Foreign Corrupt Practices Act

WILMERHALE

SEC Settlement Announced for Violations of FCPA Accounting Provisions by a Subsidiary of Oil States International, Inc.

On April 27, 2006, the Securities and Exchange Commission (SEC) announced the settlement of an investigation into improper payments made by a Venezuelan branch office of a subsidiary of Oil States International, Inc. (Oil States), a Houston-based oil drilling services provider, to employees of a state-owned Venezuelan energy company. Oil States is alleged to have committed civil violations of the accounting provisions of the Foreign Corrupt Practices Act (FCPA). According to the SEC release,[1] employees in the eastern Venezuelan branch office of the Oil States subsidiary, Hydraulic Well Control, LLC (HWC), took part in a kickback scheme and made improper payments through a local consultant to three employees of Petroleos de Venezuela, S.A. (PdV) that, in the SEC's view, violated the FCPA's accounting provisions.

The factual allegations contained in the SEC's papers highlight several common issues in today's FCPA enforcement environment, including: (a) the inclusion of employees of state-owned enterprises in the category of "foreign officials" covered by the FCPA; (b) the SEC's continuing emphasis on the need for companies to implement robust internal controls and compliance programs that extend to their subsidiaries; and (c) the fact that FCPA concerns are not limited to the contracting, sales or procurement processes notwithstanding the facially more narrow phrase "retain or obtain business." Moreover, it is notable that the terms of the SEC settlement merely involve an administrative cease-and-desist order—without the imposition of fines or "disgorgement," confirming that the SEC is willing to give substantial "credit" for cooperation, voluntary disclosure and strong remedial actions by companies at least in certain circumstances.

The FCPA's Accounting and Antibribery Provisions

The FCPA accounting provisions require "issuers," i.e., companies with securities listed in the US trading markets, to keep books, records and accounts that accurately and fairly reflect any transaction and disposition of corporate assets in reasonable detail. Those provisions further require covered companies to maintain an adequate system of internal accounting controls. 15 U.S.C. § 78m(b). An issuer is responsible for ensuring that its controlled subsidiaries and branch offices that are not separately incorporated, including foreign subsidiaries and branches, comply with the FCPA's requirements.

The FCPA antibribery provisions make it unlawful for any issuer, domestic concern or person acting within the United States to offer or make a payment of anything of value directly or indirectly to a foreign official, international organization official, political party or party official, or any candidate for public office, for the purpose of influencing that official to assist in obtaining or retaining business. 15 U.S.C. § 78dd-1 to -3. A covered company can be held liable for payments made on its behalf by agents or distributors.

The Oil States Investigation

HWC's Venezuelan branch office provided PdV with operational services on specially designed oil drilling rigs and other services at oil well sites. According to the SEC's papers, HWC retained a Venezuelan consultant in connection with its work for PdV in 2000 but did not conduct any due diligence investigation into the consultant's background. The consultant provided translation services and assisted HWC with preparing and submitting invoices to PdV; but, according to the SEC's papers, the consultant did not solicit business on behalf of HWC. HWC's contract with the consultant did not contain any clause that required the consultant to comply with the FCPA or other applicable US laws; nor did HWC provide any FCPA compliance training to the consultant.

The SEC's papers allege that in December 2003 three PdV employees, who had the ability to stop or delay HWC's work for PdV, asked the Venezuelan consultant to take part in a kickback scheme involving HWC and the consultant. Three employees in HWC's Venezuelan branch office were apprised

of the demand by the consultant and agreed to facilitate the scheme, which initially consisted of the submission of inflated invoices to HWC by the consultant, who kicked back the excess amount to the PdV employees, and of HWC's improperly billing PdV for "lost rig time" in order to cover the additional consultancy costs. Subsequently, the consultant and the HWC employees facilitated additional kickbacks to the PdV employees, billing those to PdV under the guise of costs for a chemical compound known as "gel." Between December 2003 and November 2004, according to the SEC, HWC paid over $348,000 to the PdV employees through the consultant.

The SEC's papers also allege that HWC's management in the United States had an opportunity to discover the improper payments in August 2004, when a senior finance officer took note of an increase in contract labor costs, including consultancy fees, in the Venezuelan branch office. However, because the finance officer accepted the local controller's explanation that those costs were "gel-related" and did not make further follow-up inquiries, the issue was not investigated fully. Rather, the improper payments were not discovered until the following year, when, as part of the annual budgeting process, HWC's senior management made inquiries upon noticing narrower profit margins in the Venezuelan branch office. Upon learning of the kickback scheme, HWC's senior management reported the issue to Oil States' audit committee.

The Oil States audit committee initiated an internal investigation. Oil States also terminated the contract with the Venezuelan consultant, disciplined the responsible employees, corrected the relevant books and records, improved its FCPA compliance programs and voluntarily reimbursed PdV for inflated billings. Further, upon concluding its internal investigation, Oil States voluntarily provided the report of that investigation to the SEC and to the Department of Justice.

In its papers, the SEC noted that, despite having certain FCPA-related corporate policies on paper, HWC lacked a robust compliance and internal controls program in Venezuela and that, after having taken note of a suspicious increase in consultancy costs in August 2004, the HWC finance department failed to follow up and prevent further improper payments. Based on those facts, the SEC alleged that HWC and Oil States violated the internal controls, as well as the books and records, requirements of the FCPA accounting provisions. In evaluating the appropriate penalty, the SEC acknowledged the extent of Oil States' cooperation, voluntary disclosures and remedial efforts. Instead of requiring Oil States to pay fines or "disgorgement," the SEC settled the matter solely with a cease-and-desist order.

Significant Issues Highlighted by the Oil States SEC Settlement

Employees of State-owned Enterprises Are "Foreign Officials" for Purpose of the FCPA

Once again, the Oil States SEC settlement illustrates the government's position that employees of state-owned enterprises, like government-controlled oil companies (as in this case) or government hospitals (as in other recent FCPA cases), qualify as "foreign officials" within the meaning of the FCPA and must be treated with the same caution as any other foreign official. (See WilmerHale Foreign Corrupt Practices Act Update of October 25, 2005, for discussions of the Diagnostic Products Corp. case involving allegations of improper payments to employees at state-owned hospitals in the People's Republic of China.)

FCPA Problems Can Arise Outside of the Contracting, Sales or Procurement Processes

According to the SEC's papers, the consultant for HWC was not tasked with soliciting businesses on behalf of HWC. This highlights the fact that concerns with potential FCPA violations are not limited to the contracting, sales or procurement processes, nor to dealing with foreign officials or employees of state-owned enterprises primarily responsible for purchasing or procurement decisions. Because the FCPA's antibribery and accounting provisions address improper payments made to obtain or **retain** business, FCPA concerns can arise whenever dealing, directly or indirectly, with a foreign official or employee of a state-owned enterprise "capable of stopping or delaying" an existing business relationship.

The Need for Companies to Assert Effective Control Over Subsidiaries

Although all the allegations in the SEC's papers pertain to misconduct or oversight by HWC employees or the lack of adequate internal controls at HWC, those alleged violations nonetheless are attributed to Oil States, the parent company. This again highlights the SEC's emphasis on the need for companies to implement effective controls that are applicable to their controlled subsidiaries, both domestic and overseas, to prevent improper payments in violation of the FCPA.

The Oil States SEC settlement also illustrates the importance the SEC attaches to the existence of adequate internal controls and compliance programs—in practice as well as

on paper. The SEC specifically noted that HWC had failed to conduct due diligence on the background of its Venezuelan consultant, failed to provide FCPA compliance training, and failed to include FCPA compliance clauses in the consultancy contract. The SEC also noted the failure of a senior finance officer at HWC to investigate fully the circumstances behind an increase in consultancy costs in Venezuela. The SEC's emphasis on those facts suggests that a parent company is responsible for ensuring the existence of both a system of "living, breathing" FCPA compliance programs at its subsidiaries to prevent improper payments and of strong financial controls to detect such payments once made.

The Oil States Settlement Illustrates the Application of the SEC's Statement Concerning Financial Penalties to the FCPA Context

The settlement represents the first time that the SEC's January 4, 2006, Statement Concerning Financial Penalties (the Financial Penalties Statement) has been applied clearly in the FCPA context. In the Statement, the SEC sought to describe, with the "maximum possible degree of clarity, consistency and predictability," a framework for the exercise of its authority to impose financial penalties on companies accused of wrongdoing. Specifically, the SEC identified two principal considerations and a number of additional considerations relevant to assessing the appropriateness of financial penalties.

The two principal considerations are whether a company has received a direct benefit as a result of a violation and whether a financial penalty will recompense or harm the injured shareholders. The additional considerations include: the need to deter and the difficulty to detect the particular type of offense, the extent of injury to innocent parties, the degree of complicity in the company, the level of intent of the perpetrators, the remedial efforts made by the company, and the extent of a company's voluntary cooperation with the SEC and other government agencies.

The SEC's papers in the Oil States case identify several factors relevant under the framework set forth in the Financial Penalties Statement, which may explain the lack of a fine or "disgorgement" in this case, despite its prevalence in other recent FCPA cases. First, because the kickback scheme alleged did not result in any additional business to HWC, it appears that Oil States did not derive any financial benefit from the improper payments. Second, although HWC initially improperly charged PvD to cover the kickback payments, Oil States had, as part of its remedial efforts, reimbursed PvD for those charges. Third, Oil States also voluntarily strengthened its compliance program and corrected its books and records. Finally, Oil States cooperated with the government by voluntarily disclosing the report of its internal investigation.

Significantly, the last three factors all involve voluntary remedial steps taken by Oil States after the discovery of the improper payments. This highlights the importance of cooperation and voluntary remediation by companies facing FCPA investigations, although the amount of "credit" to be "earned" as the result of cooperation and remediation often is uncertain. (See WilmerHale Foreign Corrupt Practices Act Update of October 25, 2005, for further discussion of the issue of effects of voluntary cooperation.)

Practical Advice

US companies and foreign companies that do business in the United States, or whose shares are traded on US exchanges, should seek to implement a comprehensive FCPA compliance program and to apply that program to their controlled subsidiaries. As a practical matter, the following lessons can be drawn from the Oil States SEC settlement:

- Companies with significant business dealings in countries with command economies or involved with natural resources and other industries that often are nationalized should exercise particular care to ensure that payments to employees or officers are not prohibited under the FCPA because those persons work for a state-owned enterprise.
- Companies must proactively ensure the existence of adequate FCPA compliance programs, both on paper and in practice, for their controlled subsidiaries. In addition to official policies, components of an effective FCPA compliance regime, at a minimum, consist of:
  - Assigning FCPA compliance responsibility to appropriate senior managers, especially in high-risk regions of the world;
  - Providing regular training concerning the requirements of the FCPA to agents, consultants, joint venture partners and even distributors, as well as officers and employees;
  - Establishing a system by which officers, employees, agents, consultants, joint venture partners and distributors can report suspected violations without fear of retribution;
  - Requiring a searching due diligence inquiry process whose results are memorialized, to ensure that the

company forms business relationships only with reputable agents, consultants, joint venture partners and distributors; and

- Including, in all contracts with agents, consultants, joint venture partners and distributors, warranties that no payments of money or anything of value will be offered, promised or paid, directly or indirectly, to any foreign official, foreign political party, party official, or candidate for foreign public or political office to induce such officials to use their influence with a foreign government or instrumentality to obtain or retain an improper business advantage for the company.

- Companies also must encourage the finance or internal controls staff at both the parent company level and the subsidiaries level to investigate suspicious fluctuations in consultancy fees and similar expenses relevant to FCPA compliance and not to rely on vague or general explanations.

- In deciding how to dispose of a case, the SEC likely will analyze the relevant facts within the framework set forth in the Financial Penalties Statement and will continue to give credit to companies that voluntarily made effective remedial efforts, volunteered information and cooperated in the conduct of an internal investigation in ways that make the investigation transparent to the government agencies and shed light on the factual record. To avoid financial penalties, companies also should consider providing voluntary reimbursements to third parties to compensate losses those parties sustained in connection with the alleged FCPA violation.

For a fuller discussion of these and other FCPA issues, see Roger M. Witten and Kimberly A. Parker, *Complying with the Foreign Corrupt Practices Act* (Matthew Bender, 5th ed. 2005).

NOTES

1. *See* Exchange Act Release No. 53732, Accounting and Auditing Release No. 2424, available at: http://sec.gov/litigation/admin/2006/34-53732.pdf.

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