

## The Foreign Corrupt Practices Act: A '70s Revival?

The Foreign Corrupt Practices Act (FCPA) – a venerable statute from the 1970s – is going through a 21<sup>st</sup> Century revival, spelling bad news not just for companies active in the global economy, but also for their directors, officers and employees. FCPA enforcement activity is at historically high levels, which poses a regulatory and operational concern for all companies with overseas operations. It also presents a growing source of potential liability in the form of follow-on civil litigation. This article reviews the reasons behind the revival and its extent, surveys the growing civil litigation activity, and examines the D&O insurance implications.

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### Background

The Foreign Corrupt Practices Act of 1977 is a federal law containing anti-bribery and accounting requirements. The anti-bribery provisions make it unlawful for any U.S. person (and certain foreign issuers) to make a payment to a foreign official for the purpose of obtaining or retaining business for, or with, or directing business to, any person. The FCPA (as amended) also added accounting requirements – known as the ‘books and records’ provisions – to the Securities and Exchange Act of 1934. These accounting provisions require publicly-traded companies to maintain records that accurately and fairly represent the company’s transactions. Furthermore, these provisions require companies to have an adequate system of internal accounting controls.

Under the FCPA anti-bribery provision, corporations are subject to fines of up to \$2 million. Directors, officers, employees and agents are subject to fines of up to \$100,000 and as many as five years’ imprisonment. However, as a result of the Sarbanes-Oxley Act’s (SOX) expansion of criminal penalties for willful violations of the ‘34 Act, violation of the FCPA’s accounting requirements subject corporations to fines of up to \$25 million. Individuals face fines of up to \$5 million and as many as 20 years’ imprisonment.

In recent years, a host of companies have become enmeshed in FCPA enforcement proceedings, a trend that became even more pronounced in 2007. According to a recent memorandum from the Fenwick & West law firm, 2007 was a “watershed year for FCPA enforcement.”<sup>1</sup> The memorandum specifically notes that in 2007, the number of enforcement

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actions brought by the Department of Justice (DOJ) and the Securities Exchange Commission (SEC) “doubled compared with the number brought in 2006.” In addition, during 2007, the DOJ and the SEC imposed the largest combined civil and criminal fines in history against a single company – \$34 million in fines imposed against Baker Hughes and its subsidiaries.

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There are a number of important trends driving this increased FCPA enforcement activity. Obviously, the trend toward the globalization of business activity provides an important context, but globalization alone does not explain the increased level of enforcement. The specific factors driving the enforcement activity include the following trends and patterns:

First, the increase in FCPA enforcement activity is a byproduct of SOX’s requirements that senior company management assess their companies’ internal controls and verify their financial statements. These requirements for increased management scrutiny are leading to the identification of FCPA concerns. Management, aware that their company may avoid prosecution or obtain more lenient treatment if it cooperates with authorities, has a significant incentive to self-report. Companies are choosing to voluntarily disclose FCPA violations in an attempt to receive favorable treatment and avoid harsher penalties. The increased internal scrutiny triggered by SOX and resulting rise in self-reporting has led to a substantial increase in the number of FCPA investigations and enforcement proceedings.

Second, the DOJ and the SEC have developed a practice of targeting specific industries for FCPA violations, through industry-wide investigations. For example, a recent memorandum from the Sidley and Austin law firm noted that authorities have targeted the “sales and marketing practices of companies in the medical device industry in Europe.”<sup>2</sup>

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A memorandum from the Jenner & Block law firm also cites the recent enforcement actions involving the “companies participating in the U.N. Iraq Oil for Food Program.”<sup>3</sup> The Fenwick & West memo cited above also notes that the FCPA is now “being actively enforced against technology companies.”

Third, the authorities have targeted companies doing business in countries where bribery is believed to be part of the local business culture. The Jenner & Block memo notes that authorities have “continued to press enforcement as to companies doing business in Nigeria.” Business activities in China have also drawn scrutiny, which is certainly a challenge given that many companies are finding it indispensable to have a strategy for growing their business in China.

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Fourth, the U.S. authorities have shown an increased willingness to cooperate with foreign governments in joint investigations, even, the Jenner & Block memo notes, “where the target companies are already the subject of law enforcement investigation or sanction in their home country.” Two prominent examples of cross-border investigations included the recent investigations involving Siemens and BAE Systems.

Fifth, increased M&A activity has led to the discovery and disclosure of a number of FCPA violations. The Sidley & Austin memo notes that “acquisition due diligence is an essential program, and the failure to adequately assess potential liabilities can result in serious consequences.” The Fenwick & West memorandum notes that “FCPA issues can be a major sticking point in negotiations with the acquiring party, often causing delay of the deal or a change in price terms.”

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Finally, as a result of changing priorities and increased resources, the authorities are not dependent on self-reporting alone as the means by which FCPA violations are identified. As the Jenner & Block memorandum notes, “the Government is increasingly interested in developing cases affirmatively, without relying on disclosures.” Both the DOJ and the SEC have increased their staffing in this area, and the agencies have repeatedly said publicly that they will be more “proactive.”

### The FCPA and Civil Litigation

There is no private right of action under the FCPA, and as such, shareholders and other litigants are unable to sue companies and their managers directly for FCPA violations. Notwithstanding the absence of a direct right of action in the FCPA itself,

shareholders and other litigants have pursued claims based on FCPA violations, in the form of follow-on civil lawsuits.

These follow-on civil lawsuits generally have taken two forms, either as a securities class action lawsuit filed by company shareholders or in the form of a shareholders' derivative lawsuit filed on behalf of the company itself.

Several recent securities class action lawsuits have included allegations pertaining to a company's involvement in an FCPA investigation:

- Willbros agreed to pay \$10.5 million to settle a class action lawsuit alleging that the company was forced to restate several years of financial statements and to establish a reserve to accrue for possible fines and penalties for FCPA violations.
- Immuncor agreed to pay \$2.5 million to settle claims that the company and certain of its directors and officers misled investors into an overly optimistic assessment of the extent of the company's corrupt business practices and the strength of the company's internal controls.
- Nature's Sunshine Products remains involved in a securities lawsuit in which the plaintiffs allege that the company lacked internal controls and that financial statements were materially misstated due to its failure to properly account for foreign transactions.

In the follow-on shareholders' derivative lawsuits, the plaintiffs allege that the company was harmed as a result of the defendants' failure to have appropriate safeguards in place or to appropriately supervise company practices. Several prominent FCPA investigations that have resulted in follow-on shareholders' derivative lawsuits include Siemens, BEA Systems and Baker Hughes. The filing of a derivative lawsuit is now a frequent accompaniment of a company's involvement in an FCPA enforcement proceeding.

A more recent development has been the emergence of civil litigation arising from alleged corrupt activities where no formal investigation preceded the lawsuit. For example, a Bahraini company filed a lawsuit against Alcoa, an Alcoa affiliate and two individuals, alleging that the defendants engaged in a 15-year bribery conspiracy involving a Bahraini government official. The company seeks to recover damages based on alleged violations of the Racketeer Influenced and Corrupt Organizations Act (RICO), conspiracy to violate RICO, and for fraud.

In addition, and based on essentially the same alleged circumstances, an Alcoa shareholder initiated a derivative lawsuit against the company as a nominal defendant, and against twenty of its current and former directors and officers, alleging breach of fiduciary duty, abuse of control, corporate waste and unjust enrichment.

Yet another kind of litigation involves claims by companies that lose bids to those competing companies who have allegedly offered bribes in order to secure the business.<sup>4</sup> In this particular type of lawsuit, the disappointed bidders bring private lawsuits against the corrupt company that was awarded the contract. The losing bidders seek to recover lost profits and costs that were wasted in the bidding process. Plaintiffs have brought these kinds of claims under federal and state antitrust laws, RICO, and state common law causes of action such as intentional interference with contract and unjust competition.

A final important consideration in connection with the emerging FCPA-driven litigation is that many of these cases (e.g., the derivative lawsuits against BAE Systems and Alcoa) were brought by leading plaintiffs' securities law firms.

The proliferation of this type of litigation activity and the significant involvement of the leading plaintiffs' firms suggests that this category of emerging litigation may represent an increasingly important area of potential liability to directors and officers and thus presents a number of important D&O insurance considerations.

### D&O Insurance Issues

*1. The Commissions Exclusion* – A coverage concern in connection with proceedings based on allegedly corrupt activities, either in the form of an enforcement proceeding or of a civil lawsuit, is whether the applicable D&O policy contains a so-called 'commissions exclusion.' The commissions exclusion, as typically worded, precludes coverage for loss incurred in connection with any claim "alleging, arising out of, based upon or attributable to payments, commissions, gratuities, benefits or any other factors to or for the benefit of" an agent or employee of any foreign government.

The commissions exclusion had been a standard part of the D&O policy in the years shortly after the FCPA was enacted. It has become relatively unusual in more recent years. In addition, D&O underwriters typically will agree to remove the exclusion upon the policyholders' completion of a questionnaire.

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The exclusion is obviously highly undesirable from the policyholders' perspective, given the exclusion's breadth and the growing importance of FCPA enforcement proceedings and related civil litigation. Fortunately, the commissions exclusion remains relatively unusual.

The discussion below regarding potential coverage for claims arising from allegations of corrupt activities assumes that the relevant policy does not contain a commissions exclusion.

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*2. Fines and Penalties* – The potential consequences arising directly from an FCPA enforcement proceeding are outside the scope of the typical D&O policy's coverage. The fines and penalties for which a company would be liable in an FCPA enforcement proceeding would fall outside of the definition of covered 'Loss' in most D&O policies.

There are some policy forms available in the marketplace that do specifically include coverage for certain kinds of FCPA civil penalties awarded against officers, directors or employees of a company, but only in connection with FCPA violations that are not willful and only in connection with FCPA penalties awarded as part of a securities claim within the policy's definition (typically, in connection with a books and records violation). Outside of this limited exception in some policies, there would not be coverage under most policies for FCPA fines and penalties.

*3. Defense Expense Coverage for Enforcement Proceedings* – However, there could potentially be coverage available for individual directors and officers under many D&O insurance policies for the costs of defending against an FCPA enforcement proceeding, depending on the definition of the term 'Claim' in the applicable policy. Defense costs coverage could be available, at least for expenses incurred after the investigation becomes formal, and to the extent that one of the policy's exclusions has not been triggered.

Because coverage for the company itself (so-called 'entity coverage') typically is limited to securities claims, there would be coverage under most public company D&O policies for defense expenses incurred in connection with an FCPA enforcement action against the company itself only to the extent that the proceeding involves a securities claim.

*To the extent the claims against the entity are based on RICO or other legal theories, the typical D&O policy would not provide coverage for the entity.*

Thus, for example, a company would have grounds on which to seek coverage for defense expense to the extent an FCPA enforcement proceeding involves an alleged books and records violation and the regulatory proceeding otherwise meets the policy's definition of the term 'Claim'.

*4. Follow-on Litigation Coverage Issues* – The extent of coverage available for follow-on civil litigation and other private lawsuits arising from alleged corrupt activities depends both on the nature of the claims asserted, the target of the claims, and the wording of the applicable policy.

Under the typical public company D&O liability insurance policy, coverage for the corporate entity itself is available for securities claims. Thus, there would be coverage for the entity under most policies for follow-on securities class action lawsuits, subject to all of the policies other terms and conditions. But to the extent the claims against the entity are based on RICO or other legal theories, the typical public company D&O policy would not provide coverage for the entity.

For the individual director and officer defendants, the typical D&O policy would provide coverage for most of the kinds of claims asserted in the follow-on civil litigation, subject to the policy's other terms and conditions. The so-called 'conduct exclusions', particularly the fraud and dishonesty exclusion, potentially could be involved, but those exclusions typically are triggered only if there has been an adjudication of excluded conduct. Obviously, if the civil action follows an adjudication that a specific individual actually engaged in corrupt activities, the fraud and dishonesty exclusion could present a potentially significant impediment to coverage for that individuals.

For corporate employees who are not officers and directors but who are named as a defendant in a follow-on civil lawsuit, the available coverage under the typical D&O policy would depend on the nature of the allegations. Most public company D&O policies provide employee coverage in connection with securities claims, but follow-on claims against employees based on other theories may not be covered under the typical policy. Any coverage that is available for employees would also be subject to the policy's other terms and conditions, including the fraud and dishonesty exclusion.

Given the nature of the allegations, a civil lawsuit based on allegations of corrupt activity potentially raises a multitude of other issues under the policy beyond the conduct exclusions. Many other policy provisions potentially could be relevant, including in particular the definition of loss, the retention provisions, the cooperation provision, as well as numerous other provisions, depending on the specific circumstances involved.

### Conclusion

The emergence of claims arising from allegations of corrupt activity represents an important trend that presents potential liability for directors and officers. Whether or not FCPA-related activity represents the “next corporate scandal” as one of the law firm memos cited above suggests, it clearly is a significant development with important implications for the structure and content of companies’ D&O insurance programs. The complex interaction of these kinds of claims with the terms and provisions of the typical D&O insurance policy underscores the importance of the involvement of a skilled insurance professional in the D&O insurance acquisition process.

<sup>1</sup> Fenwick & West, *The Foreign Corrupt Practices Act: The Next Corporate Scandal?*, [http://www.fenwick.com/docstore/Publications/Litigation/sec/Sec\\_Litigation\\_Alert\\_01-28-08.pdf](http://www.fenwick.com/docstore/Publications/Litigation/sec/Sec_Litigation_Alert_01-28-08.pdf) (January 28, 2008).

<sup>2</sup> Sidley & Austin, FCPA Enforcement Trends During 2007 Signal Heightened Scrutiny and Continued Vigorous Enforcement, <http://www.sidley.com/files/News/ae695ce5-1ca8-45c3-a81c-65b480436147/Presentation/NewsAttachment/d0b3e8df-57fb-4202-82ae-7c7c24f4a29c/FCPAUpdate12508.pdf> (January 25, 2008)

<sup>3</sup> Jenner & Block, *Recent Enforcement Activity Under the Foreign Corrupt Practices Act*, [http://www.jenner.com/files/tbl\\_s20Publications/RelatedDocumentsPDFs1252/1977/Recent\\_Enforcement\\_Activity\\_Under\\_the\\_Foreign\\_Corrupt\\_Practices\\_Act\\_01\\_08.pdf](http://www.jenner.com/files/tbl_s20Publications/RelatedDocumentsPDFs1252/1977/Recent_Enforcement_Activity_Under_the_Foreign_Corrupt_Practices_Act_01_08.pdf) (January 24, 2008)

<sup>4</sup> See Edwards, Angell, Palmer & Dodge, *Suing Bribing Competitors: The Next Tool in the International Anti-Corruption Arsenal?* (May 2008)

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A version of this article previously appeared on The D&O Diary, the author's Internet weblog. You can access the blog via our website at [www.oakbridgeins.com](http://www.oakbridgeins.com). To monitor developments on this and other important topics relating to directors' and officers' liability, readers are encouraged to refer to The D&O Diary regularly.

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