution and due diligence are warranted when these factors are present. I am not saying that, if you litigated the matter all the way to the U.S. Supreme Court, you could not win on some of those other elements, for example, on the corrupt intent element or the element in regard to obtaining or retaining business. The lack of these elements has many times led to successful challenges. But I am saying that, if any of the factors I have mentioned are present, you need to stop and be really careful.

Now let us take a bit of a deep dive into some of these elements. Remember, the first element is not restricted to payments, it can also be a promise of some future consideration, like an interest in a company or something else that has not yet occurred. That would be enough, just a promise. "Anything of value" has been interpreted very, very broadly by the government. You need also to remember that this is not a statute that has been litigated to any great extent. Thus, almost everything we know comes from DOJ opinion releases (because there is an opinion release procedure whenever the DOJ is asked for its view on a matter) or settled actions. There are very few litigated cases.

We can, however, anticipate the DOJ's view, which from the perspective of whether you are going to be investigated, from the SEC's view, is very relevant. The DOJ interprets the statute very broadly. Obviously, the good-old-cash-in-a-suitcase scenario fits the bill: if you have been to Nigeria, you know that still happens. I have been there, and I have seen it.

But "anything of value" does not mean only cash. It includes stock in companies, in-kind things like travel and medical expenses, even T-shirts. There's one case where buying a presidential candidate T-shirts to help support his reelection was considered an FCPA violation. The overall message is to use common sense. If you are counseling in this area and you are trying to figure out if what is being done is anything of value, remember that, if you think it is something of value, it probably is.

The payment must be to a foreign official. That is not always obvious. Take nothing for granted. Remember that employees of state-owned companies, even low-level employees of state-owned companies, can be foreign officials. If you are doing business in China or the former Soviet Union, for example, you have to be very careful because that lab technician who you just offered to fly over to see your facility, which may be okay or maybe not, could be a government official for purposes of the FCPA.

Do not be content with the designation that the person has. It is not restricted to just them; you must also look at their immediate family members. There may come that nice government official who says, "You know, it would be really helpful if you gave some money to my favorite charity. Look, it buys food for the needy in our country." That may be lawful, but you have to look carefully. Be especially cautious if you are working with anyone, even a charity, that has been recommended to you by the government. That is a classic red flag.

Finally, let me note that there is no absolute prohibition against working with a foreign official. Back in the early '80s, when the DOJ initiated its opinion release procedure, one of the first opinions talked about this. But you have to be very careful. Here, again, one must use common sense. If you are working with an official in the United Arab Emirates and he is a government official who manages education and you are looking to do something in the oil and gas industry, that might be fine, even if he is a government official, even if he is the third cousin twice removed from a person with much power in the government. On the other hand, if he is a half-brother and has no particular skills and the only thing that he can do for you is give you a relationship with his half-brother, it is probably not lawful. Again, there is no absolute prohibition against doing business with foreign officials or even employing them. It has been allowed, but you have to be very, very careful.

Much about the FCPA involves risk management. When you do business in the former Soviet Union or China, you are not going to be able to eliminate risk. It is all about risk management and setting up your continuum, reviewing probabilities, and making a call. In the context of paying third parties—and this happens in many, many countries around the world—you cannot, in some places, legally do business without engaging an agent or somebody who is your local sponsor. Payment to those third parties can also violate the FCPA if the payment is made with the knowledge that it is going to be used to bribe someone else.

Now, knowledge sounds like an advantageous factor. You might think that "knowledge" means actual knowledge. Well, unfortunately, common sense is defied. If you recall in *Casablanca*, there is the classic scene where gambling is taking place in every corner. In closing down the club, Captain Renault says, "I'm shocked, shocked to know gambling is going on in here," just as the croupier hands him his winnings. Obviously, you cannot simply say you are shocked. You cannot stick your head in the sand. This is in the legislative history and the statute itself: The knowledge requirement entails less than actual knowledge. There is a strong sense of constructive knowledge: you are not permitted to bury your head in the sand. Whether you are deemed to have knowledge is not a question just of what you actually knew; it is also a question of probabilities. This is what the statute speaks to. One of the standards is whether you were aware of the high probability of the existence of a circumstance. This is somewhat complicated. What is a high probability? They do not tell us. Is it sixty, seventy, or eighty percent? The basic idea, even if you cannot calculate it with mathematical precision, is as follows. If you are handing money over to your agent and you think it is quite likely that that agent is owned by a government official who is involved in the deal—the existence of a circumstance, i.e., the circumstance of that official's ownership—and you think it is ninety percent certain, especially when the agent says, "I'll make sure so-and-so gets the money," and you have a sense what that is, this would appear to constitute "high probability" for purposes of the statute.

JANE WEXTON: I would also add that there are a lot of tools to help you determine whether there is a high probability, including Transparency International's list of countries that are most corrupt. If you take a look at what the Department of Justice has done in the past year, Nigeria probably comes out as number one on the list, simply because there have been so many actions taken against companies doing business in Nigeria. But taking a look at that list each year is a great way of figuring out whether there is a high probability.

LISA OSOFSKY: I would like to add the idea that you would also look at the industry in which you are working or where your client comes from, because, when you talk to DOJ officials, they will admit that they will review industries and specific sectors in different jurisdictions. That is another good way of getting to that common sense point Kevin previously mentioned.

MS. WEXTON: The oil and gas industry is an example, and pharmaceuticals and medical supplies are also industries that have been heavily hit by actions in the last few years.

MR. ABIKOFF: The other thing under that very funny statute is what I call the "burden-reversing paradigm." I consider it nothing short of bizarre that, in a settled action about a year and a half ago, in connection with Baker Hughes, there was no proof that Baker Hughes, in a number of countries, had actually bribed anybody. There was no proof, but Baker Hughes could not prove to the satisfaction of the Department of Justice that they had not bribed anyone. The Justice Department took the position that, in the absence of due diligence and systems, it was going to assume, basically, that Baker Hughes had bribed somebody; however, the DOJ indicated that it would not hold Baker Hughes responsible under the anti-bribery provisions of the FCPA per se. Instead, the DOJ held them responsible under the books-and-records and internal-control provisions of that statute, which are now part of the main body of securities laws, actually enacted in 1977 as part of the FCPA. I consider it fairly bizarre that just not doing due diligence and not having a sufficiently papered file showing that you did not know can be enough for the DOJ and SEC to prosecute.

MS. WEXTON: That, incidentally, cost them a mere $44.1 million in fines imposed by the DOJ.

MR. ABIKOFF: Plus the monitor.

MS. WEXTON: Plus the cost of a monitor for three years.

MR. ABIKOFF: As with location in regard to real estate, only three things matter here: due diligence, due diligence, due diligence. You have to approach it carefully, with a mindset that you have to have the right level of detail, thinking about bigger views. You want to paper that file well. You want to have the right documents. You have to think that some day you may have to show this to the DOJ, voluntarily or involuntarily. And you have to remember the line of cases, starting with *Computer Associates* a few years back, that have shown out that, if in the course of doing due diligence or conducting an internal investigation, one of your employees lies to that investigator, even a private practitioner, that person could be held criminally liable. Thus, the stakes in these matters are very, very high, and the need to approach these matters carefully is profound.

B. FCPA Trends

MS. WEXTON: I am going to review what the trends are this year in the FCPA area. I will discuss how in six years things have changed and changed rapidly.

The first change is that there has been an extraordinary upswing in litigation and prosecutions that governments have brought. In 2004, the Department of Justice brought two FCPA actions, and the SEC, three. Last year, in 2008, there were twenty actions brought by the Department of Justice and thirteen by the SEC, so there has been a huge uptick. There are about a hundred active cases in the pipeline at the Department of Justice right now. What we are starting to see is a broadening of the categories of companies that are being investigated by the government.

The second area is that of fines and disgorgements. The size of these has been getting larger, and I will give you some information on how much larger.

The third area that I will address is international cooperation, which is a relatively new phenomenon seen over the past two years, involving extremely aggressive enforcement, not only against corporations, but also after individuals.

Two additional areas I want to address are the use of the FCPA in conjunction with the prosecution of other criminal activities. Thus, suddenly, we are seeing a combination of antitrust and FCPA violations. It was always typical to see mail fraud, wire fraud, money laundering, and other actions brought in conjunction with FCPA. But now we are starting to see a trend towards antitrust being the activity that brings a matter to the attention of the Justice Department, where then the FCPA enforcers dig into the case.

The last area I will address, for those of you doing deals—and I know there are not a lot of deals around this days—is the increased need for due diligence in mergers and acquisitions. This is a very new development.

It probably started with GE InVision, that is, when GE was acquiring InVision in California, which is a security firm that had equipment for inspecting luggage and other items passing through airports. The deal was all signed up and ready to go. Before closing the deal, they suddenly discovered that third-party intermediaries had been making payments in Thailand, China, and the Philippines in order to get the governments there to buy their particular equipment for the international airports. Uncovering this led to a delay in the closing of the deal for almost a year. It cost everybody a fortune. Once GE took over InVision, it created a three-month monitor and instituted intense requirements for redoing the entire structure of compliance within InVision. We are seeing this type of thing happen again and again. We also saw it in Vetco-Gray when it was spun off from ABB. There, the acquisition received intense due diligence scrutiny because otherwise the acquirer would have ended up with successor liability for the bad behavior of the acquired company. Undertaking the due diligence investigation before the company (with all of its faults) is acquired is key. If you work on corporate matters and deal in international or any kind of due diligence work involving parties doing business abroad, you must look at the behavior of the target company.

Let me move on to the second area, fines and disgorgement. The numbers in this area have become extraordinary. For those of you who are worried about billable hours in your law firms, apparently Debevoise & Plimpton has just completed billing 1.5 million hours on behalf of Siemens, earning over $300 million. The audit committee of Siemens had 1.6 million hours of work done by law firms, Deloitte & Touche and other forensic accounting firms. The total bill for lawyers' fees and for internal audit activities in the Siemens case was over a billion dollars. This past December, they settled with the United States government for $800 million, $350 million of which went to the Department of Justice, with the rest going to the SEC. Yet, that was not the end of Siemens's problems. Siemens also had to pay the German government, although we are not sure that the payments to the German government are complete. The total amount is more in the range of about $2.7 billion in settlements for activities that took place and were investigated all around the world. Where evidence was found of corrupt payments made on behalf of Siemens, it appears to have been standard procedure that Siemens paid off governments in order to procure contracts for the sale of Siemens's products.

MS. OSOFSKY: I would like to add here that the way in which the laws were structured in Germany resulted in a company's actually getting a tax write-off in the process!

MS. WEXTON: This was the case until 1998, and this made it difficult for people at Siemens to change. Argentina, Bangladesh, China, Iraq, Mexico, Nigeria, Russia, Venezuela, and Vietnam were the jurisdictions in which there was evidence of large-scale payments by Siemens to get their deals through. They have paid Germany $569 million in fines to date. They have paid the Munich prosecutors $287 million, and they have paid the German government $255 million in disgorgements, so the numbers are getting huge. The $44 million that was paid by Baker Hughes in 2007 looks like chump change in comparison.

Let me bring you up to date; the following was a recent headline in the *Wall Street Journal*: "Halliburton to Pay $559 Million to Settle a Bribery Investigation." This involved the production of a gas plant in Nigeria. These activities date back to the period between 1996 and 2000. I assume that this case has come to a conclusion because a subsidiary of Halliburton, Kellogg, Brown & Root, which was split off from Halliburton about a year ago, was headed by a chief executive officer who is due to go to prison for seven years. He has been cooperating with the U.S. government and probably was in the process of telling all. That is how the Halliburton case probably came to a fast conclusion. The Halliburton investigation had been going on for years. That is not the only case that Halliburton is involved in, and we will be seeing more developments. It has not yet been disclosed whether or not they are admitting or denying anything or whether they are going to be barred from being able to pursue other contracts.

One of the features of the FCPA that is important to know, especially if government contracting is involved, is that, if you are found guilty of or plead to a violation of the FCPA, you can be barred from being able to pursue future contracts, not only in the United States but also in other countries. Indeed, Siemens is in the process of being barred from pursuing contracts in certain countries where there has been past corrupt activity.

The Siemens case is perhaps the biggest case that has awakened Europe in a most extraordinary way. A great deal of the work I am currently doing is in the European area because there is less knowledge and focus there than within U.S. multinationals in regard to how to create a risk program that addresses areas where there are red flags and where problems are predictable. There is much activity in this regard in Europe. When Siemens pays $2.7 billion, other companies in Europe are surely paying attention to that.

Willbros made a $3.8 million corrupt payment in order to reduce the tax assessments that it had mainly in South America (i.e., Bolivia and Ecuador) and in Nigeria. They have just paid a fine of $22 million and $10.3 million in disgorgement of profits. Disgorgement is a new feature that has surfaced among recent developments. In addition to the fines that you pay, one of the tools the U.S. government has been using in the last few years is disgorgement, i.e., requiring a party to disgorge the profits it received from having procured a contract by making a corrupt payment.

ABB has had its second major brush with the Department of Justice. Several years ago, it was found to have been making corrupt payments. Its subsidiary ABB Vetco-Gray has certainly paid fines in the past; now ABB is being looked at in Iraq, Kazakhstan, and Nigeria. We will be hearing more about ABB.

Let me go on to the next topic, which is aggressive enforcement against individuals. Up until about two years ago, enforcement was mainly a matter of imposing fines on corporations. Having been chief compliance officer at two major corporations, at GE Capital and before that at Citibank, I can say that corporations sometimes view fines as (i) the cost of doing business and / or (ii) a black mark on the company's reputation. However, if you want to capture the attention of senior executives in any company regarding the need for getting serious about how to go to market, let them know that they can find themselves in prison for a couple of months or a couple of years. For example, we have the head of Kellogg, Brown & Root going to jail for seven years. That catches the attention of senior executives as no $559 million fine ever could. The prospect of losing one's freedom in federal prison makes the job of compliance departments much easier indeed.

A number of people are currently fugitives from justice. James Tillery, former president of Willbros is on the lam, as are Paul Novak, a consultant to Willbros, and others. There are a number of people who are living today in places like Namibia and the Bahamas, as fugitives from justice. A number of people are going to prison for payments that were made in Vietnam. In the case of Pacific Consolidated Industries, there was a $20,000 fine and probation for the person who was the president of that company. In each of the one hundred investigations that are ongoing, individuals are being scrutinized to determine whether they might be brought to justice for the corrupt payments that were made.

Before I hand the floor over to Lisa, I would like to speak about international cooperation. Mark Mendelson, who is the deputy in the Department of Justice, is the person who decides on the prosecution of all FCPA cases. About a year ago in Rome, there was a meeting of all of the countries in the Organization for Economic Cooperation and Development (OECD). What was historic was that all of the prosecutors from around the world met there and spoke about how they might cooperate with each other and share information. Subsequently, in Paris in June of 2008, there was another meeting where prosecutors from all of these countries met to talk about how they might cooperate.

Because most of these cases cross borders, obtaining information is difficult. Last year, Mark Mendelson utilized forty-five letters rogatory and made sixteen international trips, including trips to Crete, Hungary, Panama, Romania, and the U.K. Twenty-three multi-jurisdictional cases were brought. This is all evidence of an increase in international cooperation.

With that, I would like to turn the floor over to Lisa.

MR. ABIKOFF: If I could add one thing in regard to Mark Mendelson and the DOJ's commitment to cooperation, let me note that it is not just in friendly locales like Paris. I have actually been in the office of the chairman of the Economic and International Crimes Commission in Nigeria, when he very proudly showed me letters from Mr. Mendelson and the DOJ and told me how he was cooperating.

C. U.K. Perspective

MS. OSOFSKY: If I had been asked about six months ago to give this presentation, I would likely have been able to keep well within the time limitation because, if asked what the British government had been doing about foreign corrupt practices, I probably would have given a two-word answer: not much. Well, that has changed a good bit over the past six months, and I will very briefly give you a sense of what is going on in the jurisdiction where I am now located. It might also provide food for thought for you in contrasting some of the points raised by the other panelists.

"The U.K. is Trying to Make Some Inroads" might be the caption for my presentation. These inroads do not always happen in the most likely of places. For example, we have just had the U.K.'s Financial Services Authority (FSA), which is a regulatory body in the U.K., slap a £5.25 million fine on Aon Limited, while just two months before that, the Serious Fraud Office (SFO), which is the prosecutor body tasked with going after bribery, entered into a civil settlement with Balfour Beatty. Thus, as you can see, we have had some somewhat unusual results.

On second thought, "Attempting to Make In-Roads Where Possible" might be a better caption for my presentation. Perhaps in the case of certain bodies, it has been a matter of having the proverbial bird in the hand, rather than attempting aggressive enforcement along the lines we have heard previously in this program. For example, the idea of personal liability that we have just heard so clearly described has not been the focus of U.K. actions to date. However, the U.K. authorities are looking very long and hard at what is being done in the U.S., and they are taking a page out of the U.S. book in terms of how to fashion settlements and how to investigate matters. The more that there is actual cooperation in corrupt-practices matters, the more likely we will see actions that start to look and feel like those we have seen at the U.S. Department of Justice.

To give some very brief history, on 16 October of 2008, the OECD issued a report criticizing the U.K., stating basically that, although the OECD had been after the U.K. since the OECD convention came into force in 1997, the U.K. had not done what it should have done about implementing that convention. Why was there a problem? The SFO had dropped the Saudi Arabian aspect of the investigation of BAE Systems, and the matter ended up going up to the House of Lords. Several law lords said that that investigation should not have been dropped. Ultimately, on 31 July 2008, the full law lords panel proclaimed that dropping that investigation was appropriate. The reason was that the investigation had jeopardized national security and basically was not in the economic interests of the U.K. It was reported that there had been threats by the Saudi Arabian government—or at least this is what was put forth as the rationale—that might lead to harm for the people of the U.K. There had been a very public debate about this. The OECD report pilloried the U.K. government, because of the OECD's disappointment about that investigation and also in regard to the U.K.'s patchwork of laws: what was needed, the report indicated, was something straightforward that really worked, rather than having to rely on laws that were passed in 1889, 1906, and 1916.

MS. WEXTON: Lisa, as you know, one of the interesting features about the U.K. is that BAE, which is a British corporation, has got U.S. subsidiaries. And, while the U.K. has not actively pursued BAE because of claims that intelligence information was being jeopardized, the Saudis were extremely angry at the fact that there was an investigation going on about the sale of armaments to the country. The Saudis supposedly threatened not to give intelligence information over to the U.K., so one can understand why the government backed off of that. The U.S. government has not backed off. Thus, BAE, while it is not being investigated in the U.K., continues to be investigated through its U.S. subsidiaries. The lesson is that, if you have U.S. operations of a European-based multinational, the U.S. will not necessarily back off, even if the foreign country is not pursuing enforcement.

MS. OSOFSKY: And indeed, in other jurisdictions, the U.K. government—that is, the SFO in particular—is actually cooperating in those actions. There was recently an arrest with relation to the Czech Republic, and there were questions about what was going to happen next, but the answer is that the SFO seems to be keeping its hand in these matters, even if in a very limited way.

There is good news from an enforcement point of view—and, please remember, I am an ex-prosecutor and ex-deputy general counsel for the FBI, so forgive me for saying that it is good news from an enforcement perspective and the perspective of making companies compliant. In August of 2008 there was the first successful prosecution in the U.K., relating to a series of corrupt payments totaling £80,000 that were made so that a security company could win the right to provide security for Ugandan officials meeting in 2007. The case, interestingly enough, was not brought by the Serious Fraud Office (SFO), but rather by a unit of the London police called the "City of London Police Overseas Anti-Corruption Unit" that had been created fairly recently, in November of 2006. It has had a staff of only ten, but it recently received funding extending into 2011. As you can see, there does seem to be a commitment, at least on behalf of some investigative bodies operating in the U.K., to pursue these matters and see them through to prosecution.

MS. WEXTON: I would also note that the Department of Justice, up until very recently, did not have a dedicated unit of investigators. There is now an FBI unit that is reporting into the DOJ and working only on corruption cases. And that is a very new development. We never had a unit dedicated to these matters in the U.S. previously, and now we see it echoed in the United Kingdom.

MS. OSOFSKY: That is very interesting. I would also like to bring up the Balfour Beatty settlement as a point of contrast. This involved some payment irregularities in the construction of what was called the Biblioteca Alexandrina, a project of Balfour Beatty in Egypt. The project was ongoing in the 1990s, and the SFO recently entered a civil settlement, with the High Court entering a civil recovery order for £2.25 million on 6 October 2008. The specific tool it used came from a provision in the Proceeds of Crime Act, which is an anti-money laundering statute, in force from February of 2003. What is interesting in this case is that the SFO decided not to pursue criminal charges, because the time frame was thought to have been too far in the past and many of the people who had worked in the relevant subsidiary were no longer employed there. Contrast that with some of the examples we heard about from Jane.

As we know, in the context of mergers and acquisitions, companies are often held liable for actions that the acquired company undertook prior to the acquisition. So, it is interesting to me, from a U.S. perspective, to focus on the fact that the SFO traded off a criminal prosecution for the civil route. This was heralded in the U.K. press as a huge breakthrough, because it was an FCPA-style resolution. This was a situation where the company had conducted its own internal investigation, come forward with its hands up, explaining what it had done, and then implemented certain remedial provisions that were found to be satisfactory enough for them to avoid criminal liability.

I just want to talk about one policy issue and last case. On 20 November 2008, the British Law Commission, which was evaluating the law on bribery, developed a very simplified version of such a law. Rather than this cobbled-together approach from 1889, the Law Commission proposed going after the giver and the recipient and imposing liability on the company for failing to adequately prevent bribery by an employee. This is a pretty far-reaching standard. To assert an affirmative defense, the company can show that it has adequate systems and controls in place to prevent bribery. This highlights the need for corporate counsel and companies to make sure that they have the right sort of internal rules in place.

As we have seen, however, having the right rules in place is not enough. In the Aon case, there was a beautiful manual about how not to bribe people. The FSA issued a very detailed final notice on 6 January 2009, explaining that the nice map about how to behave had actually not been appropriately put into place. The Aon case showed the effect of the exact opposite of reacting to red flags. Basically, Aon in its prior iteration—i.e., two companies that were predecessor companies of Aon—had been censured by the Lloyds disciplinary board, who were looking at insurance matters and who were the regulators at the time. The censure was light by today's standards: a fine of £300,000, but you would think it would have put the Aon entities on notice that something was going on in terms of payments to overseas third parties, which is what made them targets of the FSA this year. However, they did not react to those red flags. In fact, they appeared to have done very little over a fairly long period of time. In June of 2006, some brokers who had been in the energy division left, and it then came to light that there were some issues with bribe payments, in particular in Indonesia. They did not undertake much actual internal investigation. It took until the following year, April 2007, when the Indonesian authorities advised Aon that Aon had a problem, for Aon to wake up. Aon then conducted an internal examination and subsequently explained to the FSA what had happened. The explanation resulted in the FSA's reducing the ultimate fine by thirty percent. The FSA heralded the case in the press as the largest-ever criminally related fine imposed by the FSA.

In summation, we are seeing a more active world in terms of corruption prosecution and investigation. Moreover, many of the tools that are being used by various U.K. government bodies are modeled on what has occurred in the U.S.

D. Deferred Prosecution

MS. WEXTON: There is one last trend we ought to take note of. Although this trend was noticeable a year ago, it is certainly something you should be aware of if you have not worked in this area. Instead of having American companies plead guilty, the DOJ has been using the technique of deferred prosecution agreements that last from three to five years. During the term of the deferred prosecution agreement, monitors are appointed to review the internal workings of the company to see how anti-corruption training and procedures are being implemented within the company.

For those of you who are interested, it is extremely lucrative for a lawyer to be appointed as monitor of a company. The company pays for the monitoring. There is no attorney/client privilege between the monitor and the company being monitored. In fact, the duty flows from the monitor to the Department of Justice. We have mentioned earlier how expensive the FCPA has become, but having a monitor in your presence with many associates going through everything you have done and then reporting to the government about how you are doing can also be quite disruptive for companies, and it is something that many, many companies are living with today.

MR. ARMAS: Well, thank you. We can certainly take a question or two on this panel before we move on. You will also have an ample opportunity to ask questions of the other panelists.

E. Subsidiaries of U.S. Parent

AUDIENCE MEMBER: I am from China. I can certainly echo the sentiment of FCPA enforcement because it is also quite a hot practice in China. In regard to China's commercial anti-bribery law, I think that the government of China will soon realize that money can be made from an anti-bribery regime, and there will be more intervention in this area, as well as in regard to foreign-lawyer lobbying. I have two questions. First, what is the interaction between the FCPA and a local foreign law? For example, if certain conduct would be considered bribery under local law, would the FCPA presume the conduct to be bribery for its purposes? Second, is there a test for "control" with regard to subsidiaries? For example, there are many joint ventures, some are majority-owned by foreign companies, and some are not. What is the test in applying the FCPA to foreign subsidiaries? Thank you.

MR. ABIKOFF: As to the first question, the FCPA will not automatically pick up everything that might count as a bribe in a foreign jurisdiction. Something, theoretically, could be a bribe in China that is not a bribe under the FCPA. However, since the FCPA is structured broadly, it would be hard to figure out how that would be. There is a flip side to this. The FCPA provides for certain exceptions to its applicability, for example, where certain payments are permitted under the FCPA—they may be small payments or "grease payments" as they are called—so long as they are permitted under local law. You fall out of that exception if you do not meet the FCPA test. China should be an interesting jurisdiction. Not many countries have the death penalty for bribery; China has it and has used it.

MS. WEXTON: With respect to local law versus FCPA, I would comment that I have worked in 108 countries in my career and continue to travel widely, and I have never been in a country that did not have some kind of bribery law. The difference is that the statute may not often be utilized in many countries, but it is on the books, while at the same time people will say to you, "Oh, this is the way business is done." However, slowly but surely, I think there is a growing awareness in many different jurisdictions that it is not the way business should be done. For example, the fact that the Indonesians approached Aon is striking. The first project I ever worked on was the Paiton Power project in Indonesia, which at the time was the largest electric power facility, when Suharto and his daughter and son-in-law were implicated in connection with it. The fact that the Indonesians are pursuing this today gives you a sense of how things have changed.

In terms of subsidiaries and joint ventures, which is the second part of your question, if it is a U.S.-based company, with U.S. actors, there is no rule with respect to whether it must be 24.9 or 49.9 or 51 percent: it will be subject to the FCPA. U.S. actors are involved in most of the joint ventures that I have been involved in around the world. Because there is U.S. investment as well as local investment, U.S. persons are usually found on the boards of directors of such joint ventures. They are at tremendous risk if they have not made clear their positions on these issues during board meetings. If they sit by and permit corruption that they are aware of to take place, they become part of the problem. Thus, the distinctions are blurred, regardless of whether it is a subsidiary or a joint venture, so a good rule of thumb is: don't do it!

MR. ABIKOFF: There is some language out there that there is a test for subsidiaries. If the entity is a purely non-U.S. subsidiary, the parent in the U.S. must have had knowledge of, participation in and control of that subsidiary, and there is also some notion there has to be a link to U.S. participation. Among the settled actions, there is at least one that has eroded this approach and basically held the U.S. company liable under a pure agency theory. There it was said that the subsidiary was the agent of the parent.

MS. WEXTON: Very often the books and records roll up, so that if you have consolidated returns, with the subsidiaries getting poured into the parent company, the SEC is going to look at it as a books-and-records violation. Thus, there are many ways around the subsidiary issue. Again, the bottom line advice here would be: don't do it!

MS. OSOFSKY: Let me mention one little wrinkle from an investigative perspective. We have found that our clients are frequently and particularly challenged in China, where there may be a governmental hand in many aspects of private life. That involvement may not be completely obvious to an outsider, at least at first blush. It is somewhat of a challenge to ascertain whether there is governmental involvement in a particular transaction.

MR. ARMAS: Thank you very much.

III. Making Compliance and Enforcement Real: Mock Discussions

A. Mock Discussion Between In-house Compliance Counsel and Outside Counsel

1. Introduction

MR. ARMAS: With the first presentation, the stage has been set. We now have a good understanding of the FCPA and the intense enforcement in the area. Now, in this portion of the program, we are going to bring it to life, if you will. We are doing this by way of two vignettes and two mock scenarios, whereby our fine actors, who I will introduce in a moment, will break open the practical realities of dealing with the FCPA in ways that you will hopefully find enjoyable and informative.

Our first actor is Angela Fifelski, who is Associate Counsel of Compliance with Zimmer Holdings, Inc. Zimmer is a medical device company based out of Warsaw, Indiana. They make orthopedic implants—for hips, knees, shoulders, ankles, basically any joint that you can think of. Angela runs a very broad compliance program within Zimmer in many parts around the world, including Latin America, Europe, and I believe Asia as well, just about everywhere. She will be playing the role—it is a stretch for her—of the client. And the client will, in the first vignette, be having a meeting with her outside counsel, who is Will Barry from the Washington, D.C., office of Richards Kibbe & Orbe. He is a white-collar-crime specialist. Will does a lot of complex securities enforcement work. He will be reporting to Angela about an internal investigation that he conducted on behalf of her company. We have a hypothetical set of facts, which I will describe for you so you have the factual background.

After the first vignette, we will have a second one in which Will will be meeting with Barry Sabin, who will be playing the role of attorney at the DOJ, where Barry spent eighteen years, most recently as the Deputy Attorney General for the Criminal Division. He is now a partner in the D.C. office of Latham & Watkins, where he will be running very interesting investigations, but from the other side now, as a defense lawyer.

2. Hypothetical Fact Pattern

MR. ARMAS: Let me now give you the hypothetical fact pattern for this segment of the program. Talk-a-Lot is a U.S. telecommunications company with operations in Latin America. Through local subsidiaries, Talk-a-Lot has successfully bid for contracts to develop mobile telephone networks in several Latin American countries. Talk-a-Lot is interested in expanding its operations in Panaragua.

Telecommunications services have long been nationalized in Panaragua. However, a new government announced its intentions to privatize the telecommunications industry. The legislature adopted the law permitting foreign companies to provide telecommunications services in Panaragua. The state telecommunications authority subsequently issued a request for bids for contracts to modernize the country's mobile telephone network. Talk-a-Lot submitted a bid for one of these contracts through a subsidiary in a country bordering Panaragua. Talk-a-Lot and three of its leading competitors were awarded contracts by the state telecommunications authority to develop separate parts of the telecommunications network.

Talk-a-Lot received an anonymous tip through its FCPA-compliance hotline soon after it was awarded the contract to assist in developing the Panaragua's mobile phone network. According to the caller, Talk-a-Lot's subsidiary hired the nephew of a legislator in Panaragua as a consultant after the government had announced its privatization plan. That legislator was one of the authors of the privatization law and purportedly lobbied the state telecommunications authority in favor of Talk-a-Lot's bid. The caller also stated that one of Talk-a-Lot's distributors in Panaragua had sold certain sensitive communications equipment to another distributor, CHE Communications. The caller said that Talk-a-Lot's distributor suspected that CHE was exporting the equipment to Cuba, which was seeking to develop its own mobile telecommunications network.

Talk-a-Lot's preliminary investigation has confirmed that over $200,000 in payments were wired from a Miami bank account to the consultant's account in Panaragua. The investigation has uncovered no evidence that the consultant paid any of the money to the Panaraguan legislator. Talk-a-Lot is not currently operating under a Deferred Prosecution Agreement and has not been contacted by the Department of Justice in connection with the Panaragua contract. However, several of Talk-a-Lot's competitors who also submitted winning bids for the Panaragua contract have recently been subpoenaed by the DOJ.

With that, we can begin the first mock discussion.

3. Mock Discussion Between In-House and Outside Counsel

ANGELA M. FIFELSKI: Will, thank you for doing the investigation. What did you learn?

WILLIAM P. BARRY: As you know, once we received the tip from the company's hotline, we instituted, as "step one," a document-retention requirement in the company with respect to its Panaraguan operations. We are in the midst of and have substantially completed our interviews with relevant business-line personnel, compliance-office personnel, and the subsidiary, as well as those responsible for the accounting controls and the books and records of the company.

I want to stress that we have not yet completed our investigation, but we are making progress. What we have identified thus far is that, consistent with the tip, there was, in fact, a payment made from a Miami account to this consultant. We have found no evidence that those monies were passed on in any way to the legislator, but we have also confirmed that there is a relationship, one of uncle and nephew, between the legislator and the consultant.

My recommendation at this point is that we schedule a meeting with the Department of Justice. We should also be scheduling something with the SEC in light of Talk-a-Lot's status in the United States. Even without that status, as a domestic concern, the company would still be required to abide by the Foreign Corrupt Practices Act. My recommendation is that we set up the DOJ meeting to inform the DOJ that we have begun this review and explain why we have done so, and stress the company's commitment to compliance and its commitment to getting to the bottom of the matter.

MS. FIFELSKI: That is a lot of information. In regard to disclosure to the government, you mentioned that the investigation is not yet finished. Why would we go to the government when we have not yet completed our investigation?

MR. BARRY: The reason I would recommend your ever going to the government at a preliminary stage of an investigation—provided that you know enough to know what you know and what you do not know—is to initiate the dialogue with the government and be seen as proactive with respect to reporting to the government. Doing that puts us in a position to report to the government at a stage when we can still react to particular concerns the government may have.

One thing I would be particularly concerned about is that, if we spent a year doing an investigation and only then went in for our initial meeting, we might only then find out—when we finally do lay it on the table—that, in fact, we missed issue x that the government was interested in based on information they had from other sources.

MS. FIFELSKI: But there is nothing in the law that says we should disclose. Must I voluntarily disclose?

MR. BARRY: Must you voluntarily disclose? I get your point. The FCPA itself does not have a requirement of disclosure, and, as I have indicated, we are not at a point where we have identified a particular violation. We have identified a concern, and we are investigating it. However, my recommendation to the company here would be to get out in front. You go in and disclose to the government, explaining to them what efforts the company is taking and informing them that, at this point, there does not appear to be evidence of an actual violation but that the company is taking the steps it needs to take.

I would suggest an additional reason for disclosure, and that is the fact that we know that competitors have received subpoenas in connection with the privatization deal at issue here. Therefore, we should expect, particularly in the current environment relating to the FCPA, that the government is aware of us, that the government is aware of the deal, and that the government may, in fact, be working with local regulators to obtain evidence and testimony that could later affect us.

MS. FIFELSKI: Well, I see your point. That makes good sense. But let us look at the business side of this. If we go to the government, that is a public disclosure. I have to think about what that is going to do to our stock in the press. Articles may be written. In addition, I have to think of employee morale.

This has wide implications for our business. I am concerned because we have the nephew-uncle relationship here. However, we do not even have proof of a payment. What if it is nothing and I go forward and disclose this, making it a public matter? I do not want this played out in the press.

MR. BARRY: My suggestion is that you need to think beyond this particular incident, this particular payment, this particular investigation, and think about what will be the company's intent going forward. This deal does not matter in the grand scheme of the company's business in the years to come or the company's ability to get government contracts, to work in this region, or to work more broadly in the marketplace where it can continue to be viewed as a trusted and compliant partner, a partner that people want to work with. You should want to be proactive here to head off any concern that people might express down the road that, if they do a deal with this company, they might get into trouble.

MS. FIFELSKI: Okay, so what I hear you say is that we can actually turn this into something positive with regard to the press, since the company would be coming forward, and that that is something for us to consider when we do this.

MR. BARRY: I think that is right. What it is, is an opportunity to show that, despite the fact there are subsidiaries, and far-flung subsidiaries, this is a company that has had systems in place that enabled it to identify the issue that we are investigating now.

MS. FIFELSKI: All right, but I need some more background. Let us go through the steps of the FCPA because I really want to understand exactly what we have and why you believe that there is enough reason to disclose right now. I am still at the point where disclosure is counter-intuitive to me. I see some of the benefits, but let us walk through some of the elements of the FCPA.

First, do we have a covered person involved here? We have a nephew. Can it even reach to the nephew, that is, is it enough that the payment went to the nephew?

MR. BARRY: Well, I think it can. There are a couple of reasons for this. First, there have been many enforcement actions and investigations that have involved relatives of foreign officials, so I think we should expect that the government would be interested in that familial relationship. There are two aspects to this. First, the government would, I think quite rightly, be interested in understanding whether the family relationship indicates that the payment made to the nephew was made in order for the nephew to serve as a conduit for passing the payment on to the official. Second, the government is going to be interested to know whether the hiring of the nephew as a consultant in and of itself was something of value as defined under the FCPA and therefore covered.

MS. FIFELSKI: You are more or less telling me I could not hire anybody. I am going into a foreign country. I need to hire someone locally that can help me. We did not go to an immediate family member, which is what the statute talks of. We went to a relative, but he is a nephew. Am I excluded from ever hiring someone in a foreign country because he or she is related to an official, even if the person I hire is an expert in this area? This particular nephew might have had all the qualifications, and, when you look at what we paid, it was only $200,000. That seems like a fair amount from a consultant-fee perspective.

MR. BARRY: We have a couple of things to unpack there. First, you are not precluded from hiring a consultant in another jurisdiction. As we know, there are often requirements that you go through a native agent when dealing with particular government-related contracts. Second, the important thing to think about from a compliance perspective is to ask what steps do you have in place at the subsidiary and monitored at the headquarters level to make sure that that consultant is who you think he or she is? Is the person qualified to perform the services for which the person was hired? Are you paying the person a rate that is commensurate with the services that he or she is providing? What has the person done? At what point did you hire the person? Was he or she hired because of a connection to the government official or in spite of it? None of these items is going to preclude you from hiring that particular consultant. But they are things that you need to look at. They are some of the red flags you need to consider to make sure that you clearly understand the relationship, the payments, the structure of the payments, and why you hired the person in the first place.

MS. FIFELSKI: That means due diligence.

MR. BARRY: Yes, due diligence. As to your second question, with respect to the amount of the payment, if he has not done any work, the payment is excessive, but there is not a materiality threshold for FCPA liability. There is no immaterial or *de minimis* amount.

MS. FIFELSKI: So the $200,000 is a material amount.

MR. BARRY: I would say anything is a material amount under the FCPA.

The last point I would make with respect to this is that we need to remember the stage at which we find ourselves. We are not at a stage where we are thinking about how we would defend ourselves at trial here. We are at a stage where we are thinking about what might be coming around the corner and how we are going to continue to do business in this region and in the U.S. and whether the DOJ is circling around us. Assume they come to you first and say that they understand that you hired this consultant or that they are investigating your involvement in this in regard to the way which the bids were parceled out for this particular deal. Do you want to be in a situation where they learned that you received a tip on your hotline but did not come to them because you did not think it mattered enough?

MS. FIFELSKI: Well, you have been reading my mind. My next question was going to be: what are the chances that they will catch us? This is such a small thing. Again, we have to consider all the business implications of this. I believe that you are saying that the chances are pretty strong.

MR. BARRY: I think the chances are pretty high, particularly because there are subpoenas issued already, and there is already underway an investigation of what happened with respect to this particular deal. In today's day and age, there are so many different conduits for information to flow to us and anti-corruption regulators, whether it is through auditors, competitors, or through those who submitted unsuccessful bids for this deal. Competitors who are under investigation may be only too happy to say that they followed the rules but heard that those other guys played a little fast and loose, since nephew Timmy is not quite as qualified as one might have liked.

I would also point out that, in large part in reaction to the enhanced enforcement of the FCPA, foreign regulators are becoming more aggressive. We can expect that there is a local investigation perhaps underway as well. We can certainly expect that there has been communication between the U.S. government and Panaraguan authorities with respect to how information will flow and cooperation will occur, whether it is through mutual legal assistance, treaties, MOUs, and the like.

MS. FIFELSKI: Can we then at least keep the disclosure limited to just this? Am I opening a Pandora's box if I approach the government? Can they look anywhere in the world and put us through a rigorous investigation? That will only cost us a lot of money. You are really asking a lot. I have to advise my board that we are opening the door to let the government tell us where they want us to now investigate. Is there a way to limit this?

MR. BARRY: I think there is. Proactive disclosure is one mechanism for doing that. We need to be in a position where we can inform the government that this issue has arisen and that we have become aware of it as a result of our own compliance infrastructure. We are taking it seriously and dealing with it appropriately. Even if it turns out that some violation occurred, the incident is out of character, and it is something that the company has taken, in the larger sense, very seriously with respect to its overall compliance program.

MS. FIFELSKI: But they could actually ask us to look at other countries.

MR. BARRY: They absolutely could. They could certainly inform you that they are interested in why you have been successful in all of the other Latin American countries in which you operate.

MS. FIFELSKI: What is the best-case scenario in this situation?

MR. BARRY: I think the best-case scenario is that they say thank you and walk away. Have they ever done that?

BARRY M. SABIN: Yes.

MR. ARMAS: Once.

MR. BARRY: I think, more realistically, what we are looking at is something along the following lines. We should be considering what we can do to protect the company to the extent that, if a violation actually occurred, the matter will proceed along civil lines as opposed to criminal or that the matter will not be prosecuted or that it will be subject to deferred prosecution and lowered fines. In addition to that, we would want also to avoid the imposition of a monitor and the expense and cumbersome process that a monitor would entail for the company.

MS. FIFELSKI: What should I do right now?—Set up a remediation plan?—Set up due-diligence processes for any time we hire a consultant? Should I terminate the person at the subsidiary that was involved in this?

MR. BARRY: What I think you have to do right now falls into two categories. One is that you need to deal with the particular activities of the subsidiary, but I am not recommending that you fire anyone right now. I am recommending that you interview all personnel that were associated with the deal and those who are in a leadership position of the subsidiary. I am recommending that you assign someone at a senior level of the company's compliance infrastructure to monitor the manner in which the subsidiary currently does business and has done business historically. In addition, I am recommending that you retrain, at the subsidiary specifically but also more broadly, and that you articulate the company's commitment to its anti-bribery practices. That means not only having your senior people convey that message throughout the global enterprise, but also reviewing the company's compliance documents as they exist today. Are there agent questionnaires, for example, that this consultant was required to fill out? Did he fill them out? What did the agent say? Is there a consulting agreement? Does it contain representations and warranties by the agent?

You need to understand that this should be done not only for purposes of how we are going to move forward with the investigation. We also want to make sure that we do not receive another tip next month, indicating that we have a pattern and practice of this, as opposed to just an isolated incident.

MS. FIFELSKI: Should I be proactive and start investigations in other countries, open that door now and get in front of it, or should I wait?

MR. BARRY: My suggestion is that, as an initial step, you reinvigorate the compliance program. I am not recommending investigations in other countries at this point. My recommendation is that we approach the Department of Justice, explain to them where we are, and see what their reaction to it is.

MS. FIFELSKI: Let us talk dollars. How much should I be budgeting for this? It sounds as if it is going to be very, very expensive for the company.

MR. BARRY: It could be extraordinarily expensive. It is hard to estimate, because we have not yet had this meeting and we do not know what their reaction will be.

MS. FIFELSKI: Well, I have to stop you there. You want me to go into a boardroom, tell the board that I do not know how much this is going to cost or where it is going to go, that I do not have all the facts yet, but that I think we should approach the Department of Justice, even though the law says I do not have to. How do I justify that? Do you have any proof that the government will actually be lenient with us if we do go forward at this time? You have got to give me something, because right now it is going against all my intuition as a businessperson.

MR. BARRY: It is counterintuitive, but there is a predicate of instances where the government has afforded more lenient treatment—assuming there is a violation, and we are not there yet—based on early disclosure and proactive cooperation on the part of the company, for example, there has been Baker Hughes or, even more recently, Siemens. If you look at the Siemens sentencing memorandum that was filed in connection with the Siemens case, it is extraordinary in the degree to which it details and relies upon the steps taken by the company with respect to addressing the investigators' concerns, as well as the steps that the company took as part of its compliance initiative going forward. There were nonetheless big fines in that case.

MS. FIFELSKI: I was going to say, the first thing they will put in my face is that Siemens paid over a billion dollars, but you appear to be saying that the fine was actually less than what might have otherwise been imposed under the sentencing guidelines.

MR. BARRY: The guidelines would have called for almost double what was actually paid.

MS. FIFELSKI: So they got off paying half?

MR. BARRY: Yes. Baker Hughes had had a history of difficulties before its most recent case. Siemens, as the investigation seems to have indicated, had a widespread problem with respect to illicit payments. We have a different story to tell. We have a good story. We have an isolated incident, as we know it now. We have an incident that arose in connection with an anonymous process and an isolated tip, so I think we may be in a much better situation than they were.

MS. FIFELSKI: All right then. I guess it is okay to set up the meeting with the DOJ. I will get my calendar cleared. Let me know the days we need to be there, and let us make this happen.

MR. BARRY: My suggestion, particularly for this initial meeting, is that your outside counsel attend the meeting.

MS. FIFELSKI: Do you mean that I should not attend?

MR. BARRY: You should not attend. The reason is that I would like to be able to lay out our preliminary investigation to the government, hear what they have to say so we can then filter their requests and figure out how aggressive or not aggressive we want to be in responding to those requests. This would be preferable, in particular, because of your role in connection with compliance. While it is not something I would expect, you could be asked questions about what you would or would not be willing to do in connection with the program going forward, and I would like to avoid that, particularly at an initial meeting.

MS. FIFELSKI: Thank you very much.

B. Mock Discussion Between Outside Counsel and the DOJ

MR. ARMAS: Well, let us now see how well Will does with Barry Sabin. Again, just to reiterate, Barry was at the Department of Justice for eighteen years, and he did a lot of this type of thing while he was there. Good luck!

MR. BARRY: First, thank you for seeing us. As I indicated when we set up the meeting, Talk-a-Lot received an anonymous tip on its anonymous-tip line that referred to a payment made to the nephew of a legislator in Panaragua and linked that payment to Talk-a-Lot's success, first of all, in both the privatization of the telecom industry and in enacting the relevant statute for that, and then also in Talk-a-Lot's winning the bid to perform part of the work under the contract. The reason that the company wanted me to come in today is to be prompt and proactive in raising the issue, to assure the government that we are taking the matter very seriously, and to talk with you a little bit about the next steps we intend to take and what we might do going forward.

As I think you will see as we talk, this is a company that really has a history of compliance. We think this payment is an outlier. What we have found thus far and what we expect that what we are going to find upon further investigation is that the company reacted promptly, has the procedures in place, and—notwithstanding the fact that it had appropriate procedures in place—is taking significant and serious steps to reinvigorate its compliance program, regardless of whether there is anything to this incident, in order to make sure the message is clear that the company does not tolerate such behavior.

BARRY M. SABIN: Well, thank you for coming in today. I appreciate your setting up the meeting. As a foundational matter, the credibility that you, individually, and your firm bring to the table is important to the Justice Department in our enforcement efforts. We appreciate the matters that you have worked on previously and are mindful of that in our conversation today. As to fundamental foundational issues, specifically who do you represent? Is it the corporation or is it something else?

MR. BARRY: I represent the audit committee of Talk-a-Lot, which commissioned independent counsel to undertake the investigation here. I want to stress that we are in the preliminary stage of the investigation. I thought it was important to come in to tell you what we know now to make sure we are on the same page as we move forward with our work.

MR. SABIN: Have there any other counsel that have been retained that you are aware of, such that the Justice Department should be mindful of others representing persons or parties?

MR. BARRY: The company has retained its own counsel. To my knowledge, there are no individuals represented at this time, although that may change.

MR. SABIN: Are there any counsel retained abroad, in Panaragua or elsewhere, that you are aware of?

MR. BARRY: No, not that I am aware of at this time.

MR. SABIN: In terms of your investigation, have there been any document preservation efforts undertaken by you yourself or the company?

MR. BARRY: Yes, in conjunction with advice from counsel and at the direction of the audit company, the company immediately implemented a document-hold across all of its locations with respect to information related to Talk-a-Lot's operations in Panaragua.

MR. SABIN: When you say "across its locations," what is the geographic scope of the actions taken by the company? Is it limited to that country? Is it limited to a particular chain of command? Could you expand on that for me?

MR. BARRY: Sure. The document-preservation requirement at present applies to everyone in the Panaraguan operation, notwithstanding particular positions. With respect to subsidiaries in other countries in Latin America in which Talk-a-Lot operates, the retention requirement relates to those in the telecom business line, in the accounting controls line, and at the executive level.

MR. SABIN: Has there been any disclosure by you yourself or the company to any other enforcement, either regulatory bodies or law enforcement agencies, or is this the first step in the process?

MR. BARRY: This is the first step in the process.

MR. SABIN: Both in the United States and elsewhere?

MR. BARRY: This is the first such disclosure. This is the first meeting in which we are making in-depth disclosure. We have had discussions with the authorities in Panaragua and discussions with the FCC.

MR. SABIN: Has there been any on-site visitations by you yourself or your team with respect to the internal investigation yet?

MR. BARRY: Yes, my team has conducted preliminary interviews.

MR. SABIN: Approximately how many?

MR. BARRY: I would say that approximately twenty interviews have taken place over the last month.

MR. SABIN: That gets us to timing. Walk me through the timeline as to when the call came in on the hotline and the steps that were then taken either by the company or you yourself that bring us together today.

MR. BARRY: Sure.

MR. SABIN: Generally at an initial meeting, we do not have to go through every chapter and verse.

MR. BARRY: The call came in from the hotline about two months ago. The company established its initial document-hold and then raised the issue with the audit committee. The audit committee retained counsel, and we began our investigation approximately a month ago.

MR. SABIN: So there was a time period of about a month where it was internal to the company before you were brought in?

MR. BARRY: Before audit committee counsel was hired, yes.

MR. SABIN: Did they take any steps that you are aware of, in that one-month period, relating to interviews or document retention?

MR. BARRY: There were steps taken with respect to document retention and relevant hard drives. There was a document hold put in place.

MR. SABIN: Are there any particular technology issues or language issues relating to Spanish or English or other languages that the government should be mindful of as part of the internal investigation that brings nuances that are not readily apparent to this matter?

MR. BARRY: There are language issues. My team is prepared to conduct the investigation as appropriate, whether it be in Spanish or English, as is our forensic accounting team. There may be issues with respect to data-protection regulation. That is something that we have not yet looked at, and I do not have a position on it.

MR. SABIN: You mentioned the compliance plan and reinvigoration of that. Could you give me a sense of what compliance measures were in place at the time that the hotline contact was made and give me also some sense of the history of the company, in terms of any recidivist behavior and the like?

MR. BARRY: Well, first of all, as I think will become clear as we move along, the company has had a compliance process in place with respect to the Foreign Corrupt Practices Act for years. It has an anonymous tip line, and I want to emphasize that, because it is the reason that I am here, and it is the reason that I am here as early as I am.

The company felt it was important to give people a way to identify and ferret out these issues as early as possible. The company has an explicit policy and code of business conduct that cover both payments and gifts—from a conflict-of-interest perspective, a broader business perspective and also more explicitly in regard to the U.S. Foreign Corrupt Practices Act. The company's policy manual is in the appropriate language at the appropriate subsidiary, and personnel are trained on it on a regular basis.

MR. SABIN: In regard to the history of the company, is there any prior misconduct that should be brought to our attention, either relating to this particular subject matter or overall?

MR. BARRY: What I will say is that the company's compliance initiative was particularly strong at this subsidiary, because there had been an instance of false invoices on the part of some lower-level employees two or three years ago. The company had internally investigated that matter. There did not appear to be any other difficulties with the invoices. Notwithstanding that fact, the company put in place at that time more stringent controls with respect to accounts payable, petty cash, and books and records.

MR. SABIN: Has your internal investigation reached any tentative conclusions as to the potential misconduct or the extent of that misconduct?

MR. BARRY: No. I want to stress that it is early. We have found evidence of the payment to the consultant. What we have not found yet—despite having asked for it—is evidence that the payment was not in some way passed along to the legislator at issue, or that the hiring of the consultant himself was related in some way to an effort to influence the legislator to act or not act in connection with the privatization or the bid process.

MR. SABIN: Thank you for that information. Do you have any thoughts in regard to where you are now and your landscape for an investigative plan?

MR. BARRY: Yes. First, as I am sure you are aware, conducting these investigations, particularly in a smaller nation like Panaragua, takes time and creates difficulties, whether it is the data-protection issue that I raised before or more practical, logistical issues. As a result, I think this is going to take time and it is something the company wants to do right. That is why I am here now telling you that we are starting the process. Keeping in mind the need to obtain electronic data, to the extent we are able to do that in a way that is legal in the local jurisdiction, to continue with the second round of interviews, and to have our forensic accountants complete the review that they have begun, I would expect that we are looking at about a six-month period before we will have completed with investigation.

MR. SABIN: You have retained forensic accountants?

MR. BARRY: Yes.

MR. SABIN: Who are they?

MR. BARRY: J. Alex Partners.

MR. SABIN: In regard to the six-month time period, what is the scope of what you would be looking at during that time period? Is it your current sense—understanding that things change over time—that you will focus on Panaragua or on a more expansive geographic area to see if this is a systemic problem elsewhere?

MR. BARRY: At this point, we do not have any evidence that it is a systemic problem. Thus, our intention is to focus on Panaragua. However, I will say that I would rather look broadly and then come back to you and say that I have ruled things out, but it is just not practical for me to go to each and every country in which this company has subsidiaries and look at every employee and every e-mail. What I would like to do is begin with Panaragua. If evidence surfaces or if there are indications that we need to look more broadly, that is what we are going to do. But at this point, it is not our intention to look more broadly. We do not have a reason to do it. We have a compliance program that has identified this particular potential issue, and the same program is in place at the company's other operations.

MR. SABIN: Are there any other facts or issues that you wanted to bring to our attention at this initial meeting?

MR. BARRY: No. There is nothing further at this time. I do want to emphasize that the company is working hard to see both how its compliance program was documented and how it was actually carried out day to day. We are in a preliminary stage. We want to cooperate. We are not looking to surprise you or, frankly, be surprised by you down the road. To the extent there are particular things that you would suggest I look at or if there is any particular investigation that is underway that you are able to let me know about, to help me guide this investigation, I would be happy to hear about it. I am willing to listen and want to talk about it. This might help ensure you get a result that gives you comfort.

MR. SABIN: I appreciate that. We are looking forward to having a dialogue subject to grand-jury secrecy and other aspects, as well as coordinating with our colleagues in the other agencies, whether or not that is the SEC, as you indicated. Obviously, we will be making sure we have appropriate parallel proceedings in place and perhaps checking with our foreign counterparts to see what is occurring in Panaragua or elsewhere.

I am not inclined to provide you today with the specifics of what that overall dialogue would consist of. Once we digest what you have provided to us today, however, we would be flexible in figuring out a means by which it would not be cost-burdensome for the company to address whether or not there is particular misconduct here rising to the level of a federal violation.

MR. BARRY: If I might, I have just a couple other items I wanted to raise.

MR. SABIN: Please.

MR. BARRY: Obviously, we are dealing with a foreign set of laws that affects what we can ask witnesses, what we can do with the results of those interviews, and what documents we can produce. My request is that we proceed formally along the terms of the Mutual Legal Assistance Treaty (MLAT) with respect to any documents that you want to subpoena so that I can make sure my client, as well as the means by which we produce the documents, is protected.

MR. SABIN: Certainly. We want to make sure we have all our bells and whistles and the ability to ensure that the evidence has a proper foundation. For this reason, we have historically gone through the legal assistance channel. As we have increased our interactions in this area, we certainly have an informal dialogue with our foreign counterparts and have the ability to receive documents, not necessarily through the formal mutual legal assistance channels, which can take time, but often by way of courtesy copies from our foreign counterparts. To the extent we are able to work that through with our foreign counterparts and to the extent it could impact the particular work product and efforts by your internal investigation, we would be happy to coordinate that.

MR. BARRY: Is there a timeline along which you would like to continue to discuss where things stand?

MR. SABIN: Yes. I think we will be at more liberty to have that conversation once we have had a dialogue with our other colleagues in government, both domestically and internationally. Therefore, let us put that on a follow-up list for the coming days.

MR. BARRY: Great, thank you.

MR. SABIN: Thank you for your time.

C. Questions

MR. ARMAS: I know there were many questions that we could not address before, so now is a good opportunity to ask those questions of the different panelists, from their different perspectives. I think they can give you broad answers to your questions.

JIM DUFFY: One thing that I find very troubling in this entire discussion is, firstly, the fact that the most difficult thing to prove is a negative, and, secondly, the fact that we have no idea what the total project costs for mobile telephone networks in Panaragua might cost and whether this payment of $200,000 was at all material in relation to those total project costs. If this man is to be paid at one-quarter of one percent of the total project cost for reviewing the project and making sure it complies with local bid specifications or something like that, this payment could be totally legitimate. There has been no investigation into that question. I think that that is really troubling.

MR. SABIN: Fair point, from my perspective as one who formerly wore a government hat. At the investigative stage, materiality is not an issue in regard to whether it is appropriate to open an investigation. The amount, as Will pointed out earlier in the first vignette, is not relevant, because we must try to ascertain whether there is more to it. While the $200,000 in and of itself may not be significant or material, in the overall scope of the anti-bribery initiative, it may provide the proverbial foot in the door. That is roughly the government's perspective in regard to materiality. Generally, at the opening of an investigative stage, lack of materiality would not preclude moving forward.

AUDIENCE MEMBER: Could I just ask why would you recommend going ahead without initially at least interviewing the person who signed off on the $200,000 payment to ask what he or she was told would be obtained for that $200,000? Even if the answer to that question is bad news, it seems to me that it would be better to find that out before going to the Department of Justice than afterwards.

MR. BARRY: I agree.

AUDIENCE MEMBER: That was not the conversation you had with the general counsel. You recommended he go right ahead before you had interviewed the chap responsible for the payment.

MR. BARRY: Well, for purposes of our fact pattern, I did not list specifically who had been interviewed or who had not been interviewed. But you are right: we did not lay out what we learned from the person who signed off on the payment. We also did not lay out, for example, whether we had tried and been successful in interviewing the consultant.

AUDIENCE MEMBER: If you had interviewed the person responsible for the payment and found out it was bad news, what do you do then when you talk to the government? Do you include that in your disclosure, or is there some way you do not have to include that in your disclosure?

MR. BARRY: I think it would depend on when the initial meeting is held. In this vignette, the point of the initial meeting really was to say, "Here we are, we are working hard, and we know that you are out there doing your own investigation. Let us do ours first." That's really what the point here was. I would expect that down the line we would be relaying the particular relevant facts to the government in the course of the meeting that comes next. Yes, I strongly believe that the reason the guy at the company says he did it is important. It may not be the real reason, but whatever that might be, you want to find it out first and make sure you know it so you do not get your credibility questioned six months from now or two years from now if the government decides they would like to invite that person to an interview.

MS. FIFELSKI: I think the fact that they are already investigating the industry moves up timing of disclosure to the government. This is because the government is already there, they are already going through your industry, and others have been subpoenaed. In such a case, you will want to make disclosure sooner rather than later. That is part of why we threw that fact in there. I agree that, if there is no investigation going on in the industry, I would want that answer first. I know that is what my board is going to want to hear, and we are going to want that fact, but, with this situation, it is very possible the government already knew it.

MR. SABIN: Right.

MS. FIFELSKI: So disclosure becomes a much more immediate concern.

MR. SABIN: It was easier under this hypothetical, because of the grand jury investigation. That made it easier to make the initial recommendation to sit down with the government. Piggybacking off the first panel, which I thought was excellent, it is important to understand the whole dynamic of enforcement and voluntary disclosures. In addition, there are those obviously huge amounts of fines, which have increased over the last few years.

Previously, as a result of Sarbanes-Oxley, as well as due to other reasons and M&A activity, a lot of matters that were opened in the Justice Department and the SEC were opened pursuant to voluntary disclosure. For those matters publicly disclosed between 2005 and 2007, there were sixty-eight FCPA investigations and probably forty-four of them were pursuant to voluntary disclosures. But the trend in the last few years, that is, in 2007 and 2008, has been that investigations that are being opened are not being done primarily by voluntary disclosure by corporate entities, although some continue to be conducted in that manner. At the DOJ, only a third of the matters were opened in 2007 because of voluntary disclosures, whereas you had whistleblowers, competitors in the industry, and other activities causing the bulk of that case load. There has now been a more nuanced and more interesting development as to how the information ultimately reaches law enforcement officials.

MR. BARRY: As commented on in the previous panel, particularly in the joint venture and M&A contexts, the FCPA has become a much more significant category in due diligence investigations. Reports, whether in regard to international or other enforcement actions, arise from that due diligence process.

AUDIENCE MEMBER: I understand from what you have said that, in regard to the FCPA, the DOJ does not have a formally articulated leniency or amnesty policy, similar to what the antitrust division has. If my understanding is correct, should there not be such a formal policy?

MR. SABIN: That is an excellent question. Antitrust leniency policy is very different from that of the criminal division and FCPA enforcement policy. This gets into some internal DOJ niceties, if you want to know. It is very interesting because, unique among federal statutes, the FCPA is, as a general proposition, enforced by main Justice, not the U.S. Attorney's offices around the country. As was mentioned earlier, it is the criminal division's fraud section, led by Deputy Chief Mark Mendelson, that is implementing the statute along with the FBI squad out of the Washington, D.C., field office, which is a dedicated squad. The idea is that, because of the international ramifications and the venturing into other subject matters—whether antitrust, national security, or other processes, you want to make sure it is done with a small group of individuals. It should be considered whether that results in the backlog of a hundred investigations, causing frustration. The idea behind this is, however, that you will have consistency throughout enforcement and not a rogue prosecutor out there doing things that might not be consistent with the overall policy.

The thinking is that there should not be a special leniency program like that for antitrust. That requires a much longer discussion, but there is discretion in the sense that prosecutions are conducted by that unique group of prosecutors and agents.

AUDIENCE MEMBER: How often do these investigations bleed over or get drawn into actions by the IRS and maybe the Office of Foreign Asset Controls (OFAC)? What is the experience of the speakers?

MR. SABIN: The answer is that there is coordination, and there is interaction between OFAC, Treasury, and other regulatory agencies. Communication and coordination, both at the domestic level and at the international level, are really increasing.

There have been references to actions in Italy and Paris last year. The U.S. is a significant player in coordinating what is occurring in such cases and how it occurs. Thus, there are coordinated enforcement actions, where there may be a foreign jurisdiction bringing a case, the U.S. bringing a case, and the SEC bringing a case. These actions would be coordinated so that the affected company can take comfort in having only one bad press day and in being able to move forward without having enforcement actions taking place serially.

MS. FIFELSKI: From a settlement perspective, you want to settle with everybody if you can. You would therefore want them to have that kind of communication so that, when you are done, you are done. When you close one investigation or reach a settlement with one agency, you do not want to have to worry about other government agencies knocking on your door.

MR. SABIN: By the way, the folks over at OFAC are often ex-DOJ folks.

MS. WEXTON: I would like to add a comment about a new phenomenon that has been occurring. There is now some evidence that, after the dust settles on the DOJ and SEC side, shareholder and derivative suits are being brought by shareholders against the corporations for a failure to have an appropriate compliance program. I expect, for example, that Siemens and Halliburton will end up with shareholder actions over the settlements that they made and their failure to create internal systems to prevent the huge fines and violations of law that occurred.

MR. SABIN: That is absolutely the case. There is increased civil litigation. That often affects the dialogue which we alluded to earlier, in regard to the attorney/client privilege, selective waiver, and new Rule 502 of the Federal Rules of Evidence. All of this affects how you are going to provide comfort to the company, as well as the ability of the DOJ and the SEC to undertake enforcement actions.

AUDIENCE MEMBER: I am curious. We have had the FCPA since 1977. We have had the U.N. Convention since 2001, and we have Sarbanes-Oxley. Why has the culture not changed? Going all the way back to 1977, why has the culture not changed in companies? Why are we seeing these high penalties, and how do you think we can change the culture?

MS. FIFELSKI: That is a really good question. Changing cultures is what compliance programs are all about. It is like anything else in our society. Look, for example, at speeding. People are going to speed unless they know that there is a speed trap set up or that there are cops enforcing the speed limit. Once the DOJ started enforcing the FCPA, companies have started to look at changing their cultures. That is what you do with your compliance program. You start with that code of conduct, build your policies and procedures, and train, train, train. It is slow, but actually it is just a matter of American culture. Unless people actually get a speeding ticket or receive some form of slap on the hand, they will try to get away with what they can. You must be super-diligent in trying to change the culture through your programs and then catching things as they arise. I think enforcement is what drives change. That is why you are seeing changes now, and why it has taken so long.

MR. ARMAS: As you know, while the statute has been in the books for thirty years, it was hardly enforced in any meaningful way until very recently. There have only been slightly over a hundred cases over the last thirty years, and most of them were brought in the last five to six years. I think we are going to start seeing changes, and I think the big eye-popping numbers with Siemens and Halliburton will perhaps hasten them. In addition, if the rest of the world cooperates and starts creating pressure locally, especially in the emerging markets, I think you will start seeing broader and perhaps quicker change. At the end of the day, it is a matter of human nature; it has been around forever and probably will be around forever.

MR. BARRY: I would like to add to Angela's point. I think that it is not only a matter of developing your culture of compliance; it is also a matter of developing your compliance infrastructure, particularly if a multinational is at issue. There have been many instances where I have been told by someone in-house on the U.S. side that he or she had just found out about a particular matter where their legal team in another jurisdiction had approved of the illegal conduct because they figured that it was not happening in the United States. These large deterrent actions not only deter companies from doing what they know is wrong, but they cause them to learn how to deal with compliance by making sure they have the infrastructure set up so there is a centralization of knowledge as to what types of payments are being made and what people are being told about them. This would serve to prevent someone in Belgium, for example, from approving an improper payment because the payment was to be made in Denmark.

MR. SABIN: Perhaps one of the footnotes to the Siemens case is that there was an asset forfeiture action brought against a foreign official. When you review the elements and the people who might be potentially liable, you typically go after the person who is providing the bribe or the third-party agent. Here the question is whether you can pursue the foreign official. Some think that you can, although most believe that, under the FCPA, you cannot pursue the foreign person who received the bribe. The ability to pursue the foreign officials' funds, along with disgorgement and other activities, is another robust tool that is being looked at for potential future use.

AUDIENCE MEMBER: It seems to me that the long answer to the issue of changing cultures is that you have to change the culture in the countries that give rise to much of these cases and incidents, because the business people are otherwise always going to be under pressure. In the end, they have a bottom line they are responsible for. If the way of doing business in a particular country is that you must grease palms all the time, they are under tremendous tension. A deterrent effect from the U.S. side does not perhaps seem as real when you get into the real day-to-day situation, unless the culture of the country in which they are located has the same mindset. As you pointed out, some of the other countries are getting more serious about things, but it seems to me these people are in a tough jam.

MR. SABIN: You are absolutely right. That is why the message has been that it must be a level playing field. The argument used to be that folks would leave the U.S. market and go abroad, because they would not want to be jeopardized for that kind of activity. That is why you need international agreements, international dialogue, and, as the first panel pointed out, enforcement activity like that which is occurring in Japan and the U.K. and elsewhere.

MR. ARMAS: As was mentioned earlier, governments may see this as an opportunity to raise significant revenue. I am sure that is not necessarily the driving force, but clearly, if we are going to start seeing numbers like the numbers that have been tossed about this room this morning, this is serious stuff. And China, as you mentioned, sir, perhaps might start stepping up enforcement as a result.

There is a big emphasis and focus on the BRIC nations—Brazil, Russia, India and China—for a lot of reasons that are obvious. But in Latin America where, as many of you know, I do a lot of my work, we are starting to see more and more local pressure and emphasis. I know, for example, that the local regulators in Brazil are very active in a whole host of areas, including monitoring phone calls and the like. This has created a real concern in Brazil, but I think that Brazil is going to be one of the countries where we are likely to see stepped-up enforcement in our own hemisphere. We know it, and we are there. In fact, our International Section is trying to coordinate with the Brazilian Bar Association to have what would be the first FCPA conference in Brazil later this year. Earlier, you heard about conferences they were having in Europe, and now we are starting to see these conferences and issues popping up in the emerging markets. When you went to those markets before to talk about FCPA, their reaction was typically that the issue was not really going to affect them, since FCPA was a U.S. law and they were not so sure about the extraterritorial application of that law. They would assert that they had other protections and issues in their jurisdictions. They were not focusing on the FCPA. Now they are because they are starting to see their own local regulators much more conversant in regard to all anti-corruption and anti-bribery issues, including the FCPA.

AUDIENCE MEMBER: We are both from Brazil. I might add that the situation is exacerbated by the fact that, increasingly, Brazilian multinationals are going abroad. JBS Freeboard bought Swift here in the United States; somebody just bought Anheuser-Busch; many companies are listed on the New York Stock Exchange. These companies are suddenly waking up to the fact that they are operating in a completely different field with different compliance requirements from those that they are used to, and that both local and international legislation is applicable to these multinationals.

MR. ARMAS: Absolutely. Are there any other questions?

AUDIENCE MEMBER: What is the extent of concern about the impact on potential civil liability of what you are doing with the government? What role, if any, does this play in your thinking about whether or not you should approach the government?

MR. BARRY: I think it absolutely does play a role. As Ms. Wexton has mentioned, while there is not a private right of action under the FCPA, there has been a blossoming of derivative actions predicated on mismanagement of companies because of a failure to implement appropriate compliance controls. At the end of the day, particularly for companies that need to do business with the government, the FCPA is, in some instances, the primary concern, because if you get debarred, you cannot do the work. Thus, it often makes sense to deal with any problem head-on as opposed to trying to hold back and then, if the government thought you were holding back, be the focus of an investigation that might be broader and deeper than it would otherwise be. There is nothing worse than having had the meeting we had and six months later finding out that Barry had been sitting there with a whole pile of information that he had received from the company's competitors or from corporate interviews that local regulators had conducted, and that he knew what I was not telling him, particularly as the meetings go forward.

MR. ARMAS: That is a bad meeting, by the way. Next question, please!

AUDIENCE MEMBER: My question pertains to companies that are listed here but that do not have operations here, such as companies listing their ADS on the NASDAQ. Are these types of companies subject to the FCPA?

MR. SABIN: Yes. As issuers, they would be. Issuers, domestic concerns or acts in furtherance of the scheme are the three different jurisdictional prongs that my former employer construed very broadly.

MR. ARMAS: Thank you for an excellent discussion.

IV. In-House Counsel Roundtable: Day-to-Day Compliance from the Perspective of Corporate Counsel

A. Introduction; Risks at Participants' Firms

CAROLE BASRI: We have an excellent panel for you today, and that is because we have three people in the compliance field in-house: one from the pharmaceutical sector, one from the area of consumer finance, and one from the securities and financial area. I think that hearing the insights of in-house counsel can demonstrate what is really going on, what we are doing about the culture we are now living in now, that is, a culture experiencing financial crisis and bribery that is rampant. There is need to have change here.

I would like now to introduce our panel. Let me start with Piyush Sharma, who joined Pfizer in the corporate compliance group in 2004. He has diverse experience working with both domestic and international investigations, as well as areas involving compliance training, proactive market review, assessment and the rolling out of a global FCPA program. He also recently joined Pfizer's emerging markets business unit as lead compliance programs counsel. We welcome him. I think that his experience will really be valuable to the group.

Next is Abby Fiorella. Abby is senior vice president, deputy chief compliance officer, for MasterCard Worldwide. She is responsible for implementation and day-to-day management of MasterCard's ethics and compliance program, which helps the company manage and meet its ethical and legal commitments. Notice that the program's title refers both to ethics and compliance. It involves compliance with U.S. and international laws governing corruption, antitrust policy, money laundering, and securities. In addition, Abby oversees and conducts internal investigations of employee fraud and misconduct related to potential violations of the law, regulations, and public policies. Abby joined MasterCard in 2003 and, interestingly, served as vice president for audit and forensics. Though now a member of the law department, Abby continues to serve on the management team of the audit department and has responsibility for internal-fraud risk-management initiatives, including mitigating fraud risk through the development and employment of training aimed at increasing awareness of fraud and enhancing internal controls. Prior to that, Abby spent five years at KPMG. I think that the audit connection to the financial area, particularly in regard to FCPA, with anti-money laundering work as well, is a very important one.

Finally, we have my co-chair on the International Compliance Committee, Rick Morris. Rick is a very active member of the Executive Committee of the International Section. He is also a member of the global compliance department at Goldman Sachs, where he is currently in his second year of secondment from Axiom Global Inc. He works in the New York office of the Global Control Room, providing securities law compliance support to investment banking teams and trading desks worldwide.

I could go through all of the resumes for each of these panelists. They are quite illustrious, but the salient point is that we have someone here from foreign business, from the consumer finance system, and from the securities and financial services business. This is a wonderful opportunity to examine many hot issues.

To start the discussion, I would like the panelists to speak about compliance risks specific to the particular organizations and industries each of them represents. Let us begin with the pharmaceutical industry.

PIYUSH SHARMA: In regard to the pharmaceutical industry, I think of two big buckets of risks in the FCPA world. First and foremost are our interactions with healthcare professionals. We are a big company, we have about 75,000 employees, and we do business in over one hundred countries, and most of those markets are international markets. The healthcare professionals with whom our sales force, our medical department, and our marketing departments interact tend to be employed by government-owned or government-controlled hospitals and clinics. Typically, they work for the ministry of health in the particular country. They are therefore all governmental officials in our eyes and certainly fall under the FCPA.

A second broad bucket—just briefly to sketch where we see the risks—relates to transactions with third-parties, our vendors and suppliers. We have different business units, different business divisions. The manufacturing business operates very differently from our R&D operations and very different from our animal health business, which is also very different from typical pharmaceutical operations. In these contexts, the risks lie chiefly in our dealings with third parties: our vendors, suppliers, meeting organizers, and others of that nature.

These are our two big risk categories.

MS. BASRI: Abby, what would you say are the risk categories that you encounter at MasterCard?

ABBY FIORELLA: Let me just define MasterCard a little bit. First, we are a multinational company. We operate in over 200 countries. Contrary to popular thought, MasterCard does not issue cards, nor do we extend credit to consumers. We are a franchiser, which means, among other things, that our brand is licensed to our customers, which for the most part are banks. We also are a processor; thus, those transactions will ride MasterCard rails for clearing, authorization, and settlement. And, lastly, we are an advisor, that is, we have a consulting arm to our business as well. That is a broad profile of who we are, what we do, and where we do it. As I have indicated, the people that we interact with most frequently, our primary customers, are banks, who are part of our franchise. As a result, we do a lot of promotion of our brand, a lot of sponsorship activity. We have a marketing arm within us as well, and we deal with a lot of vendors and suppliers. That is a very general, broad-based profile.

MS. BASRI: Our next speaker is the co-chair with me on the International Committee for Compliance. Rick, please give us an idea of what the key areas are at Goldman Sachs.

RICK MORRIS: Transparency International in December 2008 published its latest list called the "Bribe-Payers Index," where they analyze sector by sector who is at risk in the global economy. The good news is that banking and finance is listed as being least at risk. I hate to say that the sector is in "first place," because it did not get a perfect ten by any stretch of the imagination, but it did well when compared to other industries, such as those involving aerospace, oil and gas, and even pharmaceuticals. There are fewer cases in the banking and finance sector, and they are not in the headlines. You do not see investment banks leading the way with the latest settlements, fines, or DOJ and SEC reported releases. Hopefully, this will continue to be the case. Another element, however, is not quite so rosy for our sector.

There are two primary risks, of course, for an investment bank. The first has been touched on earlier: the M&A environment is a very hot area for enforcement. We are often engaged by clients as either a buy-side advisor or a sell-side advisor. If two companies are combining, we will be advising either one of them, whether it be the buyer or the seller, in regard to the due diligence process. We assist the buyer or seller in that process, together with counsel and the client's own internal staff.

As has been mentioned earlier, successor-liability issues are at the forefront these days. A key case in this area was the jettisoned acquisition by Lockheed Martin of Titan after the T-shirt incident that was alluded to earlier. That matter involved bribing a foreign government official in the country of Benin in Africa. Ultimately, the deal was derailed as a result of what was uncovered during the due diligence process. It was an example of an M&A transaction gone haywire, because Titan did not have a robust compliance program. Lockheed Martin had itself been under investigation previously, and, as a result, it had a very good due diligence system. As a result, they were told what was going on in an expedited way, and it did not come back to haunt them on the back end.

M&A is obviously a big area. The other big area is underwriting, where investment banks are not so much looking out for their client per se as much as they are looking out for themselves and their own firm. This is the case, for example, in regard to their underwriting risk in connection with an IPO offering or the like. If the firm is going to be active in underwriting and issuing shares and issuing them as primary-market trading, the firm itself is at risk. One of the main tools that can be used over time to mitigate that risk is what is called a commitment committee. It is a committee in which members of senior management within the firm have the deal team present to them what they are proposing to do as an underwriter, and the issuer, the corporate client, is scrutinized in great detail. FCPA exposure and liabilities are certainly something the committee would take a look at if any issues in regard to them were uncovered in the due diligence process, which is quite an extensive one.

The advisory side is one part, and the underwriting side is the other main aspect for investment banks.

B. Overview of Participants' Firms; Compliance Tools Used

MS. BASRI: I have a short question for each of you before we get to the next set of issues. I would first like to know a bit more about each of your companies; after that I would like each of you to tell us what kinds of compliance tools your companies have on hand. If you could start, Piyush, by telling us about Pfizer: how many employees do you have at Pfizer and how global are you?

MR. SHARMA: Pfizer is very global, as you know. We have about 75,000 employees. I have just switched to a new position in emerging markets where I am acting as lead compliance-programs counsel. In the emerging markets, we are in more than seventy countries and have about 16,000 employees. One of the things we have done at Pfizer is to implement a global anti-bribery procedure, and that applies to all of our colleagues across all business units and divisions worldwide. Our approach has a number of different features: an internal code of conduct, an open-door policy, a hotline, a dedicated compliance group, and compliance resources. Yet, in terms of the FCPA, the biggest thing we have done is to implement a global anti-bribery procedure that applies to everyone across all business divisions.

MS. BASRI: Abby, if you could give us an idea how many employees work at MasterCard Worldwide, and in how many countries MasterCard has a presence.

MS. FIORELLA: I do not know the exact number, but I think we have over 6,000 employees. We operate in over two hundred countries, and increasingly what we have seen, which is consistent with a lot of industry trends, is that the focus of the business is outside the U.S. Thus, similar to the situation at Pfizer, we have taken efforts in our compliance programs to take into account where we do business.

I would like to add that, regardless of the industry, you have to start with a series of questions along the following lines: Where are you doing business? Who is your universe of government officials? Who within your organization interacts with those government officials? And, finally, who interacts with government officials on your behalf? You must ask those threshold questions, and you have to design your program around them. Like the approach described by Piyush at Pfizer, we have a uniform policy, guidelines for implementation, procedures for hiring agents, and required contract provisions. Our approach is directed not just at the FCPA, but also at anti-corruption and anti-bribery laws in different locations. In addition, we provide mandatory and supplemental training. Certifications and attestations are required. We post progress considerations and red flags for all of our managers on our internal Web site. We preapprove payments through our finance and legal divisions. This can involve small matters such as T&E reimbursements or more transactional-type payments. The key is that there is transparent record-keeping. We monitor for red flags, which is also key. All of this cannot just be on the front end. You also need detection and investigation. We monitor for red flags, and we also have targeted audit procedures.

MS. BASRI: Could you tell us a little about Goldman Sachs, Rick? How many employees do you have, and in how many countries do you have a presence? How many people do you really have to reach within your organization that operate internationally?

MR. MORRIS: In the case of Goldman, global activity is actually a relatively new phenomenon. I was somewhat surprised to learn that it was only in the 1980s that Goldman Sachs became increasingly devoted to global expansion and not just focused on Wall Street and the U.S. market. It has been only twenty-five years that Goldman Sachs has been involved in a global way. Today, we have well over 30,000 full-time employees. They are a bit hard to count, and I am a good example of why that is the case. I work at Axiom Legal, but I am working full-time in-house in the compliance department of Goldman. The compliance department itself has several hundred members, as does the legal department, all in house. I have counterparts in London, Hong Kong, Tokyo, and Sydney that do exactly the same sorts of things that I do in New York. We have various clocks on the wall so we know exactly what time it is in our various worldwide locations, because we have a rolling 24/7 phone system. Thus, if you are an employee needing compliance support and you call your local regional compliance support, you will get rolled over to the relevant office in whatever time zone is working at that time. For example, if you are working late on a Thursday night and you call the New York office, you may reach someone in Sydney, Tokyo or Hong Kong, depending on the time of day. You will always reach somebody who can help you with whatever compliance issue you have, regardless of what time it is or where you are.

When the firm first decided in the 1980s that it was going to make a major push to go global, one of the senior partners, John Whitehead, was concerned that the standard of the firm would possibly be at risk. He was concerned that they would continue to maintain the high standards of the firm, not just in terms of compliance per se but just in terms of the work product standard locally. One of the things that was extremely useful was that, at that same time, the same senior leadership that decided to expand also devised a set of what are still known as the Goldman Sachs business principles. You can find them on the firm's Web site. There are fourteen principles enumerated there. I will read one of them, because it is so critical and because it sets the tone from the top and is embraced by the management committee, CEO, and everyone at the most senior echelons within the business. This was penned in the 1980s and still applies certainly today. It reads as follows:

> Our assets are our people, capital and reputation. If any of these is ever diminished, the last is the most difficult to restore. We are dedicated to complying fully with the letter and spirit of the laws, rules and ethical principles that govern us. Our continued success depends upon unswerving adherence to this standard.

I know that management takes these statements seriously, and I know as a compliance officer that I do not have to fight to convince people internally that compliance is something they should take seriously. It is implicit and ingrained. New hires are trained in this from their first day at the firm. It is therefore no accident that, when we first began to expand, we also began to be concerned about maintaining high standards, integrity, and business principles. That simply reflects the business principles. Knowing that we have the full and complete support of senior management is something that makes Goldman special.

I certainly recommend this approach to any sector, to any type of company. It is a pleasure to work in such an environment, which really trickles down not just vertically, but also horizontally. I have been associated with companies in the past that have had a lesser standard. When you have to be the advocate for compliance in an environment where compliance is not assumed to be important, the task of compliance officer is much more difficult.

MS. BASRI: Thank you very much. Now, Piyush, please tell us about the compliance tools that are used at Pfizer.

MR. SHARMA: I would like to echo something that Abby mentioned earlier. We refer to this whole sector as our international anti-bribery, anti-corruption procedure. It is not limited to an FCPA procedure. I think this makes clear that it applies to all non-U.S. government official interactions, to all of our international employees, and to all third-party transactions.

Similar to MasterCard's policy that Abby mentioned, we impose due diligence requirements in regard to our third-party transactions and annual certification requirements on our vendors. There are also additional steps and requirements that are imposed on an employee who interacts with a healthcare professional who is deemed to be a government official in a local market. The procedure imposes ownership and accountability on our local markets—the matter is not owned by the compliance division. We are there to support and help with the implementation of local standard operating procedures (SOPs) that implement the global SOP. The message that we have been spreading is that leadership in the local markets is accountable for this.

I agree with what Rick said earlier, that is, that the tone of the talk is key. You can make presentations and talk about restrictions and the FCPA, but at some point all of it needs to be supported by the tone that management sets. I have just joined a new business unit, and I have been working on a compliance communication that the business unit president is going to send out to all of the colleagues. I have been carefully drafting the piece, wanting to strike the right tone by being firm but also letting everyone know that compliance is part of how we are going to be doing business going forward. To be successful, you really have to make ethics and integrity part of your business goals. That is really going to help drive compliance throughout the organization. It is one thing to hear it from the compliance or legal division, but it is quite another thing when this is endorsed by the business leaders.

MS. BASRI: Excellent. Now, Piyush, you have raised two issues that I would like to look into further: the connection between ethics and integrity, on the one hand, and compliance, on the other. First, I would like to talk about the name given to what all of you do. You are not calling it FCPA compliance. You have given it a broader term. Why not call it FCPA compliance? Why is that not adequate?

MS. FIORELLA: It cannot be U.S.-centric. You have to recognize that you are a multinational company. You are in industries that operate all over the world. You have to take into account the different laws in the various jurisdictions, and you have to tailor your programs accordingly. They must be risk-based programs. You need to recognize the local laws in the jurisdictions in which you are operating, and, by using tools like Transparency International, you need to gauge your risk in different markets; this would include understanding how business is done, what the local landscape is, and what the enforcement mechanisms are. As a result, I may view a series of transactions in Eastern Europe differently from how I view a series of transactions in Latin America. There are certain customs and practices that develop in different areas, and you need to be cognizant of them. In order to get buy-in from the business unit, which is critical, and to hold them accountable, you need to be knowledgeable about the practical realities of doing business in those areas, and your message must be broad enough to encompass those realities.

MS. BASRI: Could you give us an example of the difference between Eastern Europe and Latin America?

MS. FIORELLA: You can pick different countries, but there are business practices that are more commonplace in certain jurisdictions than in others. For example, it might not be unusual in a particular locale to entertain more frequently, to interact more frequently, or to go through government officials more regularly than it is in other locales. We in the U.S. have been very sensitized to this, but in emerging or developing markets they may not be. In some areas the degree of government involvement is less clear than in others. It may not even be clear who a government official is. In some places, it is less than obvious that the government has an ownership interest in a particular enterprise or that the government is operating behind the scenes. All of these things need to be taken into account.

MS. BASRI: Let us hear about the kind of compliance done at Goldman in the FCPA area. Is it just FCPA or broader?

MR. MORRIS: It is definitely broader, and the program is not called an FCPA compliance program, although it does reference the FCPA. What is extremely useful, for internal use, is a search engine for all compliance policies, and it covers all areas that are regulated, regardless of the regulator. If I am looking for the firm's FCPA policy, I can enter the acronym "FCPA" and it brings me to the firm's anti-bribery and anti-corruption policies. It is not called the "Goldman Sachs FCPA policy." It is a global policy that applies to every country in the world, that is, every employee and every office anywhere in the world. We are not trying to respond only to the risks and requirements imposed by the FCPA. The OFAC also matters, and the U.N. convention also matters, and, of course, in a very significant way, the local law of the country in which you are doing business also matters. There can be significant mismatches between what may be required or allowed under our law and what may be required or allowed under the law of the country in which you are doing business.

Another practical feature of our compliance program is that our local counsel opinions are now available in a consolidated way, similar to the search engine I just described. Thus, if you enter a country name, up pops all of the local counsel opinions that we have already obtained there, so that everyone in the legal and compliance divisions has access to them, whether they are in Hong Kong, Sao Paulo or London. I tried both of these searches and was able to pull up, within seconds, the anti-bribery policy and all of the local opinions we had obtained in a single country. This is a relatively new feature and one that is part of an effort to globalize the compliance program. It is certainly all fine and well for a country manager or whoever is involved in a specific jurisdiction to obtain legal advice from either in-house counsel or outside advisors; however, if the rest of the firm cannot benefit from that expertise, the process is inefficient and can lead to problems. This archive of opinions is something that has been rolled out recently and is a very effective way to capitalize on the opinions that we have already procured.

C. Anti-Money Laundering and the FCPA

MS. BASRI: You have mentioned the interplay between anti-money laundering (or "AML") and anti-bribery statutes. Can you address that?

MR. MORRIS: Sure. I mentioned earlier the good marks that banking and finance have received in the Bribe Payer Index recently published by Transparency International. The bad news of course is that, if you are looking at any money laundering risks, there is no better place to look than in the area of banking and finance. It is interesting to note that, in addition to commercial banks, broker-dealers and investment banks are also involved. Many of the anti-money laundering rules in the Patriot Act very explicitly apply to investment banks, and the SEC has recently made available on its Web site an "Anti-Money Laundering Source Tool for Broker-Dealers." This is an explicit recognition that investment banks are also subject to all the anti-money laundering rules.

It is interesting that the words "money laundering" are not found in the FCPA itself. There is no requirement or compliance obligation imposed within the FCPA proper in that regard. As a result, one might think that AML and the FCPA are somewhat unrelated. It may even seem counterintuitive that the AML piece of this is so closely intertwined with the FCPA. Interestingly enough, the second clause of the preamble to the U.N. Convention Against Corruption states that the parties to that convention are concerned about "the links between corruption and other forms of crime, in particular organized crime and economic crime, including money-laundering." If you think about it, in terms of the record-keeping provisions within the FCPA (and not just the anti-bribery provisions), the effort there is to prevent companies from making payments to foreign officials in the form of bribes and then concealing those payments by disguising them on their books as consulting fees or the like. Sometimes they get fairly creative with the way they try to cover up the purpose of such fees. My favorite is a coffee slush fund, where the payments were all described as being for the office coffee pool. There were only eight people in the office, however, and they had a $30,000 fund. Word of this got around; that is the bribery side of it. The obvious flip side is when someone is trying to disguise the receipt of the payment: doing that requires money laundering. The Patriot Act, in Section 315, which is a relatively new rule from October 2001, explicitly deals with this issue. Section 315 is entitled "Inclusion of Foreign Corruption Offenses as Money Laundering Crimes." The connection that is acknowledged in the U.N. Convention, but not directly acknowledged in the FCPA, is quite explicitly dealt with in the Patriot Act.

MS. BASRI: I think it is interesting to understand these practical applications and interplays, because they may not be understood by people who work outside the corporate environment. But once you see one piece, you start to look for the other piece, and the interplay is very important.

MS. FIORELLA: I could probably add that this is not even specific to AML, because we talked about how now we are seeing a combination of FCPA and antitrust issues. We have a compliance program at MasterCard under an umbrella, because you need to see across your different programs. You need to look at all of the risks, because one area bleeds into the next. FCPA may bleed into AML and may also bleed into privacy issues. We have senior professionals who have responsibility for specific compliance areas and are subject-matter experts in those areas, including in the forensic and investigations areas. It is important to be able to look across the spectrum of legal and regulatory risks to see when one area bleeds into another, because there are no bright lines.

D. Who Is a Government Official?

MS. BASRI: Now, Piyush, you mentioned something very interesting about the difficulty of determining who is a government official. As an aside, I recently read an article that pointed out that, as a result of the economic bailouts, some of the banks might be viewed as quasi-governmental entities. This might mean that there could be FCPA violations in connection with dealings with a bank that has been bailed out. Piyush, could you please address the issue of who you consider to be government officials in your line of work?

MR. SHARMA: For us in the pharmaceutical industry, there is an everyday risk, since there are interactions with healthcare officials in our foreign markets in the African, Caribbean and Pacific countries, and they can all be government officials. One of the things we have implemented as part of our anti-bribery procedure is the requirement that, before they are retained, all third-parties, such as suppliers, complete due diligence questionnaires. We ask them questions about the ownership of the third-party company, the project leaders, and the managers who are going to be working on the specific engagement. Specifically, we inquire as to whether any of those individuals occupies any positions in the government such that the individual would be deemed a government official in that market. We also ask if any of those individuals have any relatives that are in those positions. As you can see, we are trying to mitigate our risks by clarifying these questions in the course of our due diligence process. Obviously, some entities resist completing the questionnaire, and they present a challenge. We treat each of the instances where that occurs as a red flag, and we impose ownership and accountability for that on the responsible person in the local market; thus, the third-party relationship in that case would have to be approved by the local legal director or whoever is in that position in that market. We are really trying to spread accountability for compliance and make compliance a shared responsibility. To be effective in a compliance program, you want to steer away from a model where compliance is just one person or a group of people based at New York headquarters. Compliance must be a shared responsibility and incumbent on everybody.

MS. BASRI: One of the things you mentioned is that you usually assume that physicians are government officials.

MR. SHARMA: Let me clarify that. When we are dealing in a foreign market, there is always a risk that any healthcare professional you are interacting with in any type of category is a government official. We have a clear message for our employees, which we have imparted through much training, including online and in-person training; in addition, those in the local markets have done their own training. This remains a risk area for us.

MS. BASRI: If you are in a country with socialized medicine, are you dealing with government officials?

MR. SHARMA: We have taken the position that in that type of scenario everyone is a government official. Thus, doctors in China would be government officials.

MS. BASRI: That results in an amazing reach. Rick, please relate this to the bank environment.

MR. MORRIS: In the investment banking context, there are some very obvious players who are without question government officials, and then there are those unwitting elements that might be deemed government officials. There are a number of occasions where it is perfectly appropriate for an investment bank to be advising a foreign government. It happens all the time. One example is the advice given in regard to privatization, which was prevalent all over the world in the 1990s. Governments would hire an investment bank to help them divest ownership of the various entities so they could become private enterprises. That was fairly commonplace and still is. The other area has been that of sovereign debt issuance. Recently, I worked on a global bond offering for the country of Brazil. Obviously, we were dealing with the Ministry of Finance in Brazil, and there was no question that we were dealing with a government official in that context. Clearly, appropriate safeguards must be put in place when you are trying to win those types of mandates. But there are the trickier examples where it is not quite so obvious that you may be dealing with the government. We do not have the doctor problem that Pfizer and the healthcare sector have. However, we do have the added layer that one of our common investor clients might be an entity like the China Investment Corporation (or "CIC"). I believe Mr. Gau spoke at this Section's Shanghai conference, and he is clearly a decision maker in regard to where those enormous funds are going to be invested. If he were a client of a securities firm, that firm would want to be very careful, because CIC is so closely connected with the Chinese government. In Singapore, you have the GIC, but you also have the Temasek Holdings sovereign wealth fund, although they do not like to use that label. They hold themselves out as independent and autonomous, but they have a single shareholder, the government of Singapore. Thus, you may be dealing there with a government official without really realizing it up front. Then there are the banks themselves. A recent example is the Royal Bank of Scotland, seventy percent of which is now owned by the government of the U.K. It is one of several bailouts that have occurred in the last few months, and it is a dramatic example. Fortis is another example, although it is a trickier situation, because it has been somewhat fragmented. It is partially owned by the Dutch government, partially owned by the Belgian government, and partially owned by the government of Luxembourg. So if you are doing a private placement, where you are trying to induce investors to invest in the offering, you may be dealing with a government official when you interact with one of those banks.

The flip side of this is seen in the rescue financing that has been taking place. Merrill Lynch is now owned by Bank of America. Citibank has had huge injections from Middle Eastern investors. There are many other examples. When you are dealing with client work or even capitalization for your own firm, you have to be aware that you may be dealing with a governmental official, although it may not be apparent on its face.

MS. BASRI: There has been a wave of private-public partnerships in the last few years, and you need to be aware of them as also quasi-governmental. As you can see, a government official may be defined in ways you may not have considered.

E. Training

MS. BASRI: Let us now discuss training. Do you train everybody in the company, or do you target your training? Certainly you have a code of conduct that mentions bribery and the anti-bribery statutes. Please tell us about your training programs. At Pfizer, Piyush, is it done through the human resources department or is the training done by the individual units?

MR. SHARMA: The answer in short is that there is a mix of training. We just rolled out a new internal code of conduct. We call it the "Blue Book." It is in fact a blue book. In connection with rolling that out, we also rolled out an online training course for our U.S.-based employees. About 30,000 people received that training. We will be rolling that out worldwide, probably in 2012. With regard to the FCPA, we rolled out two online training modules. One was essentially devoted to the nuts and bolts of the FCPA, and the second one was more specific to our international anti-bribery and anti-corruption procedure. That was done internationally. I do not know the exact number of trainees, but that was rolled out to senior leadership and to personnel at maybe two levels below that in our foreign markets.

Our foreign markets are also responsible for conducting training. That is a requirement under our overall procedure. They have responsibility to conduct their own training, and we give them flexibility to do that. We help them; for example, we have designed some training programs, but it is really their responsibility. I do training for different audiences. Recently, I just did a training session to some marketers in our specialty oncology teams, but it is a shared responsibility.

MS. BASRI: If someone is being placed abroad, do they get training before they go?

MR. SHARMA: That is a good question. What do you do when people shift positions—something that happens all the time? They would have already received some of the basic training, and at least in theory they would have received training in our internal code of conduct. When they go to their new job and position, it will probably be more of an HR function to make sure they get particular training relevant to the new position.

MS. BASRI: Abby, please tell us about training in MasterCard.

MS. FIORELLA: Similarly, we have an online curriculum, and FCPA or anti-corruption is one module of that. It is mandatory for every employee, upon joining MasterCard, to complete the online training curriculum. We also provide supplemental face-to-face training. That is done through the compliance division, through the audit division, and through regional counsel and our finance folks in the region, as well as management there.

I would like to make a couple of particular points. When we talk about the changing landscape and who is a government official, we need to remember that risk is not static. Thus, who is a government official yesterday or who your customer was yesterday may not be the profile of your customer today. You may have performed a due-diligence investigation when you brought somebody on, but things may have changed after you brought them on. And as Piyush said, vendors or your customers may be resistant to completing those questionnaires. What else can you do from a practical point of view?

I would like to talk about some things that we do beyond training that I think supplement those efforts. The first is very important and is part of the benefit of my staying on the audit department's management team: we coordinate risk updates with our enterprise risk management group, our internal audit group, our region management region counselor, and our finance folks. We need to know what is happening on the ground when it is happening. That informs how we provide support. We need to provide the support, the guidance and the tools to the people on the front line, who like us, are accountable for compliance. I think this is key. The second thing we do supplements what we do in terms of typical training: we have an internal controls checklist. Once a year all of senior management gets this checklist. We use it as an educational tool, as well as a way to monitor compliance. Management needs to think through their familiarity with policies, what controls they have in place, to what extent those are being followed, what issues or problems they have had in the last year, and / or how compliance policies are difficult to implement. We also make use of our audit team. We have our audit folks provide training when they travel to the different regions. Beyond that, we have developed an anti-corruption questionnaire to be used during these visits to the different country offices. We do data analytics. We look at outliers and data irregularities. We might do sample or targeted testing. For example, we might look at T&E for customer-facing personnel when I know that those customers are potentially government-owned. Those are the kinds of things I want to look at. We also use our forensic personnel, who are aware of our internal investigations, in ways that are cross-functional and educational for both sides of the house. This means that we will involve forensic personnel in high-risk audit investigations, because they will bring a different perspective, a different set of eyes, a different lens to the audit team and be sensitized; moreover, they will get experience out in the audit field.

MS. BASRI: Rick, please tell us about the training at Goldman Sachs.

MR. MORRIS: It is interesting: part of the recent Transparency International report broke down by region, as opposed to sector, the views and the level of knowledge of various executives around the world with regard to the various anti-bribery rules. I was surprised to learn that, if you break it down by U.S. plus Western Europe, the results in the category of "no familiarity" with the OECD convention was eighty-five percent. That is a high percentage. The convention has been around for a decade and is therefore not new news. In light of the significance and importance of having senior management approving and implementing compliance policies and programs, it is somewhat difficult to see how they can do so if they are not even aware that this important convention exists. Training proves here too to be absolutely critical, and the devil is of course in the details with respect to how to do effective training.

Several years ago, I was conducting OFAC training where we attempted to educate a sales force about the countries that were then currently being embargoed, such that you would not want to be doing business with them. The list contained the usual suspects: Cuba, Bolivia, and others. We did a little quiz at the end of the training to see if it had sunk in, and I was a bit surprised to read answers mentioning Jamaica. I do not know where that came from, but Jamaica is not necessarily a high-risk country in terms of the embargo rules. It is tempting to have it be a fairly rote and routine exercise. This would lead to the following approach, for example: we have new-hire training, and so-and-so is a new hire, we train the new person, we check the box, and we are done. I think that is a terrible way to conduct a training program. It might be a component, but it is not sufficient.

Many of my colleagues and I try to train every day. We do not have formal sessions. We do not all meet in a conference room for training per se. It is not that formal. The point is to embed yourself into the line of business by advising on compliance principles as they arise day-to-day in every phone call that you make in every interaction that you have with a particular line of the business.

There is one semi-formalized program: I talk to the natural resources investment banking team every Friday afternoon. They tell me what is on their mind, what is going on in their sector, what is going on in their deal pipeline, and any concerns they have. I explain to them what the concerns are from where I sit and what I am worried about and want to know about, as well as any follow-up that they or I need to do. We stay in touch constantly, and it is a way to get to know the line of business that is not confrontational in any way and does not involve a subpoena or an investigation or intervention by the government. It is simply a way to keep in touch and to establish a relationship that is nothing but fruitful over time. As those relationships develop, when any on the team have a problem they know exactly who to go to, what the issues are, and how to flag them for compliance so we can help resolve them.

F. Attorneys' Role

MS. BASRI: Now let me ask a really hard question. When we were in China at the Shanghai conference, we had a very good discussion on this issue of bribery and the FCPA. One of the people was from Thailand; he was from a local firm, not an international firm. He said that, if you want to be in the local market as an attorney, sometimes you have to act as the conduit, the agent. He said that he did not want to do it, but that he felt pressured to do it from the general counsel of a client, who in turn perhaps works under global counsel at a place similar to one of the big firms. Now, if a bribe is given in that context, how do you deal with the agents of the agents, because in a sense there has been a buffer? You are using the big outside law firm to get to the small local law firm to get to the official. What do you do? Do you have any ideas on this? Is this something you see in the marketplace?

MR. SHARMA: It is something we see in the marketplace. We might see, for example, that local competitors are taking doctors out to dinner, giving them excessive gifts, or sending them on resort-like trips. We cannot do that at Pfizer, so how do we compete with that and level the playing field? We hear about this type of thing all the time, in all markets. We emphasize that we cannot follow suit, but, at the same time, we are cognizant of how this impacts us in a local market. One of our initiatives is to devise a strategy for leveling the playing field. From my own experience in compliance, where this has been effective is where other local manufacturers are part of an industry association. Getting the manufacturers of generics to the table is not easy, as you might imagine. But some formula will be needed that involves participation in an industry association and establishing an agreed-to industry code in the markets where there is none, so that there is at least a minimum standard. Our policies may be stricter, but at least we would bringing our competitors to the same sort of arena. Those are some thoughts. It is certainly an issue, and it is something that we are looking at.

MS. FIORELLA: I think everybody deals with these types of challenges. Everybody else is doing it, the sense is, so why are we not allowed to do it? At a corporate level, we are evaluated on not just what we do but, to an equal extent, on how we do it. Noncompliant conduct is just not acceptable: it is not how we do business, and in the long run it is not going to serve the company well. Trying to level the playing field by getting involved in the industry in the local jurisdiction is one way to move forward. We try to be a business partner, and, to the extent you develop those relationships with the business folks on the ground, you can come up with solutions that are compliant, that are transparent, that enable business, that are not an inhibitor, and that also do not give you cause for pause and are not going to catch up with you down the line.

MR. MORRIS: One thing we have to be careful about is that attorneys can be agents, which is part of that example that we heard in Shanghai. There is a case involving a Swiss lawyer, who was working on a privatization program with the oil industry in Azerbaijan years ago. He was in Korea on a business trip and soon found himself in a Korean prison. Under the mutual legal assistance provisions of many of the pertinent treaties, he ended up being detained by the Koreans, extradited to the United States, and then charged with both money laundering and FCPA violations as counsel. We have all heard about how the third-party and agency rules can ensnare a much broader array of individuals and actors than you might think. The actors include not just the corporate ones, but also the advisors who surround and assist them. So be mindful that the net is broad and deep.

MS. WEXTON: There are two multinational law firms that are currently under investigation, one in Hong Kong and one in Shanghai, for activities specifically in this area. This is somewhat shocking. Certainly those of you who have practiced in the criminal defense area know that you cannot allow your client to launder money through you, by paying you, for example, with tainted funds or by having you hold those monies in escrow. I think it is probably time for multinational law firms to do some in-house training of lawyers who are going to be doing deals in countries where this is more likely to be an issue.

MS. BASRI: That is an excellent comment. While we are looking at the culture of ethics in the corporate environment, we must also look at our own profession where one can act as a conduit for bribes. It can happen at the global level at the global law firms, and it can happen at the local level in the local law firms, where the ties may be much harder to understand.

G. Spotting "Red Flags"

MS. BASRI: This brings us to red flags. If each of you could perhaps name some red flags that you look for.

MR. SHARMA: This is tied to our anti-bribery procedure. We have a trend analysis reporting requirement, which is an annual procedure that looks at categories of payments to government officials. This involves looking at the recipients of the highest amounts of different types of payments (e.g., gifts, hospitality, or international meeting support in the local market). One just has to review that analysis to look for red flags indicating potentially improper trends or improper payments. If the average meeting support to a government official in the market is $5,000, but a particular government official received $20,000, the matter will warrant further examination.

MS. FIORELLA: I think the manner in which an agent requests payment can be a red flag. An agent's requesting payment in cash or untraceable funds is a red flag. If the agent asks for payment through a third party or in a third-party country, there would be cause to question that arrangement. A request for political or charitable contributions is a red flag. Moreover, hesitancy in completing a due-diligence questionnaire or abiding by the company's anti-corruption policy must give any observer reason to pause.

MS. BASRI: As you see, many of these instances have to do with money laundering, as Rick previously mentioned. Rick, what red flags do you look for?

MR. MORRIS: There are several that are specific to investment banking. One is in the context of an IPO. When the allocations are being made to the initial primary investors in the offering, there is a concern that arises in every offering about "spinning." That is a practice where it is assumed or understood that there will be a quid-pro-quo arrangement, that is, an investor receives an allocation in a hot offering, with the expectation that, the next time the investor has investment banking needs, that investor will give you the business. This type of quid-pro-quo arrangement is exactly the type that raises an anti-bribery red flag in the FCPA context. The corrupt intent that is required under the FCPA specifically refers to the notion the investment bank has in this context, i.e., that by giving this, it is going to be getting that, and, in the IPO context, that is certainly something that has to be safeguarded against.

The reason for another red flag for investment banking is the fact that worldwide there are many deals that are not yet public but would be very lucrative to trade upon if one knew about them. I have access to every deal in the firm before it becomes public knowledge, and the reason for my having that access is so that we can safeguard the confidentiality of the matter. If I were asked to give an example of a "thing of value" other than a cash payment, material nonpublic information about securities would be a good one. Interestingly, there is also a connection here with the M&A risk that we talked about earlier in regard to the Lockheed Martin and Titan incident. In that case the SEC made it clear that in the future it would consider criminal prosecution for securities fraud if a public company failed to update its representations and warranties in cases where those representations and warranties are public and where the company represents that it is FCPA-compliant when it knows that it is not. This is not only an FCPA violation, but also potentially a 10(b) violation.

In regard to money laundering, the Patriot Act, in addition to Section 315 (which I mentioned earlier), has a Section 312 relating to senior foreign political figures. If you are opening a private banking account for what is otherwise known as a PEP, or "politically exposed person," under the AML rules heightened due diligence operations apply to the opening of that account. This is so that you are not unwittingly facilitating a money-laundering cycle whereby funds are placed into a brand new account and then integrated at a later time with legitimate funds. Under this rule, any financial institution, including specifically broker-dealers, must undertake a heightened diligence inquiry in regard to foreign political officials. The definition of a PEP is very broad: it includes former and current officials; members of the executive, legislative, and judicial branches, the military; as well as their family members and their close associates, which unbelievably broadens the net. Unlike the situation in the OFAC area, where there is a "Specially Designated Nationals" (SDN) list that you can check to identify specific individuals, there is no PEP list. Such lists are provided more and more by commercial vendors that will do the research and sell the results, in a commercial product. These lists, identifying individuals and entities that would require enhanced diligence because they are somehow connected to a government official, now number in the hundreds of thousands.

H. Direct Access to the Board

MS. BASRI: I have a final question. I believe that everyone who spoke today has come from a department that is separate from the legal department. There is therefore a separate compliance department. Is that correct?

MS. FIORELLA: No, my group is part of the law department, but again I also sit on the audit management team.

MR. SHARMA: My group is also part of the legal department.

MR. MORRIS: We are totally separate. Our CCO reports directly to the CEO and top management.

MS. BASRI: Can your department at Goldman go directly to the board of directors?

MR. MORRIS: Yes.

MS. BASRI: What about you, Abby, can your compliance group go directly to the board or do they go through GC?

MS. FIORELLA: Yes, it can go directly to the board.

MS. BASRI: What about you, Piyush?

MR. SHARMA: Yes, we can go directly to the board.

MS. BASRI: They can go directly to the board of directors. Those reporting lines are very important. The more there is a separation, the better it is looked upon by the government under the sentencing guidelines.

The U.S. Foreign Corrupt Practices Act—An Overview

By Oliver J. Armas

I. Introduction

This article provides a general background into the Foreign Corrupt Practices Act ("FCPA") and recent enforcement trends. Over the past several years, the U.S. government, through the Department of Justice ("DOJ") and the Securities and Exchange Commission ("SEC"), has increased dramatically its enforcement of the FCPA. While in 2004 the DOJ and SEC collectively brought only five FCPA enforcement actions, in 2007 there were thirty-eight. Currently there are over eighty pending FCPA investigations. An April 2008 *Washington Post* column by Steven Pearlstein indicated that the DOJ has, in recent years, sextupled the number of prosecutors devoted to FCPA enforcement and provided those prosecutors with a team of FBI agents to assist in investigations.

It is not surprising that this increase in the number of enforcement actions has been accompanied by an escalation in the size of the penalties demanded by the DOJ and SEC in connection with resolving those actions. Indeed, in December 2008, Siemens AG pleaded guilty and agreed to pay approximately $800 million in fines and disgorgements to U.S. authorities in order to settle global corruption charges with the DOJ and SEC—dwarfing the $44.1 million penalty paid by Baker Hughes in April 2007, which was previously the highest FCPA penalty ever paid. In January 2009, Halliburton announced that it has agreed to pay $559 million to U.S. authorities to settle charges that one of its former units bribed Nigerian officials, setting a new settlement record for U.S. companies.

II. FCPA Background

A. Overview

Congress enacted the FCPA in 1977 in response to widespread post-Watergate allegations that a number of U.S. companies had regularly made illegal domestic campaign contributions. Further investigations by the SEC revealed that U.S. companies were also paying large sums of money to foreign government officials in return for their assistance in obtaining or retaining government business or obtaining other favorable treatment. The FCPA was the government's response to these corrupt practices.

Generally, the FCPA makes it a federal criminal offense for any U.S. person, issuer or domestic concern, or any foreign person while in the United States, directly or indirectly, to make a corrupt payment to any foreign government official to obtain or retain any business advantage (the "anti-bribery provisions").[1] The FCPA also requires companies with securities registered under the Securities Exchange Act of 1934 to make and keep appropriate books and records and to maintain a system of adequate internal controls (the "accounting provisions"). We address each in turn.

B. The Anti-Bribery Provisions

1. Overview

The FCPA's anti-bribery provisions prohibit any issuer, domestic concern or foreign person in the United States from paying money or providing anything of value to officials of foreign governments or foreign political parties with the intent to obtain or retain business. The term "issuer" covers any business entity that is registered under 15 U.S.C. § 78*l* or is required to file reports under 15 U.S.C. § 78o(d). This includes companies issuing American Depository Shares ("ADRs") that are registered and traded on a U.S. exchange.[2] ADRs that are not sponsored by the company and are not registered do not subject a company to the provisions of the FCPA, because such companies are not subject to the SEC's registration and reporting requirements, and are thus not "issuers" under the statute.[3] The term "domestic concern" is even broader and includes any business that has its principal place of business in the United States or that is organized under the laws of the United States.[4] Individuals who are citizens, nationals, or residents of the United States are also considered "domestic concerns."[5] Finally, officers, directors, employees, agents and stockholders of issuers and domestic concerns are subject to the FCPA.

Foreign corporations and foreign subsidiaries of U.S. corporations are not subject to the FCPA unless they are issuers, have their principal place of business in the United States or commit acts in violation of the FCPA while in the U.S.[6] In contrast, issuers and domestic concerns may be vicariously liable for the acts of foreign corporations and subsidiaries.[7] Furthermore, foreign individuals who act as agents or employees of issuers or domestic concerns are subject to the FCPA.[8] Finally, U.S. citizens or residents who violate the FCPA on behalf of foreign corporations may be liable as domestic concerns.[9]

2. Elements of an Anti-Bribery Violation

In order to establish a violation of the anti-bribery provisions of the FCPA, the government must prove the following elements:

(a) a payment of (or an offer, authorization, or promise to pay) money or anything of value, directly, or through a third party;

(b) to (i) any foreign official, (ii) any foreign political party or party official, (iii) any candidate for foreign political office, (iv) any official of or a public international organization, or (v) any other person "knowing" that the payment or promise to pay will be passed on to one of the above;

(c) the use of an instrumentality of interstate commerce (such as telephone, telex, facsimile, email, or the mail) by any person (whether U.S. or foreign), or an act outside of the U.S. by a domestic concern or U.S. person, or an act in the U.S. by a foreign person in furtherance of the offer, payment or promise to pay;

(d) for the corrupt purpose of influencing any official act or decision of that person, inducing that person to do or omit to do any act in violation of his / her lawful duty, securing any improper advantage, or inducing any person to use his / her influence with a foreign government to affect or influence any government act or decision; and

(e) in order to assist the company in obtaining or retaining business or in directing business to any person or to secure an improper advantage.[10]

The purpose of the payment is relevant in determining whether there has been an FCPA violation. To run afoul of the FCPA's anti-bribery provisions, a payment must (i) be made corruptly and (ii) to obtain or retain business. An act is done corruptly if it is done "voluntarily and intentionally, and with a bad purpose of accomplishing either an unlawful end or result, or a lawful end or result by some unlawful method or means."[11] The FCPA also prohibits payments made in order to assist a company in obtaining or retaining business for or with, or directing business to, any person. If the payment or offer to pay was to secure an improper advantage in obtaining or retaining business, then the business purpose test of the FCPA has been met and the FCPA has been violated.

Under the FCPA, knowledge is established "if a person is aware of a high probability of the existence of such circumstance, unless the person actually believes that such circumstance does not exist."[12] Thus, a company cannot be willfully blind to any action or fact that should reasonably alert it to a high probability of an FCPA violation occurring either directly or indirectly through others. In such cases, knowledge may be inferred even if the company does not have actual knowledge of an improper payment being made to a foreign official. Indeed, in one SEC enforcement action the improper payments were made without the knowledge or approval of any of the company's employees in the United States.[13]

The FCPA also contains two affirmative defenses to liability under the anti-bribery provisions. *First*, the FCPA provides that there can be no liability for an otherwise prohibited payment if the payment "was lawful under the written laws and regulations of the foreign official's, political party's, party official's, or candidate's country."[14] *Second*, the FCPA provides that no liability attaches to a payment to a government official if the payment was "a reasonable or bona fide expenditure, such as travel and lodging expenses," incurred by or on behalf of a foreign official and was directly related to "(A) the promotion, demonstration, or explanation of products or services; or (B) the execution or performance of a contract with a foreign government or agency thereof."[15]

C. The Accounting Provisions

The FCPA also contains two interrelated accounting provisions: one requiring the keeping of accurate books and records, and the other requiring the maintenance of adequate internal controls. The record-keeping and internal controls provisions of the FCPA only apply to issuers. Accordingly, private equity companies and hedge funds (which typically are not considered issuers) tend not to focus on the accounting provisions. However, because (as noted above) private companies do sometimes acquire issuers, it is important to be familiar with these provisions.

Issuers and their employees or agents are required to "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions" of their assets.[16] The FCPA defines "reasonable detail" to mean "such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs."[17] This provision is designed to prevent three types of conduct: (1) the failure to record improper transactions; (2) the falsification of records to conceal improper transactions; and (3) the creation of records that are quantitatively correct but fail to specify the qualitative aspects of a transaction that might reveal the true purpose behind a particular payment.[18] To avoid liability, company books and records must include information that in effect would alert the SEC to any possible impropriety.[19]

In addition, issuers are required to "devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances" that transactions and assets are properly maintained,[20] i.e., that (1) transactions are executed with management's authorization and recorded as necessary to permit preparation of financial statements in conformity with generally accepted accounting principles or other applicable criteria and to maintain accountability for assets, (2) access to assets is allowed only with management's authorization, and (3) 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 FCPA defines the term "reasonable assurances" to mean "such level of detail and degree of assurance as would satisfy prudent officials in the conduct of their own affairs."[21] Several factors are considered when determining the adequacy of a system of internal controls, including: (i) the role of the board of directors; (ii) communication of corporate procedures and policies; (iii) assignment of authority and responsibility; (iv) competence and integrity of personnel; (v) accountability for performance and compliance with policies and procedures; and (vi) objectivity and effectiveness of the internal audit function.[22]

The accounting provisions apply to issuers, regardless of whether they have foreign operations and whether bribery is involved. In addition, reasonableness, rather than materiality, is the threshold standard. In other words, to have a violation of the FCPA, the inaccurately recorded transactions in question do not have to be material under the federal securities laws. The test of a company's control system is not whether occasional failings can occur, but rather, when such breaches do arise, whether they are isolated rather than systemic and likely to be uncovered in a timely manner and remedied promptly.[23]

Note that criminal liability under the accounting provisions may only be imposed where a person "knowingly" circumvented or failed to implement a system of internal accounting controls or "knowingly" falsified any book, record, or account. However, civil liability may arise for issuers if their books fail to adequately represent an improper payment, even though the falsification, for example, occurred at a subsidiary with no evidence of involvement by the parent.[24] The test used by the SEC for civil liability on the part of a parent is that of control.[25]

D. Penalties Under the FCPA

Violations of the FCPA can carry significant penalties. For failing to comply with the anti-bribery provisions, a company can be fined up to $2 million per violation as well as be forced to make restitution. For each criminal violation of the books and records provisions of the FCPA, a company can be forced to pay up $25 million in fines plus restitution; for each civil violation, a company can be forced to pay up to $10,000. Additionally, a company found to violate the FCPA can be suspended or barred from contracting with the U.S. government and have its import and / or export licenses revoked or denied. For individuals, anti-bribery violations can carry with them fines of $250,000 per violation, five years of imprisonment and / or a requirement of restitution. Individuals found to have violated the books and records provisions can face criminal penalties of up to $5 million, twenty years in prison and restitution per violation, and civil penalties of $10,000 per violation.[26]

III. Recent FCPA Enforcement Activities

As noted above, the government has dramatically increased its FCPA prosecutions since 2005. In the past few months alone, there has been significant governmental activity. For example:

- On 23 September 2008, a former Alcatel executive was sentenced to thirty months' imprisonment for violating the FCPA. The government alleged that Christian Sapsizian made illegal payments to Costa Rican officials in return for a telecommunications contract with a government-owned entity. In that case, the government: (a) asserted jurisdiction over the defendant based on the fact that Alcatel registered and traded ADRs on the NYSE; and (b) the actual payments were made by wire from Europe to Costa Rica through Miami (thus satisfying the interstate commerce requirement).[27]
- On 4 September 2008, a grand jury sitting in Philadelphia returned an indictment against Nexus Technologies, Inc., Nam Nguyen, Joseph Lukas, Kim Nguyen, and An Nguyen, on one count of conspiracy to violate the FCPA and four substantive counts of violating the FCPA. The government alleged that Nexus and the four individuals bribed Vietnamese officials in exchange for contracts to supply equipment and technology to government agencies in Vietnam.[28]
- On 3 September 2008, Albert "Jack" Stanley, a former officer and director of KBR, Inc. (a Halliburton Company), pleaded guilty to conspiring to violate the FCPA by participating in a decade-long scheme to bribe Nigerian government officials to obtain engineering, procurement and construction contracts valued at more than $6 billion. Stanley agreed to cooperate with the government in its ongoing investigation, pay a $10.8 million fine, and he faces up to ten years' imprisonment when he is sentenced.[29]
- On 14 May 2008, Willbros Group, Inc. and four of its former employees settled civil charges brought by SEC, and the company also settled criminal charges brought by the DOJ. Under the terms of the settlement, Willbros agreed to pay $32.3 million. In addition, several of Willbros's former employees pleaded guilty to criminal violations of the FCPA, and await sentencing.[30]

During this decade, in terms of industries, energy, technology, telecommunications, and pharmaceutical / medical devices have most often been involved in FCPA investigations and enforcement actions. Some recent examples follow below.

A. Oil-for-Food Program

The government's investigation and prosecution involving the Oil-for-Food Program ("OFFP") is the largest FCPA investigation ever, involving a U.N.-commissioned international investigative body, four congressional committees, the DOJ, two U.S. Attorneys' Offices, the SEC, the Manhattan District Attorney's Office, the Department of Treasury's Office of Foreign Assets Control ("OFAC"), and at least six foreign governments. The investigation began with the appointment of former Chairman of the Federal Reserve Paul A. Volcker to investigate alleged corruption regarding the OFFP. His final report named 2,253 companies worldwide as having made more than $1.8 billion in "kickback" payments to the Iraqi government. More than two dozen companies have since publicly disclosed that they are under investigation by the DOJ and / or SEC. As detailed below, the following companies have already settled with the government for their participation in the OFFP.

1. El Paso Corporation

On 7 February 2007, El Paso settled with the SEC on charges that it violated the FCPA's books-and-records and internal controls provisions, and at the same time entered into a non-prosecution agreement with DOJ. El Paso purchased oil from third parties while knowing that the third parties had themselves made approximately $5.5 million in illegal kickback payments in connection with their purchase of the oil from the Iraqi government. El Paso allegedly reimbursed the intermediary purchasers for their kickback payments through higher commission payments and then improperly recorded the whole of the commissions as "cost of goods sold." El Paso agreed to pay a $7.73 million civil fine to settle with the government.[31]

2. Textron, Inc.

On 23 August 2007, Textron, Inc. settled with the DOJ and SEC over allegations that it failed to maintain adequate books and records as required under the FCPA. The government charged that two recently acquired French subsidiaries of Textron used a third-party agent to funnel $580,000 to ministries of the Iraqi government in connection with the sale of industrial pumps and related spare parts under the OFFP. Textron paid a $1.15 million fine to the DOJ as part of a non-prosecution agreement, and paid an $800,000 civil penalty to the SEC along with approximately $2.7 million in disgorgement, with prejudgment interest. Both the DOJ and the SEC acknowledged Textron's early discovery and self-reporting of the improper payments, as well as the company's remedial actions and significant cooperation in the government's investigation of it and other companies.[32]

3. York International Corp.

On 1 October 2007, York settled FCPA and related charges with the SEC and the DOJ over allegations that its Dubai subsidiary paid approximately $670,000 in kickbacks to the Iraqi government through third-party agents, funded by inflated contract price submissions to the United Nations. York paid a $2 million civil penalty to the SEC and agreed to disgorge just over $10 million in profits plus prejudgment interest. As part of a deferred prosecution agreement with the DOJ, York paid a $10 million criminal fine and was required to retain an independent compliance consultant.[33]

4. Ingersoll-Rand Co. Ltd.

On 31 October 2007, Ingersoll Rand settled with the DOJ and SEC over allegations that several of its foreign subsidiaries paid or promised to pay approximately $1.5 million in kickbacks to officials of the Iraqi government through third-party agents. Under the terms of the settlement, the company paid a $2.5 million criminal fine to the DOJ, and $4.22 million in penalties and disgorgement to the SEC.[34]

5. Chevron Corp.

On 14 November 2007, Chevron Corporation entered into a books-and-records and internal controls resolution with the SEC and agreed to pay a $3 million penalty to settle allegations that it purchased oil from third parties while knowing that the third parties had themselves made approximately $20 million in kickbacks in connection with their purchase of the oil from the Iraqi government. Chevron's SEC settlement required $20 million in disgorgement, but the disgorgement was deemed satisfied by the company's payment of the same amount to the Development Fund for Iraq as part of a non-prosecution agreement on non-FCPA charges. The company also paid a $2 million civil penalty to OFAC and paid $5 million to the Manhattan District Attorney's Office to reimburse it for investigative costs.[35]

6. Akzo Nobel N.V.

On 20 December 2007, Akzo settled FCPA charges with the DOJ and the SEC over charges that its Dutch subsidiaries paid approximately $280,000 in kickbacks to ministries of the Iraqi government through their third-party agents, funded by inflated contract price submissions to the United Nations. Akzo Nobel agreed to pay a $750,000 civil penalty to the SEC and to disgorge approximately $2.23 million in profits plus prejudgment interest. The non-prosecution agreement entered into with the DOJ does not require the payment of a fine, on the condition that one of the company's subsidiaries enter a settlement with the Dutch government over the same conduct.[36]

7. Flowserve Corp.

On 21 February 2008, Flowserve agreed to pay $10.5 million in fees and penalties to the SEC and DOJ in settlement of enforcement actions brought by the government in connection with corrupt payments of approximately $820,000 that were made to the Iraqi government by two of Flowserve's foreign subsidiaries. As part of the settlement, Flowserve entered into a three-year deferred prosecution agreement in which it, among other things, agreed to pay a $4 million penalty. In its settlement with the SEC, Flowserve agreed to pay approximately $6.5 million in combined penalties and disgorgement of profits.[37]

8. AB Volvo

On 20 March 2008, AB Volvo agreed to pay $19.6 million in combined fees and penalties to settle DOJ and SEC actions relating to $6.3 million in improper kickback payments made by two of its wholly owned subsidiaries to the Iraqi government under the OFFP. In a parallel enforcement action, the SEC filed FCPA books and records and internal control charges against AB Volvo. Without admitting or denying the allegations, AB Volvo agreed to pay a $4 million civil penalty and approximately $8.6 million in disgorgement of profits, plus prejudgment interest.[38]

B. Technology

1. Vetco International Ltd.

On 6 February 2007, three subsidiaries of Vetco International agreed to pay a combined $26 million in criminal fines to settle charges that they had paid $2.1 million to Nigerian customs officials. The companies made 378 separate payments over two years in relation to work providing engineering services and subsea construction equipment for a Nigerian deepwater drilling project. One of the Vetco subsidiaries had also pleaded guilty to FCPA violations on 6 July 2004, when it was owned by ABB Handels- und Verwaltungs AG.[39]

2. Paradigm B.V.

On 24 September 2007, the DOJ announced a $1 million settlement with Paradigm B.V., a software provider for oil and gas exploration and production companies. Paradigm admitted making payments to government officials in China, Indonesia, Kazakhstan, Mexico, and Indonesia in order to sell the company's products and obtain service contracts. The company identified possible FCPA violations during due diligence in connection with an IPO; after disclosing the conduct to the DOJ, the company agreed to pay a fine, implemented internal controls, and retained outside compliance counsel.[40]

3. Siemens AG

On 5 October 2007, German conglomerate Siemens AG announced that it had accepted a German court's order to pay a €201 million ($284 million) fine in connection with alleged bribes paid by Siemens's telecommunications unit to win contracts in a number of countries, including Russia. Siemens also agreed to pay German tax authorities €179 million ($253 million) in back taxes related to improper deductions taken for the unlawful payments. In addition, the German authorities indicted at least one executive from the telecommunications unit in connection with the alleged bribery, and press reports indicate that additional indictments are expected. These significant fines came on the heels of a €38 million ($51 million) fine levied against Siemens's power-generation unit in May 2007, and Siemens has confirmed that it is continuing to investigate suspicious payments made by several other units. China, Greece, Hungary, Indonesia, Italy, Japan, Norway, and Switzerland also reportedly launched investigations of the same conduct.[41] In December 2008, Siemens AG plead guilty and agreed to pay approximately $800 million in fines and disgorgements to U.S. authorities—representing the largest FCPA penalty ever assessed—in order to settle global corruption changes with the DOJ and SEC.[42]

4. Westinghouse Air Brake Technologies Corporation

On 14 February 2008, Westinghouse agreed to pay almost $700,000 in fees and penalties to settle DOJ and SEC enforcement actions relating to payments made to Indian government officials by a foreign subsidiary. The subsidiary, a manufacturer of brake equipment, paid over $137,000 to officials on the Indian Railway Board in order to obtain and retain business, and to influence regulators and tax auditors. Westinghouse paid approximately a combined $390,000 in penalties, and agreed to the disgorgement of approximately $288,000 in profits in the SEC action.[43]

5. Pacific Consolidated Industries

On 8 May 2008, a former PCI executive, Martin Self, pleaded guilty to charges he had violated the FCPA by bribing a UK government official in order to obtain defense contracts. Self and another PCI executive wired more than $70,000 to the relative of an official in the UK Ministry of Defense; Self admitted he had had no knowledge of any legitimate services the relative provided. He avoided learning about details of the payments, although he understood they were likely being used to influence the government official. The DOJ sought a prison sentence of eight months in the plea agreement.[44]

6. Kellogg, Brown & Root Executive

On 3 September 2008, a former officer and director of Kellogg, Brown & Root, Albert Stanley, pleaded guilty to DOJ charges that he had conspired to violate the FCPA over a ten-year period. As the head of a KBR predecessor company, Stanley helped manage a joint venture that built liquefied natural gas production facilities in Nigeria. Between 1994 and 2005, Stanley approved payments of over $180 million to outside consulting firms with the intention that the funds be used to bribe Nigerian government officials; Stanley and others met repeatedly with officials to discuss upcoming contracts and to negotiate kickbacks. Stanley faces a prison sentence of seven years under his plea agreement, and must pay $10.8 million in restitution. The SEC has charged Stanley separately with civil violations of the FCPA.[45]

7. Nexus Technologies, Inc.

On 5 September 2008, the DOJ announced indictments against an export company and four of its employees for allegedly paying over $150,000 to Vietnamese government officials. The company purchased equipment and technology in the U.S., including underwater mapping equipment, bomb containment equipment, chemical detectors, and satellite communications parts, for export to Vietnam. The DOJ alleged that the company paid the bribes over ten years in order to obtain government contracts. The company could be subject to $10 million in fines for five counts of violating the FCPA and conspiring to violate the FCPA; the individual defendants face fines and prison sentences for the same charges.[46]

8. AMAC International

On 24 September 2008, the DOJ announced the arrest of Shu Quan-Sheng, a physicist in Virginia and President, Secretary and Treasurer of AMAC on various grounds stemming from his sale of space launch technology to the People's Republic of China. Shu was charged with violating the FCPA by bribing a Chinese research institute to award a $4 million project to a French company; AMAC received a commission for successfully brokering the deal. He faces a possible five-year prison sentence in addition to any punishment for the other charges against him.[47]

9. Halliburton

On 26 January 2009, Halliburton announced that it has agreed to pay $559 million to U.S. authorities to settle charges that one of its former units (KBR, Inc.) bribed Nigerian officials during the construction of a giant liquefied natural gas (LNG) plant on the Nigerian coast near Port Harcourt from 1996 through the mid-2000s.[48] Pursuant to the terms of the settlement, which is currently under review for final approval, Halliburton would pay $382 million to the DOJ and $177 million to the SEC. Interestingly, the prospective settlement with the DOJ would not require Halliburton to engage a monitor. The prospective settlement with the SEC, on the other hand, would require Halliburton to retain an independent consultant to perform a sixty-day initial and, approximately one year later, a thirty-day follow-up review and evaluation of Halliburton's anti-bribery and foreign agent internal controls and record-keeping policies and to adopt any necessary improvements.

C. Telecommunications

1. Alcatel CIT

On 23 September 2008, a former Alcatel executive, Christian Sapsizian, was sentenced to thirty months in prison after pleading guilty to charges that he had violated the FCPA by participating in the payment of over $2.5 million to Costa Rican government officials to win a mobile telephone contract. Sapsizian and another Alcatel employee paid the bribes over four years through a local consulting firm; they intended to cause Costa Rican officials to follow a bid procedure that favored Alcatel technology and to vote to award Alcatel the contract. Alcatel did receive the $151 million contract in August 2001. Although Alcatel is a French company, the parent corporation has American Depository Receipts traded on the New York Stock Exchange.[49]

2. ITXC Corporation

On 25 July 2007, two former executives of ITXC pleaded guilty to charges that they had conspired to make corrupt payments to employees of foreign-state owned and foreign-owned telecommunications carriers in Nigeria, Rwanda, and Senegal. The DOJ charged the executives with paying over $250,000 in bribes to obtain and retain contracts; employees of the foreign companies were considered foreign officials within the definition of the FCPA. The ITXC executives faced up to $250,000 in fines and five years in prison.[50]

3. Lucent Technologies, Inc.

On 10 December 2007, Lucent entered into settlements with the DOJ and SEC over allegations that its employees had made corrupt payments to Chinese officials. The government charged that Lucent had paid for Chinese government officials to travel to the United States and elsewhere for sightseeing, entertainment, and leisure purposes. According to the government, Lucent spent over $10 million on travel and entertainment expenses from 2000 to 2003 for approximately one thousand employees of state-owned or state-controlled telecommunications enterprises in China which were prospective or existing Lucent customers. Lucent agreed to pay $2.5 million to settle the charges.[51]

D. Pharmaceuticals / Medical Devices

1. Syncor International Corp.

On 27 September 2007, the SEC settled an FCPA enforcement action against Monty Fu, the founder and former chairman of Syncor, a provider of radiopharmaceuticals and medical imaging services. The SEC alleged that Fu violated the FCPA's accounting provisions. Between 1985 and 2002, a foreign subsidiary of Syncor paid commissions and referral fees to doctors in private and public hospitals in Taiwan who used Syncor products and services—the fees averaged over $170,000 annually by the end of the period, and were recorded as "Advertising and Promotions" expenses rather than as commissions and referrals. The SEC alleged that Fu knew the fees were not properly recorded or was reckless in not knowing. Fu neither admitted nor denied the charges, but agreed to an injunction against further FCPA violations and a civil penalty of $75,000. The settlement with Fu followed actions by the SEC and DOJ against Syncor, where the company settled in 2002 for about $2.5 million in fines.[52]

2. Immucor, Inc.

On 28 September 2007, the SEC announced a civil settlement with the CEO of Immucor, Inc., Gioacchino de Chirico, over payments of €13,500 to the director of a public hospital in Italy in exchange for favorable consideration of the company's bid to sell the hospital supplies and equipment. Chirico agreed to the final entry of a $30,000 fine without admitting or denying the SEC allegations. Separately, Immucor agreed to a cease-and-desist order against future FCPA violations without admitting or denying any SEC findings.[53]

3. AGA Medical Corporation

On 3 June 2008, AGA agreed to pay a $2 million criminal penalty in response to DOJ charges that the company had made corrupt payments to doctors at public hospitals in China between 1997 and 2005. AGA employees agreed to pay the kickbacks through their local distributor in order to sell products used in the treatment of congenital heart defects. In addition, AGA paid kickbacks to officials in the Chinese State Intellectual Property Office in order to win the approval of several patent applications. As part of a deferred prosecution settlement, AGA agreed to the fine, enhanced compliance policies, and to engage an independent monitor.[54]

IV. Conclusion: Outlook

Enhanced FCPA enforcement is not expected to slow down under the Obama administration. Speaking at a conference in Frankfurt, Germany, Mark F. Mendelsohn, Deputy Chief of the Fraud Section at the DOJ, recently provided a list of Top Ten Trends for 2009. These were as follows.[55]

1. The level of enforcement is at an all-time high and is likely to remain there.
2. Prosecuting senior company executives in their individual capacities will be a priority.
3. The U.S. will investigate U.S. and foreign issuers equally, as well as companies operating within U.S. territory.
4. Multi-jurisdictional investigations are on the rise.
5. Informal international cooperation will continue to improve, together with increased mutual legal assistance.
6. The DOJ and FBI are committing more resources to FCPA enforcement, including eight full-time, dedicated FBI investigators.
7. The DOJ will coordinate, where appropriate, sector-wide investigations, as it has in the oil and gas, medical devices and freight-forwarding industries.
8. The pace of voluntary disclosures is likely to continue.
9. FCPA due diligence will be a regular feature of mergers and acquisitions and transactional work.
10. Increased enforcement of other crimes, alongside FCPA violations, is expected, including money-laundering, export controls violations and false accounting.

Endnotes

1. *See* 15 U.S.C. § 78dd-1(a); 15 U.S.C. § 78dd-2(a); 15 U.S.C. § 78dd-3(a).
2. *See, e.g. S.E.C. v. ABB Ltd.*, No. 04 Civ. 1141 (D.D.C. 6 July 2004).
3. R. Witten and K. Parker, COMPLYING WITH THE FOREIGN CORRUPT PRACTICES ACT § 2.02 n. 5 (Matthew Bender 2007).
4. *See* 15 U.S.C. § 78dd-2(h)(1)(B). Typically, private equity companies and hedge funds are considered subject to the FCPA because they are "domestic concerns." However, private equity companies and hedge funds also can become liable under the FCPA if they acquire a company that is an "issuer," such as, for example, a foreign company that trades on a U.S. exchange through ADRs.
5. *See* 15 U.S.C. § 78dd-2(h)(1)(A).
6. *See* R. Witten and K. Parker, note 3 *supra*, § 2.02.
7. *Id.*
8. *Id.*
9. *Id.*
10. *See* 15 U.S.C. § 78dd-1(a); 15 U.S.C. § 78dd-2(a); 15 U.S.C. § 78dd-3(a).
11. *United States* v. *Liebo*, 923 F.2d 1308, 1312 (8th Cir. 1991).
12. *See* 15 U.S.C. § 78dd-1(f)(2)(B); 15 U.S.C. § 78dd-2(h)(3)(B); 15 U.S.C. § 78dd-3(f)(3)(B).
13. *See In re Schering-Plough Corp.*, Exchange Act Release No. 49838 (9 June 2004).
14. 15 U.S.C. § 78dd-1(c)(1); 15 U.S.C. § 78dd-2(c)(1); 15 U.S.C. § 78dd-3(c)(1).
15. 15 U.S.C. § 78dd-1(c)(2); 15 U.S.C. § 78dd-2(c)(2); 15 U.S.C. § 78dd-3(c)(2).
16. *See* 15 U.S.C. § 78m(b)(2)(A).
17. *See* 15 U.S.C. § 78m(b)(7).
18. *See* D. Cruver, COMPLYING WITH THE FOREIGN CORRUPT PRACTICES ACT at 14 (American Bar Association 2d. Ed. 1999).
19. See *id.* at 16 (stating that records will not be deemed fair and accurate unless company describes illegal payments as "bribes to secure business").
20. *See* 15 U.S.C. § 78m(b)(2)(B)(i)-(iii).
21. *See* 15 U.S.C. § 78m(b)(7).
22. *See* SEC Statement of Management on Internal Accounting Controls, Exchange Act Release No. 34-16877, 1980 WL 20857, at *12-13 (6 June 1980).
23. *See* Foreign Corrupt Practices Act of 1977, Statement of Policy, Exchange Act Release No. 34-17500, 1981 WL 36385, at *9 (29 Jan. 1981) (Remarks of Harold M. Williams).
24. *Id.*
25. *Id.*
26. *See* 15 U.S.C. § 78ff.
27. *See* http://www.usdoj.gov/opa/pr/2008/September/08-crm-848.html.
28. *See* http://www.usdoj.gov/opa/pr/2008/September/08-crm-782.html.
29. *See* http://www.usdoj.gov/opa/pr/2008/September/08-crm-772.html.

30. *See* http://www.usdoj.gov/opa/pr/2008/May/08_crm_417.html.

31. *See* http://www.sec.gov/litigation/litreleases/2007/lr19991.htm.

32. *See* http://www.usdoj.gov/opa/pr/2007/August/07_crm_646.html.

33. *See* http://www.usdoj.gov/opa/pr/2007/October/07_crm_783.html.

34. *See* http://www.usdoj.gov/opa/pr/2007/October/07_crm_872.html.

35. *See* http://www.sec.gov/litigation/litreleases/2007/lr20363.htm.

36. *See* http://www.usdoj.gov/opa/pr/2007/December/07_crm_1024.html.

37. *See* http://www.usdoj.gov/opa/pr/2008/February/08_crm_132.html.

38. *See* http://www.usdoj.gov/opa/pr/2008/March/08_crm_220.html.

39. *See* http://www.usdoj.gov/opa/pr/2007/February/07_crm_075.html.

40. *See* http://www.usdoj.gov/opa/pr/2007/September/07_crm_751.html.

41. *See* http://www.sec.gov/Archives/edgar/data/1135644/000132693207000471/f01847e6vk.htm#313.

42. *See* http://www.usdoj.gov/opa/pr/2008/December/08-crm-1105.html.

43. *See* http://www.usdoj.gov/opa/pr/2008/February/08_crm_116.html.

44. *See* http://www.usdoj.gov/opa/pr/2008/May/08-crm-394.html.

45. *See* http://www.usdoj.gov/opa/pr/2008/September/08-crm-772.html.

46. *See* http://www.usdoj.gov/opa/pr/2008/September/08-crm-782.html.

47. *See* http://www.usdoj.gov/opa/pr/2008/September/08-nsd-851.html.

48. *See* http://www.halliburton.com/public/news/pubsdata/press_release/2009/corpnws_012509.html.

49. *See* http://www.usdoj.gov/opa/pr/2008/September/08-crm-848.html.

50. *See* http://www.usdoj.gov/opa/pr/2007/July/07_crm_556.html.

51. *See* http://www.usdoj.gov/opa/pr/2007/December/07_crm_1028.html.

52. *See* http://www.sec.gov/litigation/litreleases/2007/lr20310.htm.

53. *See* http://www.sec.gov/litigation/litreleases/2007/lr20316.htm.

54. *See* http://www.usdoj.gov/opa/pr/2008/June/08-crm-491.html.

55. *See* http://wrageblog.org/2009/01/28/fcpa-enforcement-top-ten-trends-for-2009/.

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Obtaining Evidence in Cross-Border Commercial Disputes: International Arbitration in Europe

By Stephen R. Bond

I. Introduction

As in litigation, the evidence that a party can use to prevail in an arbitration only comes from two sources, witness testimony and documents. However, none of the major arbitration rules guarantees that a party will have access to persons employed, or documents held, by the other side, let alone persons not connected with the parties to the case or documents held by a third party. This is so whether or not the opposing party is located in the same jurisdiction.

One major reason for this is that international arbitration, as it exists today, is largely a creation of continental Europe and its civil law approach to judicial decision-making.

As one well-known Swiss arbitrator has written:

> The principal objective of procedural rules in civil law countries is the efficient settlement of disputes, while the principal objective of procedural rules in common law countries is to determine the truth.[1]

Indeed, civil law jurists sometime consider that forced document production constitutes a reversal of the burden of proof, since a party is no longer relying on its own resources to carry its burden. For example, another well-respected Swiss arbitrator wrote in a procedural order issued in 1991, in a case where both parties were represented by U.S. counsel:

> In Civil law countries, the principle *Onus probandi incumbat alleganti* is construed as leaving to each party the full burden of collecting whatever evidence it wishes to bring to the attention of the Court. There is, in the Civil law tradition, no duty of discovery from the other side, except to the extent that each party has to indicate in advance the evidence on which it intends to rely.
>
> […]
>
> The request for production of documents must be specific. It should be directed at the production of an individual contract, of a particular letter, such as a letter mentioned in another letter already produced to the Court, or the like.
>
> Under Swiss concepts, the proper method for obtaining information pertaining to the case from documents or accounts held by the other side or by third parties is through the appointment of an expert by the Court.
>
> By contrast, the parties are not given access to the documents examined by the expert.
>
> […]
>
> This general approach has been adopted by the authors of the Supplementary Rules of Evidence for use in International Arbitration, enacted in 1983 by the International Bar Association.

These are some of the reasons why Continental arbitration laws do not generally contain express rules on document production, while Section 34(2)(d) of the 1996 English Arbitration Act does deal with the matter.

Given that arbitrators do not have the authority to issue subpoenas for persons or documents, whether or not the opposing party is in a foreign jurisdiction from that of the seat of arbitration, the question arises whether counsel in an arbitration are doomed to rely only upon witnesses and documents from his / her client in setting out the claims or defenses.

The happy answer is no, probably . . . . depending.

Depending on what?

II. The IBA Rules

The 1983 IBA Rules referred to by the Swiss arbitrator quoted above have evolved, as have so many other aspects of international arbitration. These "Rules" (which are, of course, non-binding), intended to set out "best practices" in the area, at first reflected a more civil law approach to arbitration, such that under the Rules no internal documents could be sought from the other side and only specifically identified documents could be requested.

The 1983 Rules were soon bypassed by practice and experience. They were *too* oriented to the civil law approach and too unsuited to the ever-growing complexity of the cases and issues being submitted into international arbitration. They were also not meeting the desires of the ever-growing number of U.S. and British counsel who were becoming involved in international commercial arbitration in ever-increasing numbers and whose experience with document production under their domestic court procedures was at polar opposites from that of their civil law brethren.

For example, long before 1999, in order to help convince an arbitral tribunal to order the production of certain categories of documents held by the other side, the author submitted to an arbitral tribunal as evidence of then-current arbitral practice a letter from a lawyer with wide experience in ICC arbitrations. The letter explained that it has been the experience of the letter-writer that most seasoned arbitrators, whether from civil or common law tradition, were willing to grant document production requests not only for specific and identified documents but also for reasonably specific *categories* of documents, provided that they were relevant. The letter went on to list the categories of documents which the arbitral tribunal, in two arbitrations in which the author of the letter was involved, had ordered produced. These categories included (i) all minutes of the Board of Directors of one party referring to the transaction in question; (ii) all internal memos (except privileged communications) dealing with a particular corporate decision; (iii) all correspondence with a specified third party; (iv) all reports of meetings on a specified subject; and (v) all complaints about a specific matter received from third parties.

The 1999 IBA Rules in Evidence in International Commercial Arbitration, which are the most recent to appear (although currently being revised), specifically allow for categories of documents to be requested as well as internal communications, and constitute a highly desirable, generally accurate codification of actual document production practice as it had evolved in international arbitration.

Article 3 of the IBA Rules requires that a Request to Produce contain:

(a) (i) a description of a requested document sufficient to identify it, or (ii) a description of sufficient detail (including subject matter) of a narrow and specific requested category of documents that are reasonably believed to exist;

(b) A description of how the documents requested are relevant and material to the outcome of the case; and

(c) A statement that the documents requested are not in the possession, custody or control of the Requesting Party, and of the reason why that Party assumes the documents requested to be in the possession, custody or control of the other Party.

If the requested party objects to the Request to Produce then it must make its objections known to the Arbitral Tribunal. The valid reasons for objecting to a request for production of documents are set out in Article 9.2 of the IBA Rules as follows:

(a) Lack of sufficient relevance or materiality;

(b) Legal impediment or privilege under the legal or ethical rules determined by the Arbitral Tribunal to be applicable;

(c) Unreasonable burden to produce the requested evidence;

(d) Loss or destruction of the document that has been reasonably shown to have occurred;

(e) Grounds of commercial or technical confidentiality that the Arbitral Tribunal determines to be compelling;

(f) Grounds of special political or institutional sensitivity (including evidence that has been classified as secret by a government or a public international institution) that the Arbitral Tribunal determines to be compelling; or

(g) Considerations of fairness or equality of the parties that the Arbitral Tribunal determines to be compelling.

III. Other Major Arbitral Rules

The major arbitral rules currently in force reflect the evolution seen in the IBA Rules:

- **Article 26(3) Stockholm Rules**: "At the request of a party, the Arbitral Tribunal may order a party to produce any documents or order evidence which may be relevant to the outcome of the case."
- **Article 20(5) ICC Rules**: "At any time during the proceedings, the Arbitral Tribunal may summon any party to provide additional evidence."
- **Article 24(3) Swiss Rules**: "At any time during the arbitral proceedings, the arbitral tribunal may require the parties to produce documents, exhibits or other evidence within such a period of time as the tribunal shall determine."
- **Article 24(3) UNCITRAL Rules**: This article contains the same wording as Article 24(3) of the Swiss Rules.
- **Article 22.1 LCIA Rules**: "Unless the parties at any time agree otherwise in writing, the Arbitral Tribunal shall have the power, on the application of any party or of its own motion, but in either case only after giving the parties a reasonable opportunity to state their views to order any party to produce to the Arbitral Tribunal, and to the other parties for inspection, and to supply copies of, any documents or classes of documents in their possession, custody of power which the Arbitral Tribunal determines to be relevant."

IV. The Practical Implications

So, all is well?

Not necessarily.

Notwithstanding that all the major arbitration rules give the arbitrators the *authority* to order documents to be produced, unless all the parties to the arbitration specifically agree on document production, the Tribunal is not obliged to accept that this be done—and one sometimes still runs up against the rare arbitrator of the old school.

Almost always, however, at least insofar as the author is aware, even where the parties do not agree, if one of the parties strongly insists on document production, the Terms of Reference or an early procedural order will provide that the IBA Rules shall be used as guidelines for document production.

So, all is well?

Not necessarily.

It does happen that, even when an arbitral tribunal orders document production, a party does not honor the order, either by producing few or even none of the required documents. Pursuant to the IBA Rules (Article 9(5)):

> If a Party fails without satisfactory explanation to make available any other relevant evidence, including testimony, sought by one Party to which the Party to whom the request was addressed has not objected in due time or fails to make available any evidence, including testimony, ordered by the Arbitral Tribunal to be produced, the Arbitral Tribunal may infer that such evidence would be adverse to the interests of that Party.

However, it would appear that too many arbitral tribunals do not use this provision in any meaningful way, so that a party may indeed be better off by flouting the document production order of the Tribunal than by obeying it.

In such circumstances, where the delinquent party is in a jurisdiction outside of the seat of the arbitration, what can be done to obtain the sought-after documents (or, for that matter, a witness that is not within the jurisdiction)?

In reality, not much. As pointed out elsewhere, the Hague Convention of 18 March 1970, on the Taking of Evidence Abroad in Civil or Commercial Matters, does not apply to arbitration proceedings.

While various jurisdictions do allow either a party or the arbitral tribunal or both to request the assistance of a national court to order the production of documents or to order witnesses to appear before the tribunal, these rules only apply to persons or evidence within the jurisdiction of the seat of arbitration.[2]

Does the absence of compulsory mechanisms for obtaining evidence from abroad in international commercial arbitration render international arbitration in Europe[3] gravely deficient as a dispute resolution mechanism?

I would say no.

From my own experience, in most cases where we have requested document production, the result has been the production of a smoking gun from the other side, as parties generally do not wish to be openly defiant of an arbitral tribunal by blatantly ignoring document production orders.

Where a party does so defy a tribunal's orders, the evident bad faith of that party is certainly taken into account by the tribunal, even if precise "adverse inferences" are not set down in the award.

Finally, there is some support for the view that a party's evasive and dilatory conduct regarding document production, in certain circumstances, can justify an arbitral tribunal awarding attorneys' fees against that party.[4]

In sum, evidence-gathering procedures in international arbitration are not those to be found in the U.S., England, or any of the other common law countries. There are grounds for saying that, as set out in the IBA Rules, they are indeed "best practice," but avoiding the trap of "the best being the enemy of the good."

Endnotes

1. M. Worth, *Ihr Zeuge Herr Rechtsanwalt ! Weshalb Civil-Law-Schiedsrichter Common-Law-Verfahrensrecht anwenden* in ShiedsVZ at 9 (2003).
2. *See, e.g.*, UNCITRAL Model Law Countries: Article 27 of the Model Law; Switzerland: Article 184(2) of the Swiss Private International Law Act 1987; England: Section 42 of the 1996 Act.
3. As for the United States, see 28 U.S.C. § 1782.
4. *InterChem Asia 2000 Pte Ltd v. Oceans Petrochemicals A.G.*, 373 F. Supp. 2d 340, 355 (S.D.N.Y. 2005).

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Practical Aspects of U.S.-Style Discovery Within Germany

By Denis Gebhardt

I. Introduction

The substantial differences between the rules of civil procedure in the USA and in Germany have been correctly referred to as a clash of legal cultures.[1] Such a clash would remain theoretical as long as there were no interrelation between judicial proceedings in the two jurisdictions. However, due to increasing globalization, the number of cross-border disputes is increasing steadily.

A result of internationality is often that, while a case is litigated in one jurisdiction (as the "forum state"), at least some of the evidence needed for the litigation in the forum state must be gathered in another jurisdiction. This is exactly the situation where judicial proceedings and their underlying rules in more than one jurisdiction become interrelated, because the court of the state where the evidence is located may be called upon to render legal support to the court in the forum state. Consequently, the clash of legal cultures creates a number of actual and serious legal issues.

The issues involved have been known for decades. Nevertheless, Germany has refused until today to enact statutory rules which would address the differences between the German and the U.S. systems. Instead, the competent German courts must decide in each case how they will structure evidentiary proceedings in support of U.S. legal proceedings. Since the range of available options is fairly wide, the German court could choose to apply German rules strictly. For proceedings before a court in the USA, however, such a result would be of limited use, if not completely useless, taking into account that, for example, the examination of a witness under German rules would not involve the preparation of a verbatim transcript, which would be necessary for the examination to be of evidentiary value in the USA.

In order to accommodate the particularities of the U.S. rules of civil procedure, German judges are sometimes inclined to incorporate elements of U.S.-style proceedings so that the result is at least usable in the proceedings on the other side of the Atlantic. However, the judge has full discretion as to whether he or she complies with the requests made by the parties and the U.S. court, and even if the German judge is willing to accommodate such requests, there are no statutory rules which would provide the parties with guidance. What makes the proceedings even more nontransparent for the parties is the fact that relevant decisions of German courts are hardly ever published and that the relevant proceedings are generally not open to the public. In fact, a certain gray area of law has developed and, without knowing the fundamental rules, the parties run the risk that even a request for legal support to be rendered by the German court will be inadmissible.

This article is intended to shed some light on this area -- which to U.S. parties and their counsel sometimes seems to be like a black box. Due to the lack of published precedents, the comments made below primarily reflect the experience of the author in the course of numerous pertinent proceedings.

In this context, the focus is on witness discovery. This is so because document discovery is excluded under the German rules of civil procedure, since Germany has objected to Article 23 of the Hague Convention on the Taking of Evidence Abroad in Civil or Commercial Matters of 18 March 1970 ("Hague Convention").[2] Thus, German courts will refuse to render legal support in the form of document discovery when so requested by a U.S. court. Consequently, there are no practical aspects of document discovery in Germany, since equivalent proceedings will not even be commenced.

II. Legal Framework

The course of the proceedings and the setting of applicable rules with regard to witness examinations are substantially driven by the willingness of the prospective witness(es) to appear voluntarily. If the witness cooperates, there is no need for any procedure to compel the witness to appear. The situation is, obviously, different when it is likely that the witness has no interest whatsoever in testifying or even has expressly stated that he will do everything to prevent the examination. It would not be worth the effort and cost of commencing proceedings in Germany if the applicable rules would not allow the witness to be compelled to testify.

A. Cooperative Witness

The willingness of a witness to testify voluntarily simplifies proceedings. However, in most cases German witnesses have a skeptical or even a hostile attitude when they learn that they are to become a witness in U.S. litigation. The reasons for this are manifold. Most of the time, witnesses are afraid of making themselves subject to civil claims or criminal charges. Moreover, they do not know what to expect or how the proceedings work. Hence, they are concerned about doing something wrong, and it is not uncommon for witnesses to bring their own counsel to the examination.

It is, thus, crucial to contact the prospective witness as early as possible and to explain what to expect. In this context, it is appropriate to offer to take the witness's schedule into account and the witness's preferences as to the location of the examination when preparing the deposition. This might increase the willingness of the witness to appear voluntarily.

However, the co-operation of a witness does not fully release the parties from observing the rules in Germany. One such rule is that a deposition, even though organized and conducted by the parties, is considered an official act of the U.S. court.[3] Thus, it is mandatory that the German authorities are informed about the details of the deposition. Subsequent to such information, the German authorities will send an information sheet out to the witness, setting out his rights and privileges. Only after such steps are completed may the deposition proceed. Furthermore, the deposition may only be conducted in the facilities of the U.S. embassy in Berlin, which will charge a fee consisting of at least a flat fee of US$ 475 for the scheduling / arranging, and an hourly fee of US$ 235 for the officer attending the deposition.[4]

The time and costs involved in connection with informing the German authorities and conducting the deposition at the U.S. embassy often motivate the parties to look for alternatives. One alternative that has proven to be helpful is to ask the witness to travel to London (against cost-reimbursement) and to take his deposition there, since the rules in the UK are more flexible and allow the parties to conduct depositions without being subject to the obligation to inform the local authorities.

To the extent that the witness is willing to be examined, many of the issues discussed in Part II.B below, including language, transcription of the proceedings, oath, and regulation of objections, can be regulated by mutual agreement.

B. Uncooperative Witness

1. Letter of Request under the Hague Convention

In cases where the witness must be compelled to testify, the parties must rely upon rules which provide for the summoning of the witness. A bilateral agreement between the USA and Germany which would contain such rules does not exist. However, the parties may revert to the Hague Convention, which provides in Article 10 that the requested court shall apply the appropriate measures of compulsion in the same instances, and to the same extent, as provided by its internal law for the execution of orders issued by the authorities of its own country or execution of requests made by parties in internal proceedings.[5]

The commencement of proceedings under the Hague Convention first requires the drafting of a letter of request to be filed by the U.S. court with the competent German court.[6] This exercise is not only a tightrope walk but can also lead to a number of falls off the high wire.

It is advisable that the letter of request already set out which elements of the U.S. proceedings are to be embedded in the German proceedings so that the German court is notified about the expectations of the parties and the U.S. court. However, the more requests incorporated in the letter of request, the higher the risk that the German court will refuse to honor the letter of request. Theoretically, the German court could dismiss the letter of request if it contains elements which are not part of the German system and, in fact, letters of request have been dismissed on this ground. Alternatively, the German court could revert to the U.S. court with a letter in which it explains that it is not inclined to follow some or all of the requests made. This way, the U.S. court can (in co-ordination with the parties) amend the letter of request and thus avoid its dismissal.

In any event, it is helpful, if not crucial, to contact the German judge prior to filing the letter of request. This way, the expectations and needs of the parties can be explained to the judge. In the event that the judge is not familiar with U.S.-style litigation, a pre-application discussion is also helpful to reduce potential skepticism. Thus, it is easy to determine what is the judge's position in regard to implementing the various elements of the requested U.S.-style proceedings in order to adapt the German proceedings to the U.S. proceedings, and the results can be implemented in the letter of request under the Hague Convention.

The letter of request for legal support under the Hague Convention is signed and forwarded by the U.S. court to the German court. Prior to this step, the parties negotiate the wording of the letter of request, which can be a time-consuming and tedious exercise. If there is a dispute about wording, the U.S. court makes the final determination.

Even though Article 3 of the Hague Convention expressly prescribes that the name and private address of the witness to be examined is to be specified in the letter of request, one often finds the wording that "a corporate representative" is supposed to testify. However, the German court does not investigate who this representative is to be or the location of his domicile and it will refrain from issuing a subpoena to obtain that information from the corporate witness before accepting the letter of request. Instead, the German court only sends out a subpoena to the witness if the name and private address of the representative is stated in the letter of request. In the event that such information is not contained in the letter of request under the Hague Convention, the German court may either point out this fact to the U.S. court to enable identification of the witness (if possible) or it may dismiss the letter of request.

Another pitfall is that the letter of request must contain a list of questions the witness is to be asked by the German judge. That is, it is not sufficient to give a general description of the topic on which the witness is to testify.[7] In the absence of such a list, the letter of request is considered inadmissible, since the German court simply cannot assess how to render the legal support requested.

2. Language

Pursuant to Section 184 of the German Judicature Act (*Gerichtsverfassungsgesetz*, or *GVG*), the mandatory language of the proceedings is German. This provision does, not however, exclude the assistance of interpreters during witness examination in Hague Convention proceedings. A request of this kind is not generally refused by the German courts.

In some cases, witnesses have complained that translation by an interpreter substantially extends the length of the examination and is an unreasonable burden on them. However, witnesses do not succeed in such complaint since the right of foreign counsel to understand what is being said in the course of the examination is recognized and makes the involvement of an interpreter inevitable. In this context, it should be added that witnesses also cannot apply for the inadmissibility of the letter of request by arguing that the taking of evidence is a mere fishing expedition or that it is not obvious that the responses to the questions are not relevant to the outcome of the case.[8] That is because the proceedings under the Hague Convention do not provide that the German court may review the merits of the case, so the German judge is not in a position to review whether the examination has the character of a fishing expedition. Rather, the German court must rely on the assumption that the U.S. court has dealt with this issue prior to forwarding the letter of request.

3. Transcript

The way in which witness testimony is transcribed under German rules is almost always a source of confusion for the U.S. parties and their counsel. This is because in German civil proceedings the statements made by the witness are summarized by the judge (who primarily carries out the questioning) and then recorded on tape. Thus there is no verbatim transcript. In general, the questions the witness is asked are not transcribed at all. Obviously, a protocol prepared on this basis would be of no use in the civil proceedings in the USA, even though, based on Federal Rule of Civil Procedure 28(b), it could be generally admissible.[9]

In the majority of cases, German courts permit a court reporter to be present and to prepare a U.S.-style verbatim transcript of the examination. The issue regularly discussed in this context is whether a German or an English verbatim transcript should be produced in the proceedings. Here, German judges are less flexible and regularly insist on a German verbatim transcript as the official version. As a result, the parties end up with substantial translation costs and the risk that the translation is not completely accurate. An alternative solution could be that the parties ask for an English transcript to be prepared simultaneously with the German transcript, and afterwards agree that the English version shall prevail (even though it is not the official version). This option is, of course, only available if relations between the parties are such that an agreement of this kind can be reached.

4. Oath

In domestic proceedings in the USA, the oath sworn by the witness and administered by the court reporter is simply a matter of course. However, in the context of Hague Convention proceedings, several legal and practical issues arise:

- Who administers the oath?
- When is the oath sworn: at the beginning or at the end of the testimony?
- To what does the oath refer exactly?

In Germany depositions taken prior to the oral hearing in court are unknown as a part of judicial proceedings. There are therefore no court reporters available who could administer the oath. The German rules of civil procedure, in contrast, provide for the oath to be administered by the judge who examines the witness, but only if one of the parties request that the witness swear the oath.

Basically, there are two ways of solving this issue in the context of Hague proceedings. In some cases, German judges have permitted the court reporter present to administer the oath in addition to the oath sworn pursuant to German law. A prerequisite is, of course, that the German court has first agreed that a court reporter authorized to administer the oath is present. However, experience shows that it is rather the exception that a court reporter is permitted by the German court to administer the oath. Instead, it can be observed that the parties and the U.S. court find an agreement pursuant to which the oath sworn before the German judge is valid and sufficient.

A rather minor issue is the question whether the oath should be sworn by the witness prior or subsequent to the testimony. Again, the U.S. and the German systems have different approaches. While the witness testifying in the United States must swear the oath at the beginning of the examination, according to the German system the witness takes the oath subsequent to the testimony and only if the oath is requested by at least one of the parties. In practice, there is no case reported in which the fact the witness could only swear the oath after closing his examination led to the inadmissibility of the testimony in the proceedings before the U.S. court.

In cases where a witness testifies in German and the German court has permitted a translation into English in connection with the transcription of the interpreted testimony, witnesses have expressed concern that they (i) cannot determine whether the interpretation was correct, so the oath must be limited to the German version of their testimony, and (ii) cannot assess whether their testimony has been properly transcribed, so that consequently the oath must also be qualified in this respect.

The latter concern does not arise in proceedings within the German court system, since the witness can listen to the tape of his testimony (made by the judge) prior to the swearing of the oath. However, in proceedings under the Hague Convention to support proceedings pending before a U.S. court, this approach often proves to be impractical and unacceptable for the witness. Even if the examination only lasts half a day (which is rather the exception) it would take the witness another half a day to listen to the tape. The pragmatic solution to this issue would be that, prior to swearing the oath, the witness expresses a reservation that the oath only relates to the German version of his testimony, which he has given orally.

Pursuant to Federal Rule of Civil Procedure 28(b) the testimony is in general still admissible even if the German court has not actually administered the oath of the witness.

5. Use of Documents

German rules allow the witness to be confronted with documents during examinations under the Hague Convention. Such documents do not have to be authenticated prior to the testimony. The only requirement is that the opponent and the judge must be provided with a copy of the relevant documents, with a certified translation affixed to it, if the language is not German.

Such an approach conflicts with the general rule in U.S. civil proceedings, pursuant to which a document has to be authenticated, and indeed parties have challenged such a rule by introducing documents which otherwise could not be authenticated pursuant to the U.S. rules by using them in the Hague Convention examination. It is not surprising that such a procedural maneuver is heavily contested by the opponent. However, the German judge, in applying the German rules of civil procedure, has no means to prevent it as long as the document has some relevance to the testimony. It is then for the opponent to revert to the U.S. court (subsequent to the closure of the Hague Convention proceedings) and to assert the inadmissibility of the relevant parts of the testimony.

6. Objections

Even in domestic civil proceedings the admissibility and effect of objections to certain testimony are frequently sources of serious disputes between the parties. In witness examinations under the Hague Convention this potential for disputes is enhanced, since there are a second set of possible grounds for objections. Such grounds may partly be similar to the objections available in the jurisdiction in which the case was filed, but other objections may be available.

The fundamental rule is that the German court will primarily take into account and determine objections based on grounds set forth in the German code of civil procedure. The competent German judge is not authorized, and in most cases lacks, the relevant legal education to determine whether an objection, made on grounds under only the U.S. rules, can be granted.

However, Article 11 of the Hague Convention provides that, in the implementation of a letter of request, the person concerned can refuse to give evidence if he has a privilege or duty to refuse to give evidence (i) under the law of the state of implementation; or (ii) if the privilege or duty has been specified in the letter of request, under the law of the state of the forum. Thus, if the relevant letter of request specifies certain privileges or duties of the witness under the U.S. rules of civil procedure, the German court may well be compelled to take such privileges or duties into account, which may substantially delay the examination proceedings.

In practice, this issue is solved by the parties entering into an agreement, according to which objections based on the applicable U.S. rules of civil procedure are only made to the U.S. court after the examination is completed. Alternatively, it could be agreed that, in the course of examination in Germany, counsel may express an objection, and the decision of whether it will be granted is deferred until a decision is made by the U.S. court.

7. Post-examination Period

The post-examination period is characterized by the parties battling before the U.S. court over the admissibility of all evidence taken in Germany in regard to the questions the witness was asked.

In this context, it is often argued by parties who have contested the Hague Convention proceedings from the outset that, given the substantial differences between proceedings in the USA and in Germany, the evidence is completely inadmissible. In particular, it is often argued that the parties did not have the opportunity for a U.S.-style cross-examination, since the German judge primarily asked the witness the questions, and the parties only had the opportunity to ask additional questions once the judge had completed the judge's examination.

Taking into account that the United States has ratified the Hague Convention, such arguments should have no merit. By becoming a party to the Hague Convention, a state is deemed to be aware, and accepts, that rules of civil procedure may vary from jurisdiction to jurisdiction. Consequently, such differences cannot serve as an argument against the admissibility of evidence taken under the Hague Convention.

III. Plan of Action

Taking into account the above discussion, the following plan of action is recommended:

Step 1: Identify the witness (including private address).

Step 2: Contact the witness and explain the procedure.

Step 3: Contact the competent German judge and discuss the details of the proceedings.

Step 4: Negotiate and draft the letter of request under the Hague Convention.

Step 5: Sign and forward the letter of request by the U.S. court to the German court.

Step 6: Fix a date for the examination by the German court.

Step 7: Make arrangements with interpreters and the court reporter (if permitted by the German court).

Step 8: Examine the witness in Germany.

Endnotes

1. Raeschke-Kessler, *Die Unparteilichkeit und Unabhängigkeit des Schiedsrichters—ein transnationales Rechtsproblem?*, 1 ASA Bull. at 3-4 (2008).
2. The Hague Convention has been in force in the USA since 7 October 1972 and in Germany since 26 June 1979. The Convention is accessible under http://travel.state.gov/law/info/judicial/judicial_689.html.
3. Shemanski, *Obtaining Evidence in the Federal Republic of Germany: The Impact of the Hague Evidence Convention on German-American Judicial Cooperation*, 17 Int'l Law. 465-487 (1983).
4. For more details, see http://travel.state.gov/law/info/judicial/judicial_648.html.
5. See in this context also Fed. R. Civ. P. 28 (b).
6. Moore's Federal Practice, Section 28.12[8] (3d ed.).
7. Hague Convention Art. 3.
8. Court of Appeals Duesseldorf (*Oberlandesgericht Duesseldorf*), I-3 VA 2/06, 3 VA 2/06, OLGR Duesseldorf, 393.
9. The same applies if the witness has not taken the oath, Fed. R. Civ. P. 28 (b).

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"Manifest Disregard of the Law" After *Hall Street*—From One Circuit Split to the Next

By Thomas N. Pieper

I. Introduction

In addition to the statutory bases listed in the New York Convention and the Federal Arbitration Act ("FAA") for vacating arbitral awards,[1] there exists a judicially created basis commonly known as "manifest disregard of the law" ("MDL"). This doctrine has its roots in *dictum* in the decision of the U.S. Supreme Court in *Wilko v. Swan*.[2] The standard for MDL is high; mere misapplication of the law by the arbitrator is not sufficient. The arbitrator must have been conscious of the law controlling the substantive issues before him or her and must have deliberately "disregarded" this law by applying a different legal rule instead.

In *Hall Street Associates LLC v. Mattel Inc.*,[3] the U.S. Supreme Court last year decided that parties to an arbitration agreement may not expand the grounds for judicial review of an arbitral award beyond those provided in the FAA. The Supreme Court relied, among other considerations, on its interpretation of the holding in *Wilko.* However, in *Hall Street,* the Supreme Court left open the issue whether the MDL doctrine remains as an independent basis for *vacatur* of arbitral awards.[4] Lower courts interpreting and applying *Hall Street* came to different conclusions. While some courts were hesitant to equate *Hall Street* with the "death knell" of MDL,[5] others, including the Southern District of New York, concluded that the era of MDL had come to an end. As to be expected, this eventually led to a new circuit split: While the Second, the Sixth, and the Ninth Circuits seem to accept MDL (albeit for different reasons), the Fifth Circuit rejects it.

II. Historical Background of the MDL Doctrine

Neither the New York Convention nor the FAA recognizes the misapplication of law by the arbitrator as a ground to set aside an award.[6] Nevertheless, U.S. courts have created MDL as an additional non-statutory ground that provides such a review mechanism, allowing a judge to vacate arbitral awards.

The MDL standard has its roots in *dictum* from the Supreme Court decision *Wilko v. Swan*. The issue in *Wilko* was whether a pre-existing agreement to arbitrate was valid in the context of the Federal Securities Act or if the agreement created an impermissible waiver of a federal forum. *Wilko* held that, even if litigants stipulated to arbitrate, this does not forfeit their rights to address a federal court. The Supreme Court expressed its fear that the New York Convention as it stands does not allow arbitral awards to be reviewed on the merits. This was taken by courts since then to imply that a court may vacate an arbitral award if the arbitrator manifestly disregarded the law.

There are two prongs to the MDL test. A party seeking to vacate an award must demonstrate that the arbitrator (i) was aware that a certain law controlled the substantive issues before him or her and (ii) consciously ignored this law and applied a different legal rule instead. The error must have been obvious and instantly perceived by the arbitrator.[7] This standard is difficult to meet, since the moving party must show more than that the arbitrator simply misunderstood or misapplied the law. An allegation of MDL leads to essentially a *de novo* review of a case's merits because in order to determine if an arbitrator knew the governing law and consciously ignored it, a court would have to review the underlying terms of a contract in dispute and how the arbitrator interpreted these terms.[8]

A classic example of how MDL is applied can be seen in *New York Telephone Co. v. Communications Workers of America Local 1100*.[9] In this case, the arbitrator was aware of the law and the legal rule, but thought it was "time for a new court decision."[10] The Second Circuit found that the arbitrator had acted in manifest disregard of the law and held that the arbitrator could not on his own reject controlling law.

III. The Supreme Court's Decision in *Hall Street*

In *Hall Street*, the Supreme Court addressed whether the parties to an arbitration agreement may expand the grounds for vacating an award beyond those set forth in Sections 10 and 11 of the FAA. Writing for the Court, Justice Souter held that the answer is no, at least as far as out-of-court agreements are concerned.[11]

A. Factual Background of *Hall Street*

This case began as a lease dispute between a landlord, Hall Street Associates, L.L.C. ("Hall Street"), and its tenant, Mattel, Inc. ("Mattel"), regarding who was responsible for clean-up costs resulting from environmental contamination. The lease agreement did not contain an arbitration clause, and the case had been pending for several years in state and later federal court. After attempts at mediation failed, the parties sought the District Court's permission to subject the dispute to arbitration. The District Court agreed and entered the arbitration agreement as an order. The agreement provided, in pertinent part:

> [T]he United States District Court for the District of Oregon may enter judgment upon any award, either by confirming the award or by vacating, modifying, or

> correcting the award. The Court shall vacate, modify, or correct any award: (i) where the arbitrator's findings of facts are not supported by substantial evidence, or (ii) where the arbitrator's conclusions of law are erroneous.

The arbitrator found for Mattel, and Hall Street then filed a motion with the District Court to vacate the award due to legal error. The District Court, reviewing the award under the expanded review clause, agreed, vacated the award, and remanded the case to the arbitrator. Specifically, the District Court found that the arbitrator had committed legal error by failing to apply properly the Oregon Drinking Water Quality Act to environmental contamination. On remand, the arbitrator followed the District Court's legal ruling and consequently found for Hall Street. Following the decision, both parties petitioned for review. The District Court, aside from correcting the arbitrator's interest calculation, upheld the award. Mattel appealed to the Court of Appeals for the Ninth Circuit.

On appeal, the Ninth Circuit reversed the District Court's order that had confirmed the arbitration award, and held that, because the FAA specifies that arbitration awards can be vacated only in limited cases such as fraud, corruption, partiality, or where the arbitrators exceed their powers, an award has to be upheld even though it contains errors of law. The Ninth Circuit also held "the terms of the arbitration agreement controlling the mode of judicial review are unenforceable and severable," and instructed the District Court on remand to confirm the original arbitration award, unless the award should be vacated on the grounds allowed under Section 10, or modified or corrected under the grounds allowable under Section 11 of the FAA. After the District Court again held for Hall Street on the ground that it rested on an implausible interpretation of the lease, the Ninth Circuit again reversed on the basis that implausibility is not a valid ground under the FAA. The Supreme Court then granted *certiorari* to decide whether the grounds for *vacatur* and modification provided by Sections 10 and 11 of the FAA are exclusive.

B. The Legal Holdings of *Hall Street*

The Supreme Court agreed with the Ninth Circuit that the grounds promulgated under Sections 10 and 11 of the FAA are exclusive, resolving a long-standing circuit court split.[12] The Supreme Court based its decision on two grounds.

First, the Court rejected Hall Street's argument that the Supreme Court's prior decision in *Wilko* established the rule that "expandable judicial review authority has been accepted as the law." The Court noted *Wilko*'s holding that "the interpretations of the law by arbitrators in contrast to manifest disregard [of the law] are not subject, in the federal courts, to judicial review for error in interpretation." The Court also noted that *Wilko*'s "manifest disregard" language may have referred to the Section 10 grounds collectively or the Section 10(a)(3) or 10(a)(4) grounds specifically, which authorize *vacatur* where arbitrators are guilty of "misconduct" or "exceeded their powers." The Court found, however, that the *Wilko* Court's "manifest disregard" phrasing was "vague" and refused to "accord it the significance that Hall Street urges," *i.e.*, that parties may provide additional grounds for federal judicial review beyond those promulgated under Sections 10 and 11 of the FAA.

Second, the Court rejected Hall Street's additional argument that an expansion of Sections 10 and 11 of the FAA to include review for legal error should prevail because "arbitration is a creature of contract, and the FAA is motivated, first and foremost, by a congressional desire to enforce agreements into which parties have entered." Again, the Court noted that the FAA allows parties to tailor many features of arbitration by contract, including, *inter alia*, the manner in which arbitrators are chosen, procedural rules, and substantive law. But the Court noted that this argument misses the point. The issue is not whether private parties may draft and later modify arbitration agreements, but whether statutory grounds for prompt *vacatur* and modification provided by the FAA preclude private parties from drafting and later modifying arbitration agreements to provide grounds for judicial review beyond those promulgated under Sections 10 and 11 of the FAA. The Court relied upon a strict construction of the text of the FAA, holding "that the text compels a reading of the §§ 10 and 11 categories as exclusive." Coupled with the Section 9 language that district courts must grant an order confirming an arbitration award "unless the award is vacated, modified, or corrected as prescribed in sections 10 and 11 of this title," this language "unequivocally tells courts to grant confirmation in all cases," except when the specific grounds of Sections 10 and 11 apply.[13]

IV. *Hall Street*'s Implications for MDL

Prior to *Hall Street*, all the federal courts of appeal recognized and applied MDL, as did many state courts. But since *Hall Street* leaves room for interpretation as to whether MDL remains a proper basis to overturn an arbitration award despite that it is not one of the enumerated grounds of the FAA, things have changed. Different courts have come up with different views, even resulting in a new circuit split. The current legal landscape reflects the existing confusion over what *Hall Street* actually meant.

Some courts seem to think that *Hall Street* has no impact on MDL. Without even mentioning *Hall Street*, the First Circuit stated that courts retain "inherent powers outside" the FAA to vacate arbitral awards, including where the arbitrator acts in disregard of law.[14] The First Circuit also—again without any discussion of *Hall Street*—reversed the confirmation of an arbitration award (rendered pursuant to the rules of the NASD) on the basis that the award was in manifest disregard of the law.[15]

Various district courts throughout the country have confirmed arbitration awards, in part rejecting MDL challenges, without any discussion of *Hall Street*.[16] A New Jersey appellate court, while holding that *vacatur* of an award based on MDL may not be sought under the New Jersey Arbitration Act, noted that an MDL challenge is available under the FAA (without mentioning *Hall Street*).[17]

Some courts are cautious not to draw far-reaching conclusions from *Hall Street*. According to the first reported case in New York after *Hall Street*, the New York Supreme Court found the MDL doctrine to be "ambiguous," but concluded that it did nothing to "jettison the 'manifest disregard' standard of Wilko."[18] On the same day, a federal district court in Texas used the same approach, holding that *Hall Street* did not expressly decide whether MDL is a ground for vacatur separate from the statutory grounds under the FAA or a way of summarizing multiple statutory grounds. Consequently, the court analyzed the award both ways, and upheld it.[19]

Other courts are willing to go a step further. A federal district court in Minnesota found that MDL is no longer a viable basis for vacating an arbitration award under the FAA and as such did not even entertain an MDL challenge to an arbitration award. In *Prime Therapeutics LLC v. Omnicare Inc.*,[20] the court held that *Hall Street* ended MDL review: "It would be somewhat inconsistent to say that the parties cannot contractually alter the act's exclusive grounds for vacating or modifying an arbitration award but then to allow the courts to alter the exclusive grounds by creating extra-statutory bases for vacating or modifying an award." The Alabama Supreme Court in *Sherry Hereford v. D.R. Horton*[21] also found that MDL is dead. District Judge Richard J. Holwell of the Southern District of New York, in *Robert Lewis Rosen Associates Ltd v. Webb*,[22] came to the same conclusion. Because "the Second Circuit's traditional understanding of *Wilko* and § 10—that *Wilko* endorsed manifest disregard and that § 10's grounds are not exclusive—is inconsistent with the basis for the holding in *Hall Street*," he found that "manifest disregard of the law standard is no longer good law."[23] District Judge Crotty, also of the Southern District of New York, agreed: "'Manifest disregard', therefore, is no longer an independent basis on which to upset an arbitration award."[24]

The federal district court for the Northern District of New York, however, respectfully disagreed[25] and was backed by the Second Circuit.[26] In *Stolt-Nielsen*,[27] the U.S. Court of Appeals for the Second Circuit relied on one of the interpretations the Supreme Court had offered in *Hall Street*, namely that MDL "may have been shorthand for § 10(a)(3) or § 10(a)(4)" of the FAA, and accepted MDL as the equivalent of a review for "arbitrators [who] have thereby 'exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made.'"[28] The Ninth Circuit followed suit, holding that "the manifest disregard ground for *vacatur* is shorthand for a statutory ground under the FAA, specifically 9 U.S.C. § 10(a)(4), which states that the court may vacate where the arbitrators exceeded their powers."[29] The Sixth Circuit also narrowly construed *Hall Street*, restricting it to apply only to contractual expansions of judicial review.[30]

The latest development is the Fifth Circuit's decision in *CitiGroup Global Markets*.[31] While the court in *Rogers v. KBR Tech Servs*.[32] had recognized that *Hall Street* may have called into doubt the non-statutory grounds for vacating an arbitration award under Fifth Circuit precedent, it declined to reach the question there because the award would be confirmed in any case. In *CitiGroup Global Markets*, the court has now decidedly rejected any notion of non-statutory grounds for *vacatur* or modification of an arbitral award under the FAA after *Hall Street*. In *CitiGroup*, Bacon had commenced arbitration of a dispute regarding withdrawals from her investment account with Citigroup and the arbitrator eventually issued an award in her favor. Citigroup successfully moved the district court to vacate the award based on MDL. On appeal, the Fifth Circuit held that, after *Hall Street*, MDL was no longer an independent, extra-statutory ground for *vacatur*. The court specifically rejected Citigroup's claim that MDL survived *Hall Street* by noting that the language supporting Citigroup's position in *Wilko* was, at best, "vague," and *Hall Street* instead "clearly and repeatedly" held that Section 10 of the FAA provides the exclusive grounds for *vacatur* under the FAA.

V. Conclusion

Following the U.S. Supreme Court's decision in *Wilko*, courts developed MDL as an unwritten ground to set aside arbitral awards. In *Hall Street*, the U.S. Supreme Court decided that parties may not expand the scope of judicial review of arbitral awards but left open the issue whether the MDL doctrine remains as an independent basis for *vacatur* of arbitral awards. As post-*Hall Street* decisions show, there is continuing uncertainty in that regard. The Supreme Court has resolved one circuit split but effectively replaced it with another one. The highest Court will thus have to speak again on this issue, having missed its opportunity to do so in *Comedy Club*.

In the interim, attorneys should make their clients aware of the circuit split and explain the practical consequences. The seat of the arbitration is highly relevant in that context. An arbitral award made in New York may currently be challenged based on MDL, while an award issued in Houston may not. Users of arbitral clauses should also know that, while *Hall Street* may restrict the *judicial* review of arbitration awards, it certainly does not restrict the parties from contracting for expanded *arbitral* review of awards.[33] Some arbitral institutions specifically offer appellate procedures.[34]

Endnotes

1. The United States is a party to the 1958 United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards, the so-called New York Convention. 21 U.S.T. 2517, 330 U.N.T.S. 38. The New York Convention has been codified into U.S. law through the Federal Arbitration Act, 9 U.S.C. § 201.
2. 346 U.S. 427 (1953).
3. 522 U.S. __, 128 S. Ct. 1396 (2008).
4. The Supreme Court had previously declined to address whether MDL falls under Sections 9 and 10 of the FAA. *See, e.g., Bernhardt v. Polygraphic Co of America,* 350 U.S. 198, 203 n. 4 (1956).
5. *See* the commentary by Reed and Riblett, Hall Street: *The Death Knell Of Manifest Disregard Of The Law*, 23 Mealey's Intl Arb. Rep., #5 at 29-31 (May 2008).
6. Under the New York Convention there are limited grounds for non-enforcement of arbitral awards, which are procedural in nature and not intended to undermine the merits of an arbitrator's decision: (i) The agreement was invalid under the laws of the country where the award was made or the applicable law rendered the parties incapable of forming their agreement (Article V(1)(a)); (ii) the party against whom the award was invoked never received proper notice of the arbitrator's appointment or of the arbitration proceeding or was otherwise not able to present its case (Article V(1)(b)); (iii) the award deals with a dispute that does not fall within the arbitration clause or is beyond the scope of the clause (Article V(1)(c)); (iv) the arbitral panel's composition or procedure was not in accordance with the agreement of the parties or the law of the country where the arbitration occurred (Article V(1)(d)); (v) the award has not become binding on the parties, or was set aside or suspended by a competent authority of the country in which, or under the law of which, that award was made (Article V(1)(e)); (vi) the subject matter of the dispute is not subject to arbitration under the law of the country where enforcement is sought (Article V(2)(a)); or (vii) the recognition or enforcement of the award would be contrary to the public policy of the country where enforcement is sought (Article V(2)(b)).

   Section 10(a) of the FAA provides somewhat similar grounds for *vacatur* of arbitral awards (none of which deal with the merits or application of the law by the arbitrator either): (i) If the award was procured by corruption, fraud or undue means; (ii) if the arbitrator was partial or corrupt; (iii) if the arbitrator was guilty of misconduct which in turn prejudiced the rights of any party; or (iv) if the arbitrator exceeded his or her power.
7. *See Yusuf Ahmed Alghanim & Sons v. Toys "R" Us, Inc.,* 126 F.3d 15, 24 (2d Cir. 1997) ("disregard" implies that the arbitrator knew the law, but decided to ignore it).
8. Many losing parties to an arbitration have misused MDL to contrive an otherwise not available appeal, prompting some courts to impose sanctions. *See Vento v. Quick & Reilly, Inc.* 128 Fed. Appx. 719 (10th Cir. 2005) (finding MDL claims to be frivolous and fining plaintiff for attorney's and court fees). *But see W.K. Webster & Co. v. American President Lines, Ltd,* 32 F.3d 665, 670 (2d Cir. 1994) (finding that, although contention of MDL being devoid of any legal or factual basis, sanctions were still not required).
9. 256 F.3d 89, 91 (2d Cir. 2001).
10. *Id.* at 91.
11. Justices Roberts, Thomas, Ginsburg, and Alito joined; Justice Scalia joined as to all but one footnote. Justice Stevens filed a dissenting opinion, in which Justice Kennedy joined; Justice Breyer filed a separate dissenting opinion.
12. The Ninth and Tenth Circuits had found that parties may not contract for expanded judicial review (the Eighth Circuit, in *dictum*, appeared to agree), while the First, Third, Fourth, Fifth, and Sixth Circuits had held that parties may do so.
13. Although the Court agreed with the Ninth Circuit that the FAA "confines its expedited judicial review to the grounds listed in 9 U.S.C. §§ 10 and 11," the Court vacated the judgment and remanded the case. The Court posed the question whether the District Court's authority to manage its cases under Rule 16 of the Federal Rules of Civil Procedure "independently warranted that court's order on the mode of resolving the indemnification issues remaining in this case." The Court also noted that, although Sections 10 and 11 provide exclusive regimes for review under the FAA, "we do not purport to say that [Sections 10 and 11] exclude more searching review based on authority outside the statute as well."
14. *UMass Memorial Medical Center, Inc. v. United Food and Commercial Worker's Union. No. 07-2527* (1st Cir. 15 May 2008).
15. *Kashner Davidson Securities Corp. v. Mscisz,* No. 07-1231 (1st Cir. 27 June 2008).
16. *See, e.g., Grigsby & Associates, Inc. v. M Securities Investment, Inc.*, Case No. 06-23-35 (S.D. Fla. 30 July 2008); *Hicks v. The Cadle Co.*, Case No. 04-2616 (D. Col. 23 July 2008); *Remote Solution Co. v. FGH Liquidating Corp.*, Case No. 06-4 (D. Del. 31 July 2008).
17. *Maguire v. Freehold Subaru, L.L.C.,* No. A 1258-07T2, 2008 WL 2796393 (N.J. Super. Ct. App. Div. 22 July 2008), which is in contrast to the position taken by a previous panel of the First Circuit, which stated in *dictum* that "manifest disregard of the law is not a valid ground for vacating or modifying an arbitral award in cases brought under the [FAA]." *Ramos-Santiago v. UPS,* No. 07-1024, n. 3 (1st Cir. 24 Apr. 2008). (Since the case was governed by Puerto Rico state law, the court ultimately declined to "reach the question of whether Hall Street precludes a manifest disregard inquiry in this setting. Whether or not Hall Street applies, Ramos's claim fails." *See id.*) Faced with the apparent contradiction between *Ramos-Santiago* and *UMass Memorial Medical Center*, one district court in the First Circuit chose to do the analysis under both. *ALS & Associates, Inc. v. AGM Marine Constructors, Inc*., Case No. 06-10088 (D. Mass. 2 June 2008) ("Even if manifest disregard remained a valid basis for *vacatur*, however, Southeast has failed to show that the arbitrator manifestly disregarded the applicable law.").
18. *Chase Bank USA, N.A. v. Hale,* 2008 WL 1746984, *4-5 (Sup. Ct. N.Y. Co. 31 Mar. 2008).
19. *Halliburton Energy Services, Inc. v. NL Industries,* Nos. H-05-4160 & H-06-3504, 2008 WL 906037 (S.D. Tex. 31 Mar. 2008).
20. 2008 US Dist LEXIS 41306 at *15 (D. Minn. 21 May 2008).
21. No. 1070396, 2008 WL 4097594 (5 Sept. 2008).
22. Case No. 07 Civ. 11403, 2008 WL 2662015 (S.D.N.Y. 7 July 2008).
23. In *Supreme Oil Co. v. Abondolo,* Case No. 07-6479 (S.D.N.Y. 31 July 2008), an arbitration relating to claims under the Labor-Management Relations Act, 29 U.S.C. § 185(a) ("LMRA"), Judge Holwell confirmed his decision that MDL was no longer a basis to vacate an award, but at the same time noted that "*Hall Street's* effect (if any) on review of arbitration awards under the LMRA is unclear." He ultimately declined to reach that question, since he did not find any manifest disregard of the law.
24. *T. Co Metals LLC v. Dempsey Pipe & Supply Inc.,* Court Order, 07 Civ 7747 (PAC) (S.D.N.Y. 8 July 2007).
25. *Mastic N. America, Inc. v. MSE Power System, Inc.* (No. 1:08-cv-168, N.D.N.Y., 8 July 2008).

26. In a summary order dated 17 Sept. 2008, the Second Circuit had declined to express an opinion as to the continued availability of the MDL doctrine because it found that in that case the standard had "clearly been satisfied" and confirmation of the award was "plainly warranted." *ESSO Exploration & Production Chad v. Taylors International Services* (No. 06-5673-cv, 2008 U.S. App. LEXIS 20042).

27. *Stolt-Nielsen SA v. AnimalFeeds Int'l Corp*, 548 F.3d 85 (2d Cir. 4 Nov. 2008).

28. *Id.* at 95, quoting 9 U.S.C. § 10(a)(4)). The Second Circuit basically adopted the reasoning of the Seventh Circuit in *Wise v. Wachovia*, 450 F.3d 265, 269 (7th Cir.), *cert. denied*, 549 U.S. 1047 (2006), where the Seventh Circuit reconciled the MDL standard with the statutory bases for *vacatur*. While the court found that the lower court had not erred in entertaining a motion to vacate an arbitration award based on MDL, it did not find that the arbitrator actually had manifestly disregarded the law, and thus it vacated the district court's ruling.

29. *Comedy Club, Inc. v. Improv W. Assocs.*, Nos. 05-55739, 05-56100 (9th Cir. 29 Jan. 2009). Remarkably, the Supreme Court granted *certiorari* in *Comedy Club*, but, instead of reviewing the case, it remanded the case to the Ninth Circuit for reconsideration in light of its *Hall Street* ruling.

30. *Coffee Beanery v. WW LLC* (300 Fed. Appx. 415, 2008).

31. *Citigroup Global Markets, Inc. v. Bacon*, No. 07-20670, 2009 WL 542780 (5th Cir. 5 Mar. 2009).

32. 2008 U.S. App LEXIS 12320 at *5-6 (5th Cir. 9 June 2008).

33. *See Redish v. Yellow Transp., Inc.*, No. 3-07-CV-1065-0, 2008 WL 2572658 (N.D. Tex. 24 June 2008).

34. *See, e.g.*, the CPR's Arbitration Appeal Procedure, accessible at http://cpradr.org/ClausesRules/ArbitrationAppeal Procedure/tabid/79/Default.aspx (last visited on 16 Apr. 2009).

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Stately Defenses in U.S. Antitrust Litigation Involving Foreign Defendants: Foreign Sovereign Immunity, Foreign Sovereign Compulsion, Act of State, and *Noerr* Immunity

By Dustin B. Kenall

I. Introduction

Bringing claims against foreign entities for violations of U.S. antitrust laws poses unique up-front challenges. In addition to information asymmetries[1] that can complicate such normally simple tasks as determining a defendant's proper name and address, there are a number of immunity defenses that may apply. This article discusses four potent, interrelated defenses that a foreign defendant may raise to bar prosecution of a civil antitrust[2] suit filed in a U.S. court: foreign sovereign immunity, foreign sovereign compulsion, act of state, and *Noerr* immunity.[3]

Although courts typically require the development of a full factual record before resolving a dispositive motion based on these defenses, the defenses can play an important early role in shaping discovery and settlement considerations. Counsel on either side of the case should be aware of these defenses and the threshold issues they present when investigating and drafting, or responding to, a complaint against a foreign entity alleging violation of U.S. antitrust laws. For plaintiffs, such vigilance may help to avoid wasting resources on futile claims; and for defendants, the burden of responding to pre-trial discovery may be mitigated by advocating phased, limited discovery on these dispositive defenses.

II. Description of the Four Defenses to Consider in Antitrust Suits Against Non-U.S. Defendants

A. Foreign Sovereign Immunity

The first and most well-known immunity, which is conferred by the Foreign Sovereign Immunities Act (FSIA),[4] provides personal and subject-matter-jurisdiction immunity to a foreign state for its sovereign acts. It does not, however, apply to commercial or private acts. The term "foreign state" encompasses: (a) a foreign state proper; (b) its political subdivisions; and (c) its agencies and instrumentalities.[5] Most litigation related to whether the defense of sovereign immunity applies is litigated on whether a defendant is an "agency or instrumentality" of a foreign state.

An "agency or instrumentality" is defined in the FSIA as an entity "(1) which is a separate legal person, corporate or otherwise, and (2) which is an organ of a foreign state or political subdivision thereof, or a majority of whose shares or other ownership interest is owned by a foreign state or political subdivision thereof, and (3) which is neither a citizen of a State of the United States . . . nor created under the laws of any third country."[6] Accordingly, a corporation incorporated and doing business within a foreign country that is more than fifty percent owned by the state is regarded as a foreign state "agency or instrumentality."[7]

Even if a defendant fits this definition of a "foreign state," several exceptions to immunity exist, including waiver; taking of property located in the U.S.; rights to property in the U.S. acquired by gift; noncommercial torts committed in the U.S.; arbitration; admiralty; certain counterclaims; and commercial activity with a U.S. nexus.[8]

The most commonly asserted exception is "commercial activity."[9] The FSIA defines "commercial activity" as "either a regular course of commercial conduct or a particular commercial transaction or act."[10] The Act further explains that "[t]he commercial character of an activity shall be determined by reference to the nature of the course of conduct or particular transaction or act, rather than by reference to its purpose."[11] The U.S. Supreme Court has interpreted this provision to mean that "when a foreign government acts, not as a regulator of a market, but in the manner of a private player within it, the foreign sovereign's actions are 'commercial.'"[12] In this regard, the Court noted the following:

> [A] foreign government's issuance of regulations limiting foreign currency exchange is a sovereign activity, because such authoritative control of commerce cannot be exercised by a private party; whereas, a contract to buy army boots or even bullets is a "commercial activity," because private parties can similarly use sales contracts to acquire goods.[13]

Acts that have been labeled as peculiarly sovereign rather than commercial in nature include the exercise of the police power[14] and establishing the terms and conditions for removal of national resources via boycotts and price-fixing cartels.[15] Acts that have been labeled commercial, even though they are intended to have governmental effects, include the issuance of and refusal to repay government bonds in order to stabilize currency,[16] the purchase by a government of cement on the open market,[17] and patent acquisition and licensing by a national science agency.[18]

Distinguishing between commercial and regulatory activity is clearly a fact-intensive exercise; there are no bright-line rules for guidance. But there are two initial considerations to weigh. First, is the act being complained of something a private individual or entity could lawfully do? If the answer is yes, there is a chance that sovereign immunity may fail under the commercial activity exception. And if the answer is no, then sovereign immunity stands a better chance of succeeding. Second, remember that the purpose or effect of an act is not dispositive. Nearly any act could be plausibly argued as having some type of governmental effect or purpose, but such a broad interpretation of the exception would be unadministrable and would swallow up the general rule.

B. "Act of State" Doctrine

The "act of state" doctrine recalls the instinctive, childhood response to any allegation of wrongdoing: "it wasn't me." Legally phrased, the doctrine requires a litigant to establish that the allegedly unlawful conduct of which it is accused was in fact a public act committed by a recognized foreign power exclusively within the latter's own territory.[19] In effect, the foreign power must have proximately caused the alleged violation; it must, in some meaningful way, be responsible. Many of the early cases exemplifying the rule involve an agent of a foreign government expropriating a plaintiff's property. For example, in *American Banana Co. v. United Fruit Co.*,[20] the U.S. Supreme Court considered the expropriation of the plaintiff's fruit plantation by Costa Rican agents, supposedly at a competitor's request. The Court imputed the acts to the Costa Rican government, however, because, although the competitor had exhorted the government to seize his competitor's plantation, the government had "declare[d] by its conduct [the expropriation] to be desirable and proper"; therefore, "[t]he injuries to the plantation and supplies seem to have been the direct effect of the acts of the Costa Rican government, which is holding them under an adverse claim of right."[21]

The burden of proof lies on the defendant, who at a minimum must "offer some evidence that the government acted in its sovereign capacity and some indication of the depth and nature of the government's interest."[22] Indeed, the doctrine will not apply unless the conduct is "a result of a considered policy determination by a government to give effect to its political and public interests."[23] Thus, when the state acts in a ministerial capacity (e.g., granting a license or a patent), the concerns underlying the act-of-state doctrine are unlikely to be implicated because the government is merely performing a routine, nondiscretionary function.[24]

Even if the government's discretionary act is sufficiently related to the challenged conduct, it must also be authoritative. The doctrine protects only the "public act of those with authority to exercise sovereign powers."[25] "[T]here is no act of state where *both* of two conditions are met: (1) the conduct violated the fundamental laws of the foreign sovereign, and (2) the conduct was 'wholly unratified' by the nation's government."[26] Thus, the defense does not protect private actors, unauthorized acts, or anticompetitive conduct directed at a foreign government's regulatory process.[27]

In *Alfred Dunhill of London, Inc. v. Republic of Cuba*,[28] for example, the U.S. Supreme Court considered whether the doctrine barred suit by importers seeking to recover funds mistakenly sent to Cuban cigar manufacturers after their nationalization by the Cuban government. The plurality found that the conduct at issue ("the repudiation of a purely commercial obligation owed by a foreign sovereign or by one of its commercial instrumentalities") involved a commercial, rather than a governmental, function and held that, in such a case, the doctrine is inapplicable.[29] Because the decision did not command a majority of the Court, however, its precedential value was questionable and was subsequently rejected in a decision by the U.S. Court of Appeals for the Ninth Circuit. In *International Ass'n of Machinists & Aerospace Workers v. OPEC*, the Ninth Circuit stated that while "purely commercial activity" may not trigger the act-of-state doctrine, "when the state *qua* state acts in the public interest, its sovereignty is asserted."[30] In effect, the Ninth Circuit was stating that, in contrast to the "commercial activity" exception in the FSIA, the "purpose" of the act is important when considering the application of the act-of-state defense. While the U.S. Supreme Court has not since then issued an opinion with a majority forthrightly reaffirming the commercial exception articulated in *Dunhill*, it has warned that the act-of-state doctrine is to be narrowly construed, and should be applied only when a case directly presents the issue of the validity of an act of a foreign sovereign.[31]

More in line with the tenor of the Supreme Court's restrictive rulings than the Ninth Circuit's liberal interpretations, the Antitrust Division of the U.S. Department of Justice and the Federal Trade Commission, in their jointly issued "International Antitrust Guidelines for International Operations,"[32] also take a narrow view of the doctrine. For the act-of-state defense to apply, they require the challenged conduct to be (1) a public act of the sovereign; (2) within its territorial jurisdiction; and (3) governmental rather than commercial.[33] Whether an act is done within a sovereign's territory depends on (i) whether a foreign state has reasonable "expectations of dominion" over the intangible property in dispute based on the contacts between the parties, the intangible property and the foreign state, and (ii) whether the foreign government has such a significant interest in dominion over the intangible property that determination of the invalidity of the act of the foreign government by a United States court would be "likely to give offense" to that government.[34]

Apart from addressing obvious concerns of fairness, the act-of-state doctrine is intended to preclude U.S. courts "from inquiring into the validity of the public acts a recognized foreign sovereign power committed within its own territory."[35] The doctrine is, thus, viewed as an aspect of separation of powers because a judicial determination that an act of a foreign state is invalid may adversely affect the conduct of foreign relations by the Executive Branch.[36] The U.S. Supreme Court has observed that "some aspects of international law touch much more sharply on national nerves than do others; the less important the implications of an issue are for our foreign relations, the weaker the justification for exclusivity in the political branches.[37] In regard to these sensitive areas, the Court has also observed the following:

> [T]he greater the degree of codification or consensus concerning a particular area of international law, the more appropriate it is for the judiciary to render decisions regarding it, since the courts can then focus on the application of an agreed principle to circumstances of fact rather than on the sensitive task of establishing a principle not inconsistent with the national interest or with international justice."[38]

The analysis should always be "focused on the effect or lack of effect upon American foreign relations."[39]

Unlike the sovereign immunity defense, which can be waived, the act-of-state doctrine can be raised either by a defendant or by the court itself.[40] Because the defense is a judge-made doctrine of abstention that potentially is in conflict with a court's duty to exercise jurisdiction over certain disputes, however, the doctrine should be narrowly applied.[41]

C. Foreign Sovereign Compulsion

If the act-of-state doctrine is the equivalent of the "wasn't me" defense, the defense of foreign sovereign compulsion is the equivalent of: "he made me do it." It concerns not the validity or legality of a foreign government's conduct but rather whether a foreign government compelled the conduct itself.[42] In such a case, the act of the private party "become[s] effectively acts of the sovereign," so courts will not impose antitrust liability.[43] "When a nation compels a trade practice, firms there have no choice but to obey. Acts of business effectively become acts of the sovereign."[44] Because the defense derives in part from international comity considerations, the compulsion must usually take place within the foreign sovereign's own jurisdiction or territory.[45]

The compulsion defense does not extend to conduct that was merely sanctioned or assisted by a foreign government but not compelled. One asserting the defense must establish that the decree of a foreign sovereign was basic and fundamental to the alleged antitrust behavior and more than merely peripheral to the overall illegal course of conduct.[46] Thus, ministerial acts performed by a foreign government will usually, as in an act-of-state defense, fall short of establishing compulsion.[47] Additionally, separate activities unrelated to the acts of the foreign government "would clearly be unprotected even if procurement of a[n] [] act of state were one part of defendants' overall scheme."[48] In this vein, the law has refused to recognize a compulsion defense where "it cannot be said with any degree of certainty that the minimum prices . . . were in fact determined by the [foreign] Government," and "[i]t is possible to conclude that the [foreign] government merely provided an umbrella under which the defendants gained an exemption from [the foreign state's] antitrust law, and fixed their own export prices."[49] In this respect, the doctrinal limits to the compulsion defense resemble those of the act-of-state doctrine's requirement that the alleged conduct be a public act.

Attuned to this understanding, the International Antitrust Guidelines for International Operations recognize the doctrine only where there is actual compulsion of an anticompetitive act by a foreign sovereign, and the refusal to comply would result in "penal" or other "severe sanctions."[50] The requirement of penal or other severe sanctions is consistent with the focus on the defendant's actual conduct and the government's actual policy.[51] The Agencies will accept as sufficient a "foreign government's formal representation that refusal to comply with its command would have such a result . . . as long as that representation contains sufficient detail to enable the Agencies to see precisely how the compulsion would be accomplished under local law."[52] As in the act-of-state context, the U.S. government will apply the compulsion doctrine only where the activity takes place entirely within the sovereign's territory.[53] And, as in the FSIA context, the doctrine will apply only where the government is acting in its governmental, not commercial, capacity in ordering the conduct.[54]

In mixed cases where a defendant takes action above and beyond that compelled by its foreign government, the defense should fail because there is no clear conflict with U.S. law and the defendants were not formally compelled.[55] In the absence of a clearly articulated state policy upon which to direct its conduct, a defendant is essentially controlling its own activities, in which case, the interests of international comity and fairness are less salient.[56] Additionally, if a foreign government orders anticompetitive behavior before the defendant achieves market power, then there may be a break in the chain of causation sufficient to conclude that the government order was merely "one part of defendants' overall scheme" and too attenuated to serve as a predicate for immunity.[57] Ultimately, the elements of foreign sovereign compulsion may overlap in part with those for the defense of act of state and (as discussed below) *Noerr* immunity. Keeping them analytically distinct while presenting them holistically before the court requires careful attention.

D. *Noerr* Immunity

The inverse of foreign sovereign compulsion, *Noerr* immunity applies when a defendant petitions the government to take anticompetitive action. Under *Noerr*, a defendant is immune from liability for non-sham litigation, lobbying, and other types of petitioning of U.S. federal and state governments that it conducts.[58] Authorities are conflicted as to whether the law should recognize *Noerr* immunity for the petitioning of foreign governments.[59] Courts have been reluctant to apply the doctrine when (i) the posture of the litigation would render a decision premature;[60] (ii) the party raising the defense is (iii) foreign or (iv) owned by a foreign government;[61] (v) the foreign-government petitioning involved private acts occurring in the United States;[62] or (vi) international comity considerations weigh against examining the petitioning of a foreign government.[63] *Noerr* applies to a narrower class of behavior than the act of state or foreign-sovereign compulsion defenses—shielding any type of defendant but only for a specific type of conduct.

III. Conclusion

Plaintiffs bringing civil antitrust claims against foreign defendants face a number of hurdles. Not only must they demonstrate that the named defendant is guilty of anticompetitive conduct that caused injury, but, where one of the four defenses discussed above is asserted, they must also defeat the assertion that (in effect) a foreign state is not to blame. Defendants must remain alert, too, however. A victory on one or more of the defenses discussed above may shield them from liability, but it could also be the cure that is worse than the disease. If the defense fails, the defendants may potentially have created a record of incriminating evidence and party admissions that will aid the plaintiff's case.

Endnotes

1. *See, e.g.*, Jeffrey Gold, *Chinese Companies Nearly Immune to U.S. Lawsuits, Despite Trade Pressure*, Associated Press (Feb. 6, 2008) (reporting grasping in the dark by plaintiffs' attorneys seeking to apprehend fly-by-night Chinese manufacturers), http://www.signonsandiego.com/news/business/20080206-1205-suingchinainc..html (last visited on 1 April 2009).
2. These immunities are prominent in international antitrust litigation but by no means exclusive to it. Thus, any attorney contemplating a plaintiff's action against a foreign defendant should hearken to them.
3. International comity is another defense traditionally raised in international antitrust litigation. The defense requires a threshold finding of a "true" conflict between U.S. and foreign law before proceeding to balance the respective interests. *Hartford Fire Ins. Co. v. California*, 509 U.S. 764, 798-99 (1993) (requiring a showing that foreign law requires defendants "to act in some fashion prohibited by the law of the United States" or that "compliance with the laws of both countries is otherwise impossible"). Thus, international comity analyses have largely been rendered moot in international antitrust cases, because, whenever such a conflict is found, it will trigger the defense of foreign-sovereign compulsion and immunize a defendant before any further comity analysis is necessary. *Id.* To the extent comity remains relevant, it is to the question of *which* country will apply the relevant competition law based on factors of forum non conveniens—relative, cross-jurisdictional distribution of the anticompetitive effects; convenience to the parties; judicial efficiency, and deference to a foreign government's enforcement prerogatives—not *whether* liability is barred. *See Capital Currency Exch. v. Nat'l Westminster Bank*, 155 F.3d 603 (2d Cir. 1998).
4. 28 U.S.C. §§ 1330, 1602–1611.
5. *Id.* § 1603(a).
6. *Id.* § 1603(b).
7. *Clemente v. Philippine Airlines*, 614 F. Supp. 1196 (S.D.N.Y. 1985); *Outbound Maritime Corp. v. P.T. Indonesia Consortium*, 575 F. Supp. 1222 (S.D.N.Y. 1983).
8. 28 U.S.C. §§ 1605–1607.
9. *Id.* § 1605(a)(2).
10. *Id.* § 1603(d).
11. *Id.*
12. *Republic of Argentina v. Weltover, Inc.*, 504 U.S. 607, 614 (1992). *See also Outboard Marine Corp. v. Pezetel*, 461 F. Supp. 384 (D. Del. 1978) (antitrust claims not precluded by FSIA because a Polish government trade organization engaged in inherently commercial activity by selling golf carts for import into the United States).
13. *Weltover, Inc.*, note 12 *supra*, 504 U.S. at 614–15.
14. *Saudi Arabia v. Nelson*, 507 U.S. 349 (1993).
15. *Int'l Ass'n of Machinists & Aerospace Workers v. OPEC*, 477 F. Supp. 553 (C.D. Cal. 1979), *aff'd*, 649 F.2d 1354 (9th Cir. 1981).
16. *Weltover*, note 12 *supra*, 504 U.S. at 616.
17. *Texas Trading & Milling Corp. v. Fed. Republic of Nigeria*, 647 F.2d 300, 308-10 (2d Cir. 1981).
18. *Intel Corp. v. Commonwealth Scientific & Indus. Research Org.*, 455 F.3d 1364, 1369-70 (Fed. Cir. 2006).
19. *Pezetel*, note 12 *supra*, 461 F. Supp. at 397.
20. 213 U.S. 347 (1909).
21. *Id.* at 358–59.
22. *Siderman de Blake v. Rep. of Argentina*, 965 F.2d 699, 713 (9th Cir. 1992) (citations omitted).
23. *See Mannington Mills v. Congoleum Corp.*, 595 F.2d 1287, 1294 (3d Cir. 1979).
24. *Cont'l Ore Co. v. Union Carbide & Carbon Corp.*, 370 U.S. 690 (1962); *United States v. Sisal Sales Corp.*, 274 U.S. 268 (1927).
25. *Alfred Dunhill of London, Inc. v. Republic of Cuba*, 425 U.S. 682, 694 (1976).
26. *Doe v. Qi*, 349 F. Supp. 2d 1258, 1294 (N.D. Cal. 2004).
27. *Biovail Corp. Int'l v. Hoechst AG*, 49 F. Supp. 2d 750, 770 (D.N.J. 1999).
28. *Dunhill*, note 25 *supra*, 425 U.S. at 695.
29. *Id.*
30. *Int'l Ass'n of Machinists*, note 15 *supra*, 649 F.2d at 1360.
31. *W.S. Kirkpatrick & Co., Inc. v. Envtl. Tectonics Corp., Int'l*, 493 U.S. 400, 409 (1990) (act-of-state doctrine inapplicable because a claim that the defendant had bribed Nigerian officials to obtain a contract did not require the adjudication of the validity of an official act of the Nigerian government).
32. *In re Grand Jury Subpoena*, 218 F. Supp. 2d 544, 556 (S.D.N.Y. 2002) (act-of-state doctrine inapplicable because the "intended effect" of the government action was in the U.S.).
33. U.S. Dep't of Justice & Fed. Trade Comm'n, Antitrust Enforcement Guidelines for International Operations (1995) ("Int'l Antitrust Guidelines") § 3.33, http://www.usdoj.gov/atr/public/guidelines/internat.htm (last visited on 2 Apr. 2009).

34. *Tchacosh v. Rockwell Int'l Corp.*, 766 F.2d 1333, 1338 (9th Cir. 1985) (citation omitted).

35. *Banco Nacional de Cuba v. Sabbatino*, 376 U.S. 398, 401 (1964).

36. *Int'l Ass'n of Machinists v. OPEC*, 649 F.2d 1354, 1358–59 (9th Cir. 1981).

37. *Timberlane Lumber Co. v. Bank of Am.*, 549 F.2d 597, 606 (9th Cir. 1976) (quoting *Sabbatino*, note 35 *supra*, 376 U.S. at 428).

38. *Sabbatino*, note 35 *supra*, 376 U.S. at 428 (establishing a three-factor balancing test: (i) the degree of international consensus; (ii) the implications for foreign relations; and (iii) the continued existence of the foreign government).

39. *Williams v. Curtiss-Wright Corp.*, 694 F.2d 300, 303 (3d Cir. 1982).

40. *Frolova v. Union of Soviet Socialist Republics*, 761 F.2d 370, 371 (7th Cir. 1985).

41. *Compare Int'l Ass'n of Machinists*, note 36 *supra*, 649 F.2d at 1360 (finding no consensus opposing cartels), *with Prewitt Enters., Inc. v. OPEC*, 2001 WL 624789, at *7-8 (N.D. Ala. Mar. 22, 2001) (rejecting *Int'l Ass'n of Machinists*'s reasoning because it (i) gave inappropriate deference to *Dunhill*, note 25 *supra*, under which OPEC's acts were commercial; (ii) the acts were performed outside the sovereigns' territory (meetings in Europe); and (iii) the extraterritorial applicability of U.S. antitrust laws was clear). On the other hand, the recent decision in *In re Vitamin C Antitrust Litigation* noted that the defendants and the Chinese government made "a compelling argument" that the defendants' price-fixing scheme was public rather than commercial because "the government was working to guide the vitamin C industry in China's transition from a command to a market economy." Mem. & Order, No. 06-MDL-1738 at 9 n. 4 (E.D.N.Y. Nov. 6, 2008), http://www.judicialview.com/ajaxupload/upload_pdf/Antitrust/1228757999.pdf (last visited on 2 April 2009).

42. *Mannington Mills*, note 23 *supra*, 595 F.2d at 1293.

43. *Interamerican Ref. Corp. v. Texaco Maracaibo, Inc.*, 307 F. Supp. 1291, 1296-98 (D. Del. 1970) (recognizing compulsion when the Venezuelan government imposed a boycott forbidding oil sales to plaintiffs).

44. *Id.* at 1298.

45. *Sabre Shipping Corp. v. Am. President Lines*, 285 F. Supp. 949, 954 (S.D.N.Y. 1968) (noting that compulsion does not immunize defendants from responsibility for acts done in the United States).

46. *Mannington Mills*, note 23 *supra*, 595 F.2d at 1293 (declining to recognize compulsion based on a foreign government's grant of an allegedly fraudulently acquired patent); *United States v. Watchmakers of Switzerland Info. Ctr.*, 1963 Trade Cas. (CCH) ¶ 70,600 (S.D.N.Y. 1962) (declining to recognize compulsion where defendant Swiss watch manufacturers had entered into private agreements to protect their watch industry against U.S. competition, even though the consortium was sanctioned by the Swiss government, one company involved in its formation was owned by a corporation in which the government held a 37% interest, and the government had adopted legislation to facilitate the implementation of the convention); *Cont'l Ore Co.*, note 24 *supra*, 370 U.S. at 690 (declining to recognize compulsion where an official government purchasing agent of Canada under the control of the defendant had engaged in discriminatory purchasing to lock the plaintiff out of the Canadian metal market but there was no allegation that Canadian government was aware of or would have approved the monopolization scheme); *cf. Trugman-Nash, Inc. v. New Zealand Dairy Bd.*, 954 F. Supp. 733, 736 (S.D.N.Y. 1997) (recognizing compulsion where the "practical effect" of a government statute was to forbid export sales price competition).

47. *See Timberlane Lumber Co.*, note 37 *supra*, 549 F.2d at 608 (refusing to recognize compulsion based on the application by Honduran courts of Honduran laws concerning security interests and the protection of property against diminution, especially since judicial proceedings had been initiated by the defendants not by the Honduran government itself); *Mannington Mills*, note 23 *supra*, 595 F.2d at 1293 (refusing to recognize compulsion based on grant of patent).

48. *Timberlane Lumber Co.*, note 37 *supra*, 549 F.2d at 608.

49. *In re Japanese Elec. Prods. Antitrust Litig.*, 723 F.2d 238, 315 (3d Cir. 1983), *rev'd on different grounds sub nom. Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574 (1986).

50. Int'l Antitrust Guidelines, note 33 *supra*, § 3.32, Illustrative Example K (declaring that the compulsion defense would not be acknowledged for foreign exporters into the U.S. market who were urged but not ordered by foreign government officials to "rationalize" production by "cooperatively cutting back").

51. *See In re Japanese Elec. Prods. Antitrust Litig.*, note 49 *supra*, 723 F.2d 238 at 315 (refusing to dismiss antitrust claims based on a compulsion defense because "abundant evidence suggest[ed] that many defendants departed from the agreed-upon minimums and took steps to conceal their departure from [the Japanese government]," no evidence suggested that the anticompetitive practices originated with the Japanese Government, and price stabilization in the home market violated the laws of Japan).

52. Int'l Antitrust Guidelines , note 33 *supra*, § 3.32.

53. *Id.*

54. *Id.*

55. *Hartford Fire Ins. Co.*, note 3 *supra*, 509 U.S. at 798–99 (demanding a showing that foreign law required the defendants "to act in some fashion prohibited by the law of the United States" or that "compliance with the laws of both countries is otherwise impossible").

56. *See In re Japanese Elec. Prods. Antitrust Litig.*, note 49 *supra*, 723 F.2d 238 at 315 (holding that government's lack of involvement in actual price setting mitigated compulsion).

57. *Timberlane Lumber Co.*, note 37 *supra*, 549 F.2d at 608; *In re Vitamin C Antitrust Litig.*, note 41 *supra*, No. 06-MDL-1738 at 31 n.12 (noting that the plaintiffs "would have a stronger argument that defendants' actions were voluntary" if, despite the availability of a government-authorized chamber of commerce for coordination, the price fixing did not occur until market power was achieved).

58. *Eastern R.R. Presidents Conference v. Noerr Motor Freight*, 365 U.S. 127 (1961).

59. *Compare* Int'l Antitrust Guidelines, note 33 *supra*, § 3.34 (applying *Noerr* to both foreign and domestic government petitioning) *and Coastal States Mktg. v. Hunt*, 694 F.2d 1358, 1364 (5th Cir. 1983) (holding that *Noerr* protects the petitioning of foreign governments because the doctrine "reflects not only First Amendment concerns but also a limitation on the scope of the Sherman Act"), *and Carpet Group Int'l v. Oriental Rug Imps. Ass'n*, 256 F. Supp. 2d 249 (D.N.J. 2003) (same), *with Cont'l Ore Co.*, note 24 *supra*, 370 U.S. at 707 (distinguishing *Noerr* in holding that efforts to influence a private corporation acting as the agent of the Canadian government were commercial, not lobbying, activities), *and Occidental Petroleum Corp. v. Buttes Gas & Oil Co.*, 331 F. Supp. 92 (C.D. Cal. 1971) (holding that the persuasion of Middle Eastern states was beyond *Noerr*'s concerns, which were limited to protecting First Amendment freedoms and ensuring the well-functioning of representative democracy).

60. *Assoc. Container Transp. (Austl.) v. United States*, 705 F.2d 53, 59–60 (2d Cir. 1983).

61. *U.S. Power v. Siemens Power Transmission & Distribution*, 2006 U.S. Dist. LEXIS 45919, at *5 n.1 (D. Minn. July 5, 2006).

62. *United States v. AMAX Inc.*, 1977-1 Trade Cas. (CCH) ¶ 61,467 (N.D. Ill. 1977).

63. *Laker Airways v. Pan Am. World Airways*, 604 F. Supp. 280, 287 n.20 (D.D.C. 1984).

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Cuba's Fiscal Potpourri: Past and Present

By Nicolás José Muñiz Arias

I. Introduction

Cuba's fiscal regime in the 1940s and 1950s was vibrant yet cumbersome. Some of the first rulings issued by the U.S. Internal Revenue Service (IRS) as to the creditability of Latin American taxes concerned levies in force in Cuba at that time; moreover, Cuban government officials even met with their U.S. counterparts to negotiate a tax treaty. At the same time, businesses and individuals were confronted with a proliferation of taxes resulting from emergency measures, dictatorships, and the influence exerted by Spain during the colonial era and by the United States in the 20th century.

Castro's rise to power abruptly ended Cuba's preeminent role in the fiscal arena. The island's conversion to socialism in the early 1960s, with its call for the abolishment of income taxes, was viewed as a victory for the working class. Ironically, upon the demise of the Soviet bloc nearly three decades later, the Cuban government reluctantly reintroduced income taxes to combat the resultant drastic decline in trade. This article offers a historical overview of the Cuban fiscal regime up until the 1959 socialist revolution, along with that currently in place in the island, with a focus on corporate income tax.

II. Historical Overview

A. Spanish Colonial Rule and the Republic of Cuba

Beginning with Christopher Columbus's landing in Cuba in 1492 up until the Spanish-American War in 1898, no coordinated tax regime was in place; instead levies were enacted to meet specific needs as they arose, oftentimes with picturesque names.[1] Some of the more prevalent levies in force during Spain's colonial rule were, in order of importance: *almojarifazgos,* duties levied on importation and exportation of goods;[2] *alcabalas*, assessed as a percentage of the proceeds generated from the sale or exchange of property;[3] and, to a lesser extent, *diezmos*, a tithe equal to one-tenth of the good's value.[4] Municipalities likewise enacted levies; for instance, the city of La Habana (Havana) instituted a *sisa de la muralla* to finance construction of its walls.[5]

A direct tax on income first appeared with the short-lived tax reform of 1867.[6] In exchange for abolishing *alcabalas*, *diezmos*, and other contributions, a ten-percent tax was levied on rural and urban wealth.[7] Disagreements between Spanish and Cuban delegates over duties, along with lower prices for sugar and tobacco, ultimately led to the outbreak of the Ten Years War in 1868, a precursor to Cuban independence.[8] Transfer of sovereignty from Spain to the United States, as stipulated by the 1898 Treaty of Paris, signaled the start of U.S. influence over Cuba's fiscal policy. Under General Leonard Wood's governorship, a predecessor to the business profits tax was enacted addressing Cuban-source industrial and commercial profits.[9]

Following independence in 1902, levies and special funds were established to guarantee payment on credit extensions granted to the Cuban State.[10] In 1903, the Republic of Cuba negotiated a U.S. $35-million loan with a U.S. financial institution, in exchange for levying excise taxes over the manufacture and importation of alcoholic beverages and tobacco products to pay back principal and interest.[11] Two decades later, a one-percent national sales and gross receipts tax was promulgated to service a U.S. $50-million loan Cuba had concluded with J.P. Morgan.[12] The cascading effect of this indirect levy, causing prices for local goods to increase, was frowned upon, since it impacted not only imports but all subsequent sales by wholesalers and retailers.[13]

Under Gerardo Machado's dictatorship, major infrastructure projects were undertaken requiring funding. The resulting Public Works Act of 1925 called for a fifty-percent increase in the rate of sales and gross receipts tax,[14] and a tax of one-quarter of one percent on the exportation of funds, effectively levying a tax on anything of value leaving Cuban territory.[15] Increasing the sales and gross receipts tax rate coincided with the elimination of a four-percent tax on business profits established just a few years earlier; substituting a direct tax for an indirect tax, from a tax policy perspective, made the Cuban tax system less flexible in terms of addressing future economic downturns.[16]

A tax on business profits as such was first implemented under the Emergency Law of 1931, following the earlier tax on industrial and commercial profits,[17] and was notable for introducing progressive income tax rates.[18] In lieu of a tax on business profits, a gross receipts tax was assessed over certain corporations and individuals engaged in commercial activities in Cuba. The six-percent tax on net profits of foreign maritime companies, for instance, was replaced in 1928 by a three-percent tax on gross revenues derived from passengers and cargo loaded at domestic ports for foreign destinations,[19] while insurance companies were required beginning in 1932 to pay annually a four-and-one-half percent tax on premiums.[20]

B. Batista's Dictatorship and Castro's Revolution

With the election of Fulgencio Batista as President in 1940, new levies came into being three years later,[21] such as a tax on all natural and juridical persons doing business in Cuba, levied at three pesos per every 1,000 pesos, or fraction thereof, over operating capital; and a tax on all domestic and foreign companies and individuals doing business in Cuba equal to fifteen percent of profits in excess of ten percent of capital.[22] Moreover, an excess-profits tax and a tax on the exportation of funds were paid in addition to (not in lieu of) the general tax on business profits.[23] U.S. influence over the drafting of Cuban legislation continued throughout the 1950s, with the enactment of a capital gains tax[24] and a global income tax on companies earning annually less than 70,000 pesos.[25]

By the end of the 1950s, Cubans faced numerous levies, each with varying scopes, exemptions and procedures, but lacking coordination: in essence, a fiscal potpourri.[26] Reasons for this diversity range from Spain's colonial legacy, levies enacted solely to service foreign bank loans, the creation of special funds, and the issuance of emergency measures to combat budget deficits.[27] Despite well-intentioned attempts at tax law reformation, the Cuban government continued to rely on indirect taxes (mainly sales and gross-receipts taxes, and import duties), without implementing proper control over tax collection.[28]

Not surprisingly, Cuban taxpayers were oftentimes uncertain as to the amount of tax they owed to their government, and this uncertainty led to an increase in the cost of compliance and perhaps even encouraged tax evasion.[29] Most receipts collected in Cuba emanated from levies that disregarded the economic capacity of taxpayers by targeting consumption rather than income and accumulated wealth, and this resulted in a greater burden to the lower and middle classes. This systematic failure of the tax system presumably facilitated the eventual overthrow of General Batista's dictatorship.

Fidel Castro's rise to power on 1 January 1959 swiftly ended Batista's reign. The next two years were characterized by expropriations of privately owned companies, resulting in a transfer of the nation's means of production over to the state. Castro finally confirmed the socialist nature of the revolutionary movement in 1961, precipitating a breakdown of diplomatic relations with the United States, followed by the U.S. embargo on all Cuban products.[30] Shortly thereafter, the Soviet Union became Cuba's main political ally and economic partner.

Direct-type levies prevalent during Batista's rule were gradually set aside, along with municipal taxes.[31] By 1967, workers no longer had to pay tax on their remunerations.[32] The 1976 Constitution bolstered even further the state's role in the economy, by requiring prior governmental approval for all foreign investment, severely hampering flows of funds into the island.[33] To compensate for the loss of revenue, the government sought to collect revenues by way of sales taxes, and non-fiscal receipts derived from state enterprises.[34] The latter is not a tax per se, but rather a mere "transfer" of net revenues from state enterprises to government coffers.[35] The diminishing importance of tax policy led to the eventual demise of the ministry of finance.[36]

III. Current Tax Law

A. Overview

Cuba's current basic tax law is framed as Law No. 73,[37] to combat the drastic decline in trade as a result of the collapse of the Soviet bloc economies, which left a significant portion of the island's workforce unemployed in the early 1990s. To preserve "advances" made by the socialist movement, the tax burden was apportioned according to one's ability to pay.[38] The 1994 law sets forth a total of eleven taxes, three fees, and social security contributions. Presumably, the ever-increasing presence of economic associations with foreign companies prompted the government to resurrect two direct levies in existence before 1959: taxes on corporate and personal income.

B. Corporate Income Tax

Prior to 1994 only mixed (i.e., joint ventures) and commercial companies were subject to income tax. Law No. 73 expanded the scope of the corporate income tax by referring to all Cuban and foreign legal entities doing business in Cuba.[39] Legal entities established under Cuban law, or managed and controlled within Cuban territory, are subject to tax on their worldwide income. On the other hand, foreign companies with a permanent establishment (including branches and representative offices) in Cuba are taxed on income attributable to that establishment.[40]

A company's audited financial statements constitute the starting point for determining net taxable income, with adjustments made to book income. Expenses incurred to generate income are deductible, provided that they are justifiable and necessary to carry out business activities and the amount is duly registered on the company's books pursuant to generally accepted accounting principles.[41] Corporations may exclude from their taxable base any dividends received from other Cuban companies; by contrast, dividends from foreign companies are subject to tax in Cuba but entitled to a credit for income tax paid abroad.[42]

If the amount of expenses deducted in any given year exceeds taxable income, the excess may be carried forward five years as a loss to offset taxable income.[43] The resulting net taxable income is subject to a thirty-five-percent flat rate of tax.[44] Nonetheless, net taxable income reported by mixed companies and international economic associations continues to be taxed at thirty percent pursuant to Decree-Law No. 50.[45] The *Ministerio de Finanzas y Precios* (MFP) may authorize a company to determine its tax liability by reference to gross proceeds.[46] All corporate taxpayers are required to register with the *Oficina Nacional de Administración Tributaria* (ONAT),[47] make estimated payments each trimester, and file an annual tax return.[48]

A general five-year statute of limitations applies to the payment of taxes.[49]

The U.S. Internal Revenue Code denies foreign tax credits for taxes paid to certain identified countries, including those with which the United States has severed diplomatic relations.[50] The IRS initially identified a list of countries in 1987 that included Cuba.[51] Even though the number of jurisdictions has declined over time, Cuba remains on this list and will presumably remain there as long as the Castro brothers effectively retain power.[52] In contrast, income taxes paid during the 1950s to the Cuban government under Batista's dictatorship were creditable for U.S. tax purposes.

Cuba does not have an extensive tax-treaty network. The more pertinent treaties are those in force with Spain, China and Venezuela, since the volume of investments originating from those nations is rather significant, especially in the areas of tourism, mining and construction. European countries such as Italy, France, and the United Kingdom, along with Canada, are other major investors; however, at the time of publication none of them have concluded treaties with Cuba. Notably, back in the 1950s, Cuban and U.S. delegates were actively negotiating a treaty between the two nations; unfortunately, talks stalled as a result of disagreements over the use of tax sparing.[53]

C. Personal Income Tax and Selected Levies

Two broad categories of personal income are subject to tax in Cuba: earnings generated from industrial and commercial activities, self-employment, and rendering of services; and passive-type income derived from investments and rental of property. Cuban nationals are subject to a tax on worldwide net income denominated in foreign currency or convertible Cuban pesos.[54] Foreign nationals who report Cuban-source income and are physically present in Cuba in excess of 180 days in any given fiscal year are also subject to tax.[55]

Potentially all income reported by individuals is subject to tax; however, as a result of the harsh conditions prevailing in Cuba's economy, wages and pensions denominated in Cuban pesos, along with family remittances received from abroad, are exempt.[56] The resulting net income is taxed at rates ranging from ten percent for amounts up to 2,400 convertible pesos, to fifty percent for amounts exceeding 60,000 convertible pesos,[57] with rates differing somewhat if the amounts are denominated in non-convertible Cuban pesos.[58] Reflecting perhaps the Cuban government's continued ambivalence towards the private sector, self-employed individuals (family restaurant owners, taxi drivers, and lodging operators) are affected the most, as deductions for purchases are limited to ten percent of gross income regardless of expenses actually incurred.[59]

Foreign companies operating in Cuba were confronted by the economic crisis of the early 1990s. Given the prohibition against Cuban nationals' receiving wages in hard currency, a modest "stimulus," denominated in convertible pesos, was frequently awarded to workers in critical sectors of the economy. To the extent these payments were technically classified as "bonuses," rather than as salaries, they enjoyed de facto tax exemption. To settle this controversy, two years ago the ONAT issued a resolution confirming that Cuban nationals, as well as foreigners residing in Cuban territory, must pay tax on any bonuses received in hard currency.[60]

The labor-force use tax[61] and social security contributions[62] are two facets of payroll taxes. The first levy is assessed over the amount of remuneration received by Cuban or foreign workers at a general rate of twenty-five percent. Tax is withheld by employers on amounts paid to their workers; however, the rate of withholding tax is reduced to eleven percent, to the extent they employ individuals registered with the social security system. Additionally, companies make social security contributions on behalf of their employees, normally equal to fourteen percent of remuneration paid, with individual workers contributing five percent of their wages.

Consumption taxes have reemerged predominantly in the form of an indirect sales tax,[63] along with an excise tax on certain goods.[64] The former is assessed on the sale of goods consumed or used within Cuban territory, irrespective of whether the goods were manufactured totally or partially in Cuba or imported from abroad; exceptions apply to purchases of raw materials and the exportation of goods. This levy is assessed only once, upon final consumption, with rates varying, depending on the municipality where the sale takes place and the type of consumer good being sold.[65] Finally, the documentary tax constitutes one of the oldest levies in Cuba, having gone through various incarnations since Spanish colonial rule.[66]

IV. Concluding Remarks

Over the course of nearly three decades the Cuban government relied almost exclusively on non-fiscal receipts derived from state enterprises, and on a myriad of indirect taxes, including sales and gross receipts taxes. Little attention, predictably, had been granted to fostering the private sector. This changed somewhat in 1994 with the enactment of Law No. 73, whereby business and personal income were once again subject to tax.

Nonetheless, data compiled by the Cuban government suggests that indirect taxes continue even today to account for most of the country's coffers, when compared to direct levies assessed on business profits, labor force, and personal income.[67] Moreover, reliable data on corporations and individuals that actually pay tax is scarce, probably due to concerns that, as part of its program of economic sanctions against the Cuban government, the U.S. government could utilize this information to punish foreign investors operating in the island.

A broad-based, progressive, and equitable tax system would enable Cuba to gradually shift from a centrally planned economy to one that is market-driven and free from state intervention. Ideally, a future Cuban fiscal regime would consist of a select number of levies that permit taxpayers to clearly identify their obligations, creating a culture of paying tax amongst the general populace. After the Castro brothers finally relinquish power, Cuba can become a truly independent nation that is recognized for its stable fiscal environment.

Endnotes

1. René Gómez-Cortés y Cortés, El Régimen Fiscal Antes del Inicio de la Guerra de los Diez Años 45 (1959).
2. Heinrich Friedlaender, Historia Económica de Cuba 271 (J. Montero 1944).
3. Julio Le Riverend, Historia Económica de Cuba 137-138 (Editorial de Ciencias Sociales 1985).
4. Ramón de la Sagra, Historia Económico-Política y Estadística de la Isla de Cuba 237 (La Habana, Imprenta de las Viudas de Arazoza y Soler 1831).
5. Le Riverend, note 3 *supra*, at 110.
6. Real Decreto de 12 de febrero de 1867.
7. *Id.* art. 3.
8. Gómez-Cortés, note 1 *supra*, at 87-89.
9. Orden Militar No. 463 de 13 de noviembre de 1900.
10. Roswell Magill & Carl Shoup, The Cuban Fiscal System: A Study Made at the Request of the Secretary of the Treasury 12 (Secretaria de Hacienda de Cuba 1939).
11. *El Empréstito de Speyer de $35.000.000*, 19 Cuba Económica y Financiera, no. 215, at 15 (Feb. 1944).
12. Ley de 9 de octubre de 1922.
13. *Nuestro Momento Económico y Financiero*, 10 Cuba Importadora e Industrial, no. 116, at 5 (Nov. 1935).
14. Ley de Obras Públicas de 15 de julio de 1925.
15. *Economic Controls and Commercial Policy in Cuba* 18 (U.S. Tariff Comm'n 1946).
16. Grupo Cubano de Investigaciones Económicas, Un Estudio Sobre Cuba: Colonia, República, Experimento Socialista 409 (Univ. of Miami Press 1963).
17. Ley de Emergencia Económica del 29 de enero de 1931.
18. José M. Pérez Cubillas, Impuesto Sobre Utilidades: Evolución Histórica, Legislación Positiva, Jurisprudencia y Comentarios 89 (J. Montero 1936).
19. Ley de Amnistía Fiscal de 6 de julio de 1928. *See Seatrain Lines, Inc. v. Commissioner*, 46 B.T.A. 1076 (1942), where the court held that this levy was a tax assessed on income, not on the privilege of doing business, and, thus, was creditable in the U.S.; afterwards in I.T. 3903, 1948-1 C.B. 70, *obsoleted by Rev. Rul. 68-100*, 1968-1 C.B. 572, where the IRS recharacterized this tax as one in lieu of an income tax.
20. *See* Rev. Rul. 55-504, 1955-2 C.B. 578, *obsoleted by* Rev. Rul. 89-118, 1989-2, C.B. 275, where the IRS held that this levy was paid in lieu of a tax on income and, therefore, could be claimed as a credit for U.S. federal tax purposes.
21. Ley No. 7 de Ampliación Tributaria de 5 de abril de 1943.
22. *See* Rev. Rul. 56-51, 1956-1 C.B. 320, where the IRS ruled that this tax was creditable under Section 901 of the Internal Revenue Code.
23. Years later the U.S. District Court in *Motland v. United States*, 192 F. Supp. 358 (N.D. Iowa 1961), held that this levy was not a creditable substitute tax, since the individual was still liable to pay income tax.
24. Ley No. 6 de 27 de octubre de 1955.
25. Ley No. 13 de 22 de diciembre de 1951.
26. Nicolás Muñiz Rodríguez, *Los Impuestos Inútiles*, 31 Cuba Económica y Financiera, no. 360, at 27 (Mar. 1956). Taking into account national, municipal and provincial taxes, along with special funds, there were over 200 levies in Cuba.
27. Nicolás Muñiz Rodríguez, *Peculiaridades del Sistema Fiscal Cubano*, 30 Cuba Económica y Financiera, no. 349, at 15 (Apr. 1955).
28. *Recaudaciones Presupuestales*, 34 Cuba Económica y Financiera, no. 402, at 21 (Sept. 1959). Revenues from indirect taxes more than doubled those from direct taxes.
29. *See* José M. Illán, *La Reforma Tributaria Cubana y la Alianza para el Progreso* 24, VI Conferencia Interamericana de Contabilidad (N.Y. 25-29 Sept. 1962).
30. The U.S. embargo on Cuba began in 1962, under the Kennedy administration, pursuant to the Enemy Act of 1917, ch. 106, 40 Stat. 411 (1917). The embargo was reconfirmed by the Cuban Democracy Act of 1992, Pub. L. No. 102-484, 106 Stat. 2575 (1992), and the Cuban Liberty and Democratic Solidarity (Libertad) Act of 1996, Pub. L. No. 104-114, 110 Stat. 785 (1996), commonly referred to as the "Helms-Burton Act."
31. Grupo Cubano de Investigaciones Económicas, note 16 *supra*, at 1359.
32. Ley No. 1213 de 27 de junio de 1967.
33. Constitución de la República de Cuba, Gaceta Oficial, Edición Extraordinaria No. 7, del 1 de agosto de 1992, arts. 15, 17.
34. Regulated pursuant to Decreto-Ley No. 44 de 6 de julio de 1981.
35. Carmelo Mesa-Lago, Breve Historia Económica de la Cuba Socialista. Políticas, Resultados y Perspectivas 48 (Alianza 1994).
36. Grupo Cubano de Investigaciones Económicas, note 16 *supra*, at 1358.
37. Ley No. 73, Ley del Sistema Tributario, de 4 de agosto de 1994 (hereinafter, "Law No. 73"). Legislation can be accessed through the MFP's Web site at http://www.mfp.cu. (last visited on 9 Apr. 2009).
38. *Id.* art. 3.
39. *Id.* art. 12.
40. Resolución No. 379 de 31 de diciembre de 2003 arts. 6-9 (hereinafter, "Resolution 379").
41. *Id.* arts. 27-29.
42. *Id.* arts. 26, 45.
43. *Id.* art. 48.
44. Law No. 73, note 37 *supra*, art. 14.
45. *Id.*, Disposiciones Finales (Segunda & Tercera). Businesses that exploit natural resources can be subject to tax rates up to fifty percent.
46. *Id.* art. 15. *See* Resolution 379, note 40 *supra*, art. 54.
47. Decree-Law 169, art. 51.
48. Law No. 73, note 37 *supra*, art. 16.
49. Decree-Law 169, art. 87.
50. I.R.C. § 901(j)(3). Nonetheless, taxpayers can deduct taxes paid or accrued in the listed countries.

51. Rev. Rul. 87-35, 1987-1 C.B. 182.

52. Rev. Rul. 2005-3, 2005-3 I.R.B. 334.

53. *El Momento Económico y Financiero*, 33 Cuba Económica y Financiera, no. 392, at 5 (Nov. 1958).

54. Convertible Cuban pesos are special pesos that can be converted into U.S. dollars at a one-on-one exchange rate.

55. Law No. 73, note 37 *supra*, art. 17.

56. *Id.* art. 19.

57. Resolución No. 24 de 24 de noviembre de 1995, Sección 10.

58. Resolución No. 21 de 27 de marzo de 1996, Sección 18. Rates vary between five percent for amounts up to 3,000 Cuban pesos, and fifty percent for amounts exceeding 60,000 Cuban pesos.

59. Resolución No. 253 de 5 de agosto de 2003, Sección 10.

60. Resolución No. 277 de 13 de diciembre del 2007.

61. Law No. 73, note 37 *supra*, arts. 45-49. *See* Resolución No. 240 de 21 de mayo de 2002.

62. Law No. 73, note 37 *supra*, arts. 53-56.

63. *Id.* arts. 21-23.

64. *Id.* arts. 24-26.

65. *See* Resolución No. 22 del 28 de septiembre de 1994, Sección 1.

66. Law No. 73, note 37 *supra*, arts. 41-44.

67. *See Presupuesto del Estado*, Panorama Económico y Social. Cuba 2008 ch. 5(Oficina Nacional de Estadísticas), accessible at http://www.one.cu (last visited on 9 April 2009).

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Commentary:
Section 409A of the Internal Revenue Code:
Dangers Lurk in the International Arena

By Saul Ben-Meyer

I. Introduction

Section 409A of the U.S. Internal Revenue Code (the "Code") has imposed many new and complex restrictions on the design and operation of deferred compensation since it became effective 1 January 2005. Failure to comply with these rules can subject employees to harsh tax penalties. This has created a serious tax trap for employees and their employers who may not be aware of the broad range of plans, agreements and other arrangements that constitute "deferred compensation" as broadly defined under Section 409A. There is currently a high incidence of non-compliance with Section 409A since not all employers and employees are familiar with this new law and its broad scope. Such non-compliance is even more widespread in the international arena among U.S. expatriates, inpatriates and other U.S. taxpayers hired locally by companies in foreign countries since these employees and their foreign compensation are not always closely monitored in the U.S. Violation of Section 409A in the international arena can result in the acceleration of taxes, penalties, interest and the need to re-file tax returns for employees. It also exposes employers to penalties for failure to withhold taxes, the need to re-calculate tax equalization payments, and claims for indemnification by adversely affected employees.

While "good faith" operational compliance based on the statute, interim guidance, and proposed regulations was adequate until 1 January 2009, the final Treasury regulations under Section 409A are now effective and require both documentary and operational compliance as of 1 January 2009. Based on our experience, it would appear that many U.S. and non-U.S. employers have overlooked the impact of Section 409A on their U.S.-taxpayer expatriate and inpatriate employees who participate in U.S. and / or non-U.S. deferred compensation arrangements covered under Section 409A.

The regulations make it clear that 409A covers foreign plans. However, there are several general exemptions and exemptions specific to foreign plans, available under the regulations, that may apply in certain situations. Furthermore, the Internal Revenue Service (the "IRS") has implemented a corrections program that allows employers and employees to mitigate some or all of the harsh tax consequences of operational violations of Section 409A depending on how quickly the violation is discovered and corrected. Violations corrected in the year of occurrence generally escape all penalties, while violations corrected in the first and second year following the year of the violation are subject to escalating penalties. This places a premium on quickly identifying and correcting operational violations of Section 409A. Unfortunately, there is no current correction program in place for the failure to amend an arrangement to be in documentary compliance with Section 409A; however the IRS is considering such a program and has asked the public for comments and proposals for the terms of such a documentary correction program.

II. Compliance with Section 409A

A. Identification of Deferred Compensation Arrangements

The first step in complying with Section 409A is to identify all deferred compensation arrangements. "Deferred compensation" is very broadly defined under Section 409A as any arrangement where an employee has a legally binding right in one year to compensation that will or could be made in a later year. The right to the payment of compensation need not be vested and can be contingent on the occurrence of a future event.

This broad definition encompasses traditional non-qualified deferred compensation plans and SERPs, including international and "third country national" retirement plans. It also covers arrangements that would not normally be considered deferred compensation, such as offer letters, foreign assignment letters, tax equalization policies, taxable relocation benefits, reimbursement and allowance policies, severance benefits, certain stock rights, noncompete agreements, and bonus plans. Employers should perform a comprehensive review to identify all arrangements potentially subject to Section 409A and determine whether they are exempt. If not, they must be amended either to be exempt from or to comply with Section 409A.

B. Identification of Employees Subject to Section 409A

Section 409A applies to all U.S. taxpayers participating in a U.S. or foreign deferred compensation plan or subject to a U.S. or foreign agreement providing deferred compensation or benefits subject to Section 409A. This includes the following classes of employees.

- ***U.S. Citizens and Green Card Holders***—are subject to U.S. tax on worldwide income. These individuals are very likely to incur compliance problems if they are hired locally by a foreign company and participate in the company's foreign deferred compensation plans.

- ***Resident Aliens who satisfy the "substantial presence" test***—are subject to U.S. tax on worldwide income. These individuals are likely to incur compliance problems when they are temporarily transferred to the U.S. from a foreign affiliate where they continue to participate in the foreign deferred compensation plans during their assignment to the U.S.

- ***Nonresident Aliens working in the U.S.***—are subject to U.S. tax on their U.S.-source income. These individuals also are likely to incur compliance problems since they typically continue to participate in the transferor's foreign deferred compensation plan while working in the U.S.

Any of these employees who participate in a U.S. or foreign deferred compensation arrangement are subject to Section 409A, and the arrangement must be reviewed to determine whether it complies with Section 409A. Since U.S. plans presumably have been amended to comply with Section 409A, the challenge is to ensure that any foreign plans or arrangements are compliant. If necessary, a separate addendum or side agreement applicable only to U.S. taxpayers can be adopted to make any required modifications to the arrangement to comply with Section 409A without the need to amend the foreign plan as it applies to other individuals.

C. Requirements of Section 409A

Section 409A imposes strict rules that limit flexibility and discretion of employers and employees over (i) the timing of deferral elections by employees, and (ii) the time and form of payment of deferred compensation. The following are some examples of these requirements, which are among other requirements imposed by the statute and regulations.

- ***Written Plan Document***: All deferred compensation arrangements must be set forth in a written document that complies with the requirements of Section 409A.

- ***Initial Deferral Elections/Plan Terms***: Section 409A requires that employee elections and plan terms regarding the time and form of payment of deferred compensation are in place before the beginning of the taxable year in which the employee renders the services that give rise to the deferred compensation, and that these elections are irrevocable. Opportunities to accelerate payment or extend the deferral period are subject to strict rules and are extremely limited.

- ***Time of Payment***: Distributions from nonqualified deferred compensation plans may be made only upon (i) separation from service, (ii) disability, (iii) death, (iv) a specific date or pursuant to a fixed schedule, (v) certain change in control events, or (vi) unforeseeable emergency. The terms of the arrangement or the employee's election must specify both the time and form of payment (*e.g.*, lump sum on a specified date or installments over a specified period) prior to the performance of the services giving rise to such compensation.

- ***Specified Employees***: Payment of deferred compensation to certain "specified employees" due to separation from service may not be made until six months after the date of separation from service (or death, if earlier). Specified employees must be identified annually and generally include the fifty most highly paid officers of public companies (whether traded on a U.S. or a foreign exchange) and their controlled group subsidiaries.

- ***Prohibitions on Avoidance of Creditors***: Section 409A prohibits the use of "offshore" rabbi trusts to fund deferred compensation and any funding triggers tied to the deterioration of the employer's financial condition. These provisions are viewed as efforts to improperly avoid the claims of creditors of the employer.

D. Penalties for Violation of Section 409A

The failure to comply with Section 409A, either in the terms of the document or in operation, results in the following adverse tax consequences to the employee:

- acceleration of tax on vested deferred amounts in the year of violation;
- twenty percent additional income tax penalty; and
- premium interest at the IRS underpayment rate plus one percent from the year in which the compensation is vested.

The consequences for expatriates and inpatriates can be even harsher, since the acceleration of U.S. tax could result in the mis-timing of income inclusion in a foreign jurisdiction—resulting in the unavailability of a foreign tax credit or treaty exemption and the potential for double taxation of the deferred income.

Also, if a foreign deferred compensation plan violates Section 409A, all other foreign deferred compensation plans covering the employee are aggregated and treated as in violation, regardless of the type of plan. This issue is described in more detail in Part IV.B below.

III. Exemptions from Section 409A

The final regulations set forth a number of exemptions from Section 409A that may apply to a deferred compensation arrangement. Some of these exemptions are generally applicable to all deferred compensation, while others are specific to foreign arrangements and residents of foreign countries. The following is a brief summary of some of the most significant exemptions available. This summary should not be relied upon in determining whether an exemption applies to a particular situation, since the actual terms of each exemption are more detailed and complex than described below.

A. Generally Applicable Exemptions

1. U.S. Tax-Qualified and Other Plans

There is blanket exemption from Section 409A for U.S. tax-qualified retirement plans, Section 457(b) plans and certain welfare benefit plans. However, unless one of the specific foreign plan exemptions applies, non-U.S. tax-qualified plans, such as U.K.-registered schemes, are not exempt.

2. Grandfathered Plans

Any compensation deferred and vested prior to 31 December 2004 may be grandfathered under prior law, provided the terms of such arrangement are not "materially modified" at any time after 3 October 2004.

3. Short-Term Deferrals

Any payments that are made no later than the fifteenth day of the third month following the calendar year in which they vest are exempt. This exemption often applies to annual bonus plans where the bonus is paid before 15 March of the year following the year in which the bonus is earned and vested. It also may apply to severance payments that are paid in a single lump sum before 15 March of the year in which employment is terminated.

4. Separation Pay

Separation pay or severance pay may be exempt where the payment is made in the event of an involuntary termination of employment or pursuant to a retirement window program and (i) is limited to no more than the two times the employee's total pay for the prior year (up to two times the compensation cap under qualified plans for the year of termination: the cap is $245,000 for 2009) and (ii) the payments are completed before the end of the second calendar year following the year of termination. A separate foreign separation plan exemption is described below.

5. Stock Rights

Certain stock rights, such as non-discounted stock options and stock appreciation rights, as well as restricted stock, qualified incentive stock options and stock purchase plans are exempt from Section 409A, provided certain other requirements are satisfied.

B. Foreign Plan/Cross-Border Exemptions

1. Funded Plans

The taxation of benefits accrued under funded plans (where the trust is protected from the claims of the employer's creditors) is determined under Section 83 or 402(b) of the Code, rather than under Section 409A. Generally, for highly compensated employees, benefits (contributions and earning) are taxable when vested. For rank and file employees, contributions generally are taxable when vested and earnings are taxable when distributed.

2. Broad-Based Foreign Retirement Plans

Certain foreign unfunded "broad-based" retirement plans are exempt from Section 409A. Broad-based plans must (i) cover a wide range of employees (including rank and file employees), substantially all of whom are nonresident aliens; (ii) provide significant benefits to a substantial majority of covered employees; (iii) provide benefits that are nondiscriminatory; and (iv) limit in-service withdrawals to discourage pre-retirement distributions.

Resident aliens who become U.S. taxpayers under the "substantial presence" test and non-resident aliens performing services in the U.S. can continue to accrue benefits under a foreign broad-based plan without violating Section 409A. On the other hand, in order to utilize the exemption, U.S. citizens and green card holders must satisfy the following additional conditions: (i) the employee is not eligible to participate in a U.S.-qualified plan; (ii) only non-elective deferrals are exempt; and (iii) the annual exemption is limited to the Code Section 415 limits on contributions and benefits under U.S.-qualified plans ($49,000 and $195,000, respectively, for 2009).

3. Benefits Earned and Vested Outside the U.S.

Any vested deferred compensation earned by a nonresident alien under a foreign plan for foreign service before transferring to the U.S. and becoming a U.S. taxpayer generally is exempt from Section 409A. Thus, employers should consider fully vesting the employee prior to a transfer to the U.S. and freezing further benefit accruals under the foreign plan until the end of the U.S. assignment. Otherwise, the employer must modify the terms of the plan as they apply to the employee by the end of the first year of the assignment to the U.S either to comply with or be exempt from Section 409A.

4. Limited Deferrals

Amounts accrued or deferred under certain foreign plans by a nonresident alien for services performed in the U.S. and taxable as U.S. source income, are exempt from Section 409A to the extent they do not exceed the limit applicable to 401(k) deferrals under U.S. plans ($16,500 for 2009).

5. Treaty Exemptions

Foreign plans are exempt from Section 409A to the extent that contributions, accruals or earnings under such plan are excludable by the employee for U.S. federal income tax purposes pursuant to a bilateral income tax treaty. For example, the U.S. Treasury's 2006 model income tax treaty excludes contributions and benefit accruals under certain foreign pension plans for services in the U.S., provided (i) the employee was participating in the foreign plan before the services are performed, (ii) the foreign plan "corresponds" to a U.S. tax-qualified plan, and (iii) the contributions and / or benefits are subject to the U.S. limits on tax-qualified plans under Code Section 415 ($49,000 and $195,000, respectively, for 2009). Examples of counties that have entered into treaties with the U.S. containing this provision include Canada, France, Germany and the U.K.

6. Foreign Earned Income

U.S. citizens and green card holders transferred to a foreign country are exempt from Section 409A on deferred compensation up to the amount of the "foreign earned income exclusion" available under Code Section 911 ($91,400 for 2009) less the amount of foreign earned income actually excluded. This exclusion provides limited relief for lower paid taxpayers. For example, an expatriate earning $80,000 can defer up to $11,400 ($91,400 minus $80,000) of income in 2009 without violating Section 409A.

7. Foreign Separation Pay

Separation and severance pay required under local foreign law is exempt from Section 409A, provided the income is received from a foreign employer for services performed in the foreign country. This exemption is broader than the general separation pay exemption described in Part II.A.4 above, since it is available for voluntary terminations and there is no limit on the amount or time of payment.

8. Tax Equalization Agreements

Compensation paid to transferred employees (expatriates and inpatriates) to make them whole for the additional taxes they owe as a result of the foreign assignment is exempt from Section 409A, provided it is paid within certain time frames based on the due date of their U.S. or foreign tax return.

9. Foreign Social Security

Benefits payable under a foreign social security system that is subject to a totalization agreement with the U.S. (to avoid double coverage) are exempt from Section 409A. Social security benefits mandated by a foreign government also are exempt.

IV. Additional Issues in the International Arena

A. Identifying Specified Employees

As discussed in Part II.C above, "specified employees" must be identified annually and are subject to a six-month delay in payments due to termination of employment. Generally, specified employees include the fifty most highly paid officers of public companies (whether traded on a U.S. or a foreign exchange) or their controlled group subsidiaries. Under the general rule, all employees in the worldwide controlled group must be considered in identifying the fifty top-paid officers. This is generally helpful to employees, since the more slots in the list of the top-paid fifty that are taken by non-U.S. taxpayers, the fewer U.S. taxpayers will be subject to the six-month delay.

However, due to the administrative difficulty that U.S. employers may have in identifying foreign officers and their applicable compensation, employers may elect to disregard nonresident aliens with no U.S.-source income in identifying specified employees. Depending on the demographics, excluding these non-U.S. employees may result in more U.S. taxpayers being potentially subject to the six-month distribution delay, but it would dramatically simplify the recordkeeping required to track the status and compensation of employees of foreign affiliates. If this election is made, it must be specified in each deferred compensation arrangement maintained by the employer and members of its controlled group or in a separate written policy (addressing how specified employees are identified) that is applicable to all deferred compensation plans and arrangements of the group.

B. Plan Aggregation Rules

The final regulations identify nine separate categories of deferred compensation arrangements (*e.g.*, account-balance plans, non-account balance plans, elective plans, non-elective plans, separation pay, stock rights, and foreign plans). All deferred compensation arrangements in the same category maintained by an employer and members of its controlled group must be aggregated and treated as a single arrangement under Section 409A.

Since foreign plans constitute a separate category, all foreign plans covering an employee, regardless of the type (*e.g.*, account, non-account, elective, non-elective or severance) are treated as a single plan. Consequently, a violation in the form or operation of one foreign plan with respect to an employee could cause all foreign plans in which the employee participates to be in violation of 409A and subject to the applicable penalties. For example, the improper deferral of a foreign bonus could cause the innocent foreign SERP, severance plan and long-term incentive plan to be in violation of 409A and subject the covered employee to accelerated tax and penalties as well. This result varies from the rule applicable to U.S. plans, where each of the nine separate categories of plans is treated independently of each other under Section 409A.

C. Foreign Stock Rights

As discussed in Part III.A.5 above, stock options and stock appreciation rights granted at the shares' fair market value on the date of grant are exempt from Section 409A. The exercise price of the stock right may never be less than such fair market value. Generally, the fair market value of publicly traded stock must be determined on the day of, or day before, grant. An exception permits the use of a prospective averaging period of up to thirty days after the commitment to make the grant is made and its other terms and grantees are determined.

Some countries, however, permit the practice or require by law the use of an averaging period based on a look-back period ending on the date the grant is approved by the board. The final regulations under 409A provide partial relief by permitting the use of a look-back averaging period of no more than thirty days that is required by foreign law, such as in France. However, if the look-back averaging period is not specifically required by law, it cannot be used, and a permissible valuation method must be utilized.

Also, since the exercise price "may never be less than" the established fair market value, there is an issue as to whether an option can be priced in a foreign currency which may fluctuate relative to the U.S. dollar and result in the exercise price being less then the initial exercise price. Generally, if all valuations and transactions involving the grant are priced on the basis of the same currency, this issue can be avoided.

D. Other Foreign Law Conflicts

Employers and employees should be on the lookout for other situations in which foreign laws may conflict with the requirements of Section 409A. For example, a foreign law may require the payment of severance compensation within certain mandated time frames. A specified employee who is required under 409A to delay receipt of his severance pay until six months following his termination of employment may be in violation of the local foreign law.

V. Conclusion

International employers that provide any form of deferred compensation (as broadly defined in Section 409A) to U.S. taxpayers either in the U.S. or abroad, under either U.S. or foreign arrangements, must become familiar with the new rules and restrictions imposed by Section 409A. Employers must either determine that the arrangement is exempt from 409A, or amend it as it applies to U.S. taxpayers to be exempt or to comply with 409A. The broadly divergent designs of foreign deferred compensation plan and the various local foreign laws that independently apply to these arrangements complicate an already complex statutory scheme.

While penalties for non-compliance fall on the employee, the responsibility for ensuring compliance, as a practical matter, falls on the employer, since any employee confronted with the taxes and penalties imposed under 409A as a result of participation in a non-compliant arrangement is likely to seek redress from the employer.

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Commentary: A Problem in Investor/State Arbitration

By George Kahale, III

I. Introduction

States are increasingly coming to the conclusion that the playing field of investor/state arbitration is tilted heavily in favor of investors, particularly those from the most developed economies. That is why some are re-evaluating investment treaties and withdrawing or threatening to withdraw from the International Convention on the Settlement of Investment Disputes Between States and Nationals of Other States, which established the International Centre for Settlement of Investment Disputes ("ICSID").[1]

Of course, states have won cases in international arbitration, even important ones, but the thesis held by the skeptics is not refuted by the occasional victory. Cases may be won despite a structural bias in the system, just as they may be lost even in a bias-free environment.

In truth, the problem goes beyond the question of whether bias in the system actually exists. On this issue, perception matters as much as reality. States are not likely to continue to play in a game they sense, justifiably or not, is rigged against them. Since it takes two to tango, the growing dissatisfaction of states with the international arbitral process looms as a major problem in investor/state relations and requires a critical assessment of the future of international arbitration as a means of settling investment disputes.[2]

II. Historical Background

It is difficult to pinpoint the source of the problem. Here are a few possible explanations.

It was not too long ago that sovereign prerogatives generally took precedence over private interests. In the 1960s and 1970s, the United Nations was passing resolutions on what was termed Permanent Sovereignty Over Natural Resources, and developing states were taking control over their natural resources and industries in a wave of nationalizations.[3] Conventional political and legal thinking of the time fully supported such action. From an ideological standpoint, socialism and nationalism were at their peak, and from a legal standpoint, aside from the U.N. resolutions referred to above, the rules of state immunity still strongly favored states over private parties[4] and the avalanche of investment treaties had not yet begun.[5]

Significant change in the political and legal landscape began in the 1980s and continued at an accelerated pace in the 1990s. The Soviet Union collapsed, socialism fell into disrepute, privatization of anything and everything came to be viewed as a panacea for the problems attributed to the discredited "isms," and bilateral and multilateral investment treaties proliferated,[6] providing a major boost to international arbitration generally and ICSID arbitration in particular.[7]

Unlike the prior period, this period unfolded without the checks and balances ordinarily provided by serious political or legal debate between opposing ideological positions. Private interests from the more advanced economies, supported by their governments, were not met with the same resistance previously encountered from host countries, as the latter were generally aligned in ideology with the former. Simply put, the prevailing view was that privatization was good and state control over industry was bad—let the market work its magic and everyone will benefit. From a legal perspective, this ideology was fortified by an absolutist view of the principle of *pacta sunt servanda* (sanctity of contracts).

In this atmosphere, an entirely new body of international law began to develop through the interpretation of investment treaties embodying ambiguous and malleable concepts such as "fair and equitable treatment." These concepts have been developed in international arbitrations conducted pursuant to the treaties' arbitration provisions by arbitrators who had begun to resemble a club, and in this club, not too many members seemed to espouse the views that had been popular in the 1970s. By and large, the treaty interpretations tended to expand the scope of investor protection and restrict the ability of states to exercise the regulatory authority without incurring liability, a state of affairs that has led states with a renewed appetite for exercising that authority to look unfavorably upon international arbitration.

As disturbing as some of the pro-investor treaty interpretations has been the manner in which the treaties have opened the door to blatant and sometimes comical forum-shopping. Investors have little if anything to do with the contracting states were nevertheless invited to structure their investments through them to take advantage of treaty benefits. Thus, for example, companies from the United States to China were transformed into Dutch companies in an effort to take advantage of the network of bilateral investment treaties that Holland had concluded.[8] Such maneuvering was hardly noticed by states at first, but became a source of deep annoyance when disputes arose. States were being subjected to international arbitration under treaties whose substantive provisions had been stretched beyond their original intent and whose protections were being extended by some tribunals to a broad universe of potential investors.

In the last few years, the pendulum has begun to swing back as many countries have grown disillusioned with the privatizations of the 1990s. The forecasted benefits did not materialize—or, as importantly, the perception was that they did not materialize. A new wave of nationalizations has ensued, bringing back the natural competition in ideas that had previously existed and been absent for a prolonged period. However, these changes run counter to the thinking which has been developed in some circles for more than a decade, propagated in seminars and legal publications around the world, and reflected in a number of arbitral awards.

Apart from the perceived hostile environment, many states that are back in the business of exercising sovereignty over their natural resources and industries have found themselves at a distinct disadvantage in international arbitration for a number of other reasons that seem almost trivial but nonetheless are of considerable importance. First, states are almost always the defendants in investment cases, meaning that the timing of commencement of the arbitration is dictated by the private investor, which as a practical matter can take the time necessary to prepare its case. No matter how much the state prepares—and often it does not prepare much—it is not the same as being faced with the actual request for arbitration.

Second, the state must choose counsel. If it is not advised by counsel in anticipation of arbitration, this can mean selecting new counsel, often through required bidding processes wholly unsuitable for the purpose. The selected counsel may be unfamiliar with the facts of the case, with the state itself, with the legal principles at issue and even with the arbitral process, particularly if the state is required to select the lowest bidder in a bidding process. Defense counsel chosen in this manner is forced to analyze the case, carry out the necessary factual investigation and legal research, navigate the state's formal internal procedures and formulate a response all in a relatively short period of time. These are problems that no private investor has to face and that can have a material impact on the defense in the critical initial phase. Getting off on the wrong foot is not sound strategy for any litigant, and that is exactly what too often happens to defendant states unprepared for this international forum.

Third, the state has to choose an arbitrator. This crucial part of the case frequently puts states at a real disadvantage, especially when combined with the factors noted above. Many arbitrators are or have been associated with private investors or their law firms, some with track records evincing support for the expansive, pro-investor legal theories referred to above, others associated with firms that actively solicit arbitration work from investors and even encourage them to bring claims against states in arbitration. The problem is exacerbated by the fact that states, which invariably are up against the clock in selecting an arbitrator, often lack the experience to make an appropriate selection for party-appointed arbitrator.[9] Even if they do not suffer from this handicap, they still feel disadvantaged when it comes to appointment of a third arbitrator to act as president of a tribunal.

Finally, it should be noted that all of these issues are now being viewed in a different light due to the sheer size of some of the disputes in this new era in investor / state relations. There was a time when a fifty million dollar case was a big one. It is not uncommon these days to see claims many times that amount. The notion that such "megaclaims" can be decided by three arbitrators selected under the circumstances described above, or by one, simply does not sit well with states that are no longer convinced that anything favoring private investors must necessarily be in the public interest.

None of the above should be taken as an argument for or against any particular school of political or legal thought. Nor should it be taken as a commentary on the actual fairness of the international arbitral process or particular arbitrators, many of whom are very distinguished international lawyers. It is also true that it may be impossible to overcome the perception of unfairness in a system in which sensitive matters of sovereignty and national policy are placed before arbitrators holding no office recognized by the states concerned. Nevertheless, it is time to recognize that there is a perception of unfairness which can no longer simply be ignored. If the perception persists, it is to be expected that more states will withdraw from investment treaties and from ICSID, and more will simply refuse to agree to any international arbitration.

Endnotes

1. Bolivia, Ecuador and Venezuela are examples of this. Bolivia withdrew from the ICSID Convention with effect last November. On 4 December 2007, Ecuador notified ICSID, pursuant to Article 25(4) of the ICSID Convention, that it would not consent to submit disputes related to natural resources to ICSID arbitration. This past April, Venezuela gave notice of termination of its bilateral investment treaty with The Netherlands.
2. This article deals specifically with investor / state arbitration, which, unlike ordinary commercial arbitration, tends to involve sensitive issues of sovereignty and national policy. The line can sometimes be difficult to draw, with the result that the hostility of some states and state companies to international arbitration can spill over to non-investment disputes.
3. The General Assembly first declared the right of nations to permanent sovereignty over their natural wealth and resources in 1962. G.A. Res. 1803 (XVII), 17 UN GAOR supp. (No. 17)) at 15, U.N. Doc. A / 5217 (1962). In 1974, the General Assembly passed the Charger of Economic Rights and Duties of States, G.A. Res. 3281 (XXIX), U.N. Doc. A / 29 / 3281 (1974), expressly reaffirming that every State has and shall freely exercise full permanent sovereignty, including possession, use and disposal, over all its wealth, natural resources and economic activities; the right to regulate and exercise authority over foreign investment within its national jurisdiction in accordance with laws and regulations and in conformity with its national objectives and priorities; and the right to nationalize, expropriate or transfer ownership of foreign property, in which case appropriate compensation should be

paid by the State adopting such measures, taking into account its relevant laws and regulations and all circumstances that the State considers pertinent.

4. In the United States, even though the "restrictive theory" of sovereign immunity had been adopted in 1952 (letter of Jack B. Tate, Acting Legal Advisor, Department of State, to Acting Attorney General Philip B. Perlman, 19 May 1952, *reprinted in* 26 Dep't State Bull. 984 (1952)), its application remained uncertain and subject to "suggestions of immunity" by the State Department. In addition, immunity from execution remained absolute. The Foreign Sovereign Immunities Act of 1976, 28 U.S.C. § 1601 *et seq.*, began the change, codifying the restrictive theory of immunity from suit and relaxing somewhat immunity from execution, although the latter immunity remains broader than the former.

5. By the end of the 1970s, only 170 bilateral investment treaties had been concluded, of which only 136 had entered into force. RUDOLF DOLZER & MARGRETE STEVENS, BILATERAL INVESTMENT TREATIES 267-271 (1995).

6. As of the end of 2005, around 2500 bilateral investment treaties were in force. U.N. CONFERENCE ON TRADE AND DEVELOPMENT, WORLD INVESTMENT REPORT 2006, at 26.

7. Typically, investment treaties provide for ICSID arbitration, as does the 2004 U.S. Model BIT (Article 24). The number of ICSID decisions is now approaching three hundred.

8. See the press reports (*e.g., Venezuela to renegotiate Dutch investment treaty*, Reuters, 1 May 2008) of the public criticism of this practice by Venezuela's Minister of Energy and Petroleum.

9. In arbitrations conducted under the Rules of Arbitration of the International Chamber of Commerce ("ICC"), the defendant must appoint an arbitrator in its Answer to the Request for Arbitration, which must be filed within thirty days after the Request (Article 5(1)(d) of the ICC Rules of Arbitration). Extensions may be obtained for filing the Answer, but not for naming the arbitrator (Article 5(2) of the ICC Rules of Arbitration. That is simply not enough time for a state to make a proper selection, particularly in an important case. The ICSID time periods are more generous. In ICSID cases, where the parties do not agree upon the number of arbitrators and the method of their appointment, either party can invoke Article 37(2)(b) of the ICSID Convention at any time sixty days after the registration of the Request for Arbitration, to apply the default method (Rule 2(3) of the ICSID Arbitration Rules). If the Tribunal is not constituted within ninety days after notice of registration of the Request for Arbitration, ICSID will, at the request of either party and after consulting both parties as far as possible, appoint the arbitrator or arbitrators not yet appointed (Article 38 of the ICSID Convention).

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