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Drafting Foreign Corrupt Practices Act Compliance Provisions in Cross-Border Distribution Agreements

Contracting and Due Diligence Strategies to Mitigate FCPA/Anti-Corruption Exposure in International Distribution Relationships

WEDNESDAY, JANUARY 23, 2019

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Today's faculty features:

David A. Berman, Counsel, **Wilmer Cutler Pickering Hale and Dorr**, New York

Michael E. Burke, Partner, **Arnall Golden Gregory**, Washington, D.C.

Adam Munitz, Partner, **Fluet Huber + Hoang**, Tysons, Va.

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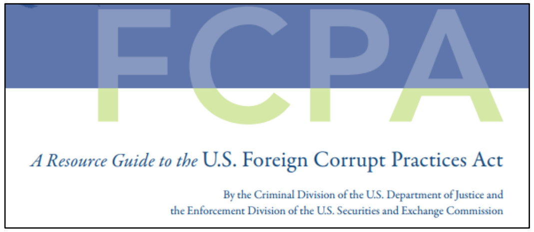
FCPA Compliance Considerations in Cross-Border Distributor Relationships

Legal Framework, Risks, and Representative FCPA Enforcement Actions

David A. Berman
Wilmer Cutler Pickering Hale and Dorr LLP

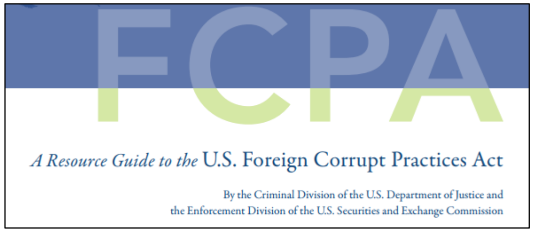
Third-Party Liability Under the FCPA

- The FCPA prohibits corrupt payments made through third parties or intermediaries.
- Companies and individuals may face liability for making payments to third parties "while knowing that all or a portion of such money or thing of value will be offered, given, or promised, directly or indirectly," to a foreign official in order to retain or obtain business. DOJ and SEC, A Resource Guide to the FCPA, p. 21 (2012) (internal citations omitted).



Third-Party Liability Under the FCPA (cont.)

- Third parties are a high risk area. The vast majority of FCPA enforcement actions have involved improper payments made through various kinds of intermediaries.
  - Both DOJ and SEC FCPA cases "demonstrate that third parties, including . . . distributors, are commonly used to conceal the payment of bribes to foreign officials in international business transactions." DOJ and SEC, A Resource Guide to the FCPA, p. 60 (2012).
  - In 2018, almost all FCPA corporate enforcement actions involved allegations of misconduct by third parties.



Third-Party Liability Under the FCPA (cont.)

— Third parties include:
- Sales agents
- Consultants
- Distributors
- Brokers
- Suppliers
- Finders
- Travel agents
- Advertising agencies
- Tax providers
- Lawyers
- Lobbyists
- Others

FCPA Risks in Distributor Relationships

- Unlike certain categories of third parties that are typically always high risk (*e.g.*, intermediaries that are true agents with power to bind the FCPA-covered entity contractually), distributors present varying levels of risk for companies under the FCPA.
- Not all distributor relationships are high risk.
  - For example, a wholesale distributor that receives a standard discount on goods (*i.e.*, not an unusually steep discount that would enable the distributor to pay bribes on top of maintaining a healthy profit margin) may be a lower risk third party, even when operating in a higher risk jurisdiction from a corruption perception perspective.

FCPA Risks in Distributor Relationships (cont.)

— That said, distributor relationships can present significant FCPA risks in certain situations. For example:

- Unusually Deep Discounts: If an FCPA-covered company sells goods to a distributor at an unusually deep discount while "knowing" that the distributor may use its enhanced profit margins to make a corrupt payment, the U.S. authorities could argue that the company gave something of value (the discounted goods) corruptly to the distributor while knowing that part of the distributor's margin would, directly or indirectly, be given to a foreign official for a prohibited purpose.
- Commissions: Due to local law or customer requirements, there are sometimes situations where the FCPA-covered company has to sell direct to the end customer, with the distributor then getting a "commission" from the seller. This may potentially lead to the distributor using a portion of the commission payment for an improper purpose. However, this risk is lower in situations where a distributor performs a valuable role in the transaction or if there is an exclusive relationship (*e.g.*, distributor is entitled to payment on all sales in a particular region).

The Knowledge Standard

— Although the general pattern of abuse of distributors can play out in nuanced ways, the risk under the FCPA is whether there is "***knowledge***" on the part of the FCPA-covered company of any potential wrongdoing by the distributor.

— "***Knowledge***" under the FCPA:

- The individual has ***actual knowledge***, meaning that person "is actually aware" of an improper payment;
- The individual ***"has a firm belief"*** that an improper payment will be made or such a result is "substantially certain" to occur; or
- The individual is aware of a ***"high probability"*** that an improper payment will be made.

Knowledge Standard (cont.)

— Broad definition:

- Not limited to ***actual*** knowledge
- ***"Head in the sand"*** is sufficient (if a person in the company consciously disregarded a "high probability" that a prohibited payment may occur)
- ***Willful blindness*** to circumstances—commonly known as "red flags"—which requires that a person must have consciously disregarded or consciously avoided red flags

— The willful blindness standard is intended to prevent individuals from escaping liability where they are aware of evidence highly suggestive that bribes may be paid but deliberately avoiding confirming their suspicions or learning the truth.

- Thus, even if a distributor takes possession and title of goods, the company may face FCPA liability if it either ***knew*** or ***ignored red flags*** that the distributor could make an improper payment.

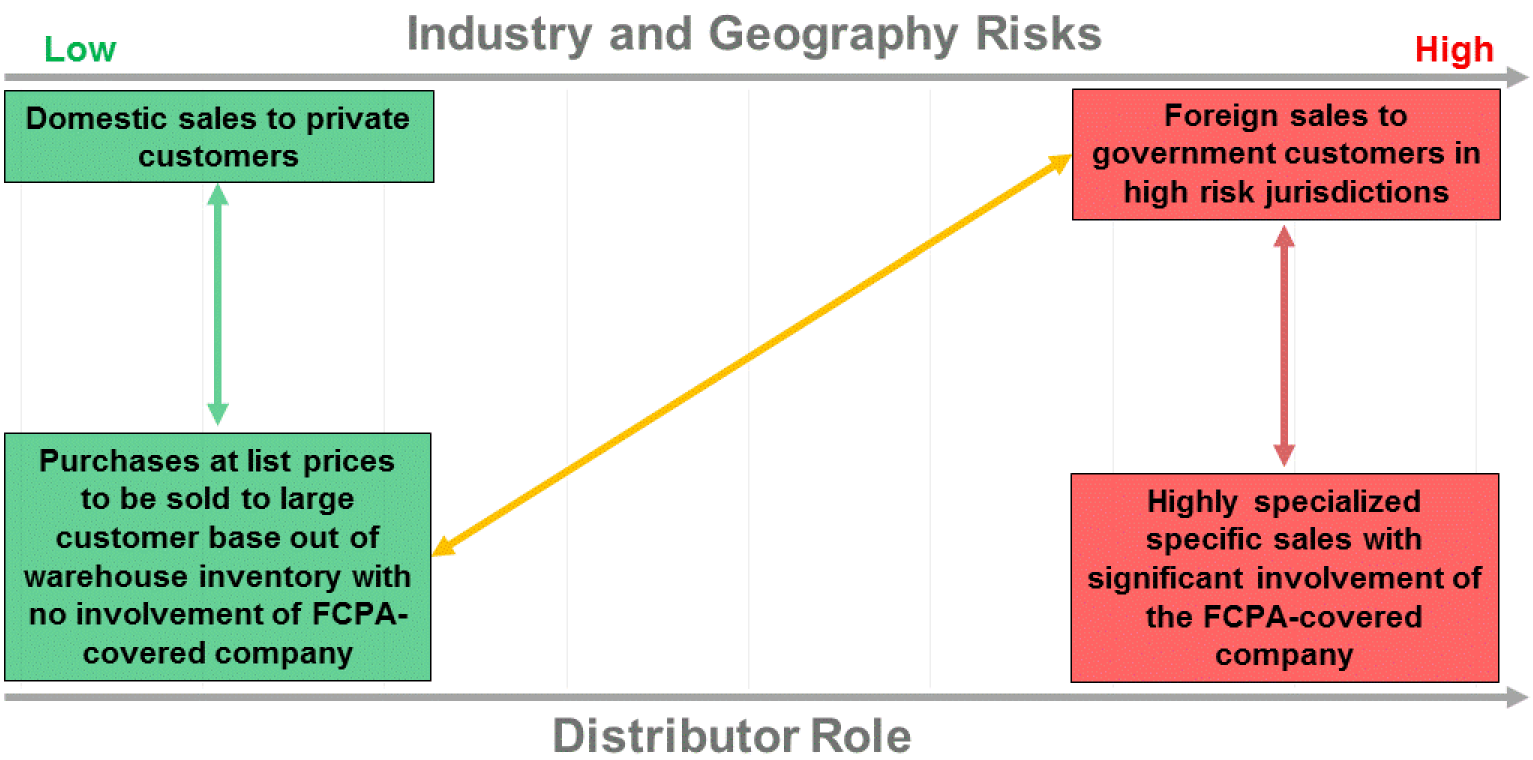
Red Flags in Distributer Relationships

- It is important to be vigilant and keep an eye out for red flags involving distributor relationships. Examples:
  - Provision of discounts or volume discounts that are unusually high for the market or beyond what is contractually required
  - Provision of funds to distributors under discount programs to create "slush funds"
  - Distributor suggests an unusual transaction structure (*e.g.*, company hiring a sub-contractor to provide many of the same services, such as installation or training, that a distributor would typically provide)
  - Distributor suggests hiring a sub-contractor at a foreign official's request
  - Distributor suggests hiring (or is) a recently incorporated company or one with little or no experience

Red Flags in Distributer Relationships (cont.)

— More examples of red flags:
  - Off-shore bank accounts established for transactions by distributor
  - Distributor or suggested sub-contractor are related or closely associated with foreign official(s) involved in the project at issue
  - Frequent and/or lavish entertaining by distributor
  - Distributor performs additional or unusual tasks such as obtaining permits, securing visas, clearing customs, etc.
  - Distributor receives "commissions" from seller in situations where seller sells direct to the end issuer and the distributor does not play a valuable role and/or there are no other legitimate circumstances justifying payment to the distributor

Risk Matrix


Industry and Geography Risks
Low
High
Domestic sales to private customers
Foreign sales to government customers in high risk jurisdictions
Purchases at list prices to be sold to large customer base out of warehouse inventory with no involvement of FCPA-covered company
Highly specialized specific sales with significant involvement of the FCPA-covered company
Distributor Role

Representative FCPA Enforcement Actions

— Polycom, Inc. ("Polycom") (2018)

- In December 2018, Polycom resolved a FCPA enforcement action by paying $16.3 million pursuant to an SEC administrative order and $20.3 million pursuant to a DOJ declination letter.
- Polycom's China subsidiary provided significant discounts to distributors, while knowing and intending that these discounts would be used to make payments to Chinese government officials in exchange for assistance obtaining orders for Polycom's voice and video communications equipment.

Representative FCPA Enforcement Actions

— Polycom (cont.)

- The scheme, orchestrated by Polycom's Vice President of China, involved the use of a separate, parallel sales management system outside of the company's official CRM. Sales personnel in China entered information about sales opportunities into the parallel system, including requests for discounts and explanations that discounts would be used to cover the cost of improper payments to government officials.
- Personnel outside of China were not aware of this separate system.

"…we promised to give [the government official] 60,000 RMB"
(Chinese sales system)

vs

"competition" with other communications products providers
(official company CRM)

Representative FCPA Enforcement Actions

— Polycom (cont.)

- The SEC faulted Polycom for internal controls failures relating to the approval of distributor discounts.

> 11. Product discounts up to a certain threshold could be approved unilaterally by Polycom China's senior managers. However, discounts above this threshold had to be approved by Singapore-based personnel who worked for another wholly-owned Polycom subsidiary. When these Singapore-based personnel sought information regarding the reasons for particular discounts, Polycom China's senior managers always cited legitimate concerns such as competition with other communications products providers or end-user budget constraints. Polycom China's senior managers never told the Singapore-based personnel that certain discounts were being used to fund improper payments to government officials.
>
> 12. During the relevant period, Polycom failed to devise and maintain adequate controls to detect whether any reasons for discounts entered in the centralized CRM database, or given to Polycom's Singapore-based personnel, were accurate. Accordingly, Polycom failed to devise and maintain sufficient accounting controls to detect whether Polycom China was using product discounts as a vehicle for funding improper payments to government officials.

Representative FCPA Enforcement Actions

— Polycom (cont.)

- The SEC also highlighted compliance weaknesses, such as Polycom's failure to translate anticorruption materials into Mandarin and to follow up with Polycom China personnel who did not participate in anticorruption trainings.

- Polycom also allegedly ignored a red flag in 2013 when a due diligence procedure uncovered allegations that one of its Chinese distributors had previously made an improper payment to a Chinese government official. Polycom did not finish the due diligence review and continued to work with the distributor.

Representative FCPA Enforcement Actions (cont.)

— Stryker Corp. (“Stryker”) (2018)

- In 2018, Stryker settled FCPA charges for violations of the books and records and internal accounting controls provisions of the FCPA for a second time. Stryker paid a $7.8 million civil penalty and will retain an independent compliance consultant.
- In **China**, the company’s subsidiary allegedly sold products through a distributor that re-sold them to sub-distributors. Stryker China did not vet, approve, or train at least 21 of these sub-distributors. Stryker China employees were aware that some of the sub-distributors were unauthorized, and falsified records to hide the sub-distributors’ involvement.

> trained by Stryker in accordance with its internal accounting controls. During that time, the sale of some Sonopet products to hospitals involved third, fourth, and even fifth tier sub-distributors, none of which were subjected to due diligence approval or training. Stryker China employees

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Representative FCPA Enforcement Actions (cont.)

— Stryker (cont.)

- Stryker's **Kuwait** business allegedly sold certain products to Kuwait's Ministry of Health through a primary distributor. From 2015 to 2017, this Kuwaiti distributor made over $32,000 in "per diem" payments to Kuwaiti health care providers to attend Stryker events even though Stryker had already covered the costs of these individuals.
  - Stryker failed to effectively exercise its audit rights over the Kuwait distributor and to implement other controls to assess whether the distributor was complying with Stryker's anticorruption policies.
- The SEC charged that internal controls failures "increase[ed] the risk of bribery and other improper payments."
  - The SEC did not allege that any improper payments to government officials were actually made.

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Representative FCPA Enforcement Actions (cont.)

— Sanofi (2018)

- In 2018, Sanofi settled FCPA charges with the SEC for violations of the books and records and internal accounting controls provisions of the FCPA. Sanofi paid $25.2 million in disgorgement and civil penalties.
- Among other conduct at issue ,the SEC alleged that senior managers at a Polycom subsidiary in Kazakhstan used local distributors to kick back monies to Sanofi employees, who then used the funds to pay bribes to government officials in exchange for awarding tenders to Sanofi.
- Monies for the bribe was generated by employees granting discounts of 20%-30% to distributors, a portion of which was used for improper payments. Employees referred to the kick backs internally as “marzipans” and tracked them on internal spreadsheets.
- At the time, Sanofi had not standardized policy for distributor discounts and did not review discounts.

SANOFI

Representative FCPA Enforcement Actions

— Mead Johnson Nutrition Company ("Mead Johnson") (2015)

- In 2015, Mead Johnson agreed to pay more than $12 million to settle SEC allegations of an improper payment scheme that its Chinese subsidiary effected using third-party distributors.
- Mead Johnson's Chinese subsidiary used distributors to market, sell, and distribute the company's products in China. It provided a discount on the products sold to distributors. The discount was allocated for a "Distributor Allowance," which was used by distributors for marketing and sales efforts on behalf of Mead Johnson's Chinese subsidiary.
- Although this Distributor Allowance contractually belonged to distributors, the SEC alleged that employees at Mead Johnson's Chinese subsidiary exercised some control over how money was spent and provided guidance to distributors regarding the use of the funds. They also maintained certain records related to how the distributors spent these funds.
- Cash and other incentives sourced from money in these funds were subsequently paid to healthcare professionals employed by Chinese state-owned hospitals to recommend Mead Johnson's products to patients.

Representative FCPA Enforcement Actions (cont.)

– **Bio-Rad Laboratories, Inc. (“Bio-Rad”) (2014)**

- In 2014, the SEC charged Bio-Rad with books and records and internal controls violations. Bio-Rad paid $40.7 million in disgorgement and prejudgment interest to the SEC.
- The charges were based in part on the fact that employees of Bio-Rad’s Singapore subsidiary sold products at a deep discount to **Vietnamese** distributors, who then resold the goods to government customers at full prices and passed through a portion of the discount as bribes to Vietnamese officials.
- The SEC alleged that Bio-Rad’s Singapore’s regional sales manager, the country manager and a finance employee had knowledge of the scheme. This included an email where the country manager proposed this distributor middleman solution to the regional sales manager and a finance employee as an alternative to the previously employed scheme where sales representative of the subsidiary made cash payments directly to Vietnamese officials.

Representative FCPA Enforcement Actions (cont.)

Facts in Vietnam

28. From 2005 through 2009, the country manager of the Vietnam office authorized the payment of bribes to government officials to obtain their business. At the direction of the country manager, the sales representatives made cash payments to officials at government-owned hospitals and laboratories in exchange for their agreement to buy Bio-Rad's products.

29. In 2006, the RSM first learned of this practice from a finance employee. She raised concerns about it to the Vietnam Office's country manager, who informed her that paying bribes was a customary practice in Vietnam. On or about May 18, 2006, the Vietnamese country manager wrote in an email to the RSM and the Bio-Rad Singapore finance employee that paying third party fees "[wa]s outlawed in the Bio-Rad Business Ethics Policy," but that Bio-Rad would lose 80% of its Vietnam sales without continuing the practice. In that same email, the country manager proposed a solution that entailed employing a middleman to pay the bribes to Vietnamese government officials as a means of insulating Bio-Rad from liability. Under the proposed scheme, Bio-Rad Singapore would sell Bio-Rad products to a Vietnamese distributor at a deep discount, which the distributor would then resell to government customers at full price, and pass through a portion of it as bribes.

30. The RSM and the Asia Pacific GM were aware of and allowed the payments to continue. Between 2005 and the end of 2009, the Vietnam office made improper payments of $2.2 million to agents or distributors, which was funneled to Vietnamese government officials. These bribes, recorded as "commissions," "advertising fees," and "training fees," generated gross sales revenues of $23.7 million to Bio-Rad Singapore. The payment scheme did not involve the use of interstate commerce, and no United States national was involved in the misconduct.

Representative FCPA Enforcement Actions (cont.)

– **Bio-Rad (cont.)**

- In addition, the SEC alleged that Bio-Rad failed to uncover a pre-existing bribery scheme when it acquired a company in **Thailand**. Unbeknownst to Bio-Rad, the Thai distributor was partially owned by one of the newly acquired company's local Thai owners and was used to make payments to government officials in Thailand.
- Bio-Rad's Asia Pacific general manager learned after the acquisition that Thai customers received payments—which he understood to mean kickbacks—from the distributor in question. The Asia Pacific general manager instructed Bio-Rad's Singapore's controller to investigate the matter. The controller confirmed that the newly acquired Thailand entity was bribing government officials through the distributor. Despite these findings, the Asia Pacific general manager did not instruct the Thai entity employees to stop the practice, allowing it to continue for almost three years and resulting in a total of $708,608 paid improperly to the distributor.
- In a parallel enforcement action, Bio-Rad paid a $14.35 million criminal penalty to resolve DOJ allegations that it violated the FCPA in connection with its sales in Russia. The DOJ's case against Bio-Rad involved improper payments made using various other intermediaries but not distributors.

Representative FCPA Enforcement Actions (cont.)

Facts in Thailand

33. Prior to the October 2007 acquisition, Diamed Thailand had an established bribery scheme, whereby Diamed Thailand used a Thai agent to sell diagnostic products to government customers. The agent received an inflated 13% commission, of which it retained 4%, and paid 9% to Thai government officials in exchange for profitable business contracts.

34. The scheme continued even after Bio-Rad acquired Diamed Thailand. Diamed Thailand renewed the contract with the distributor in June 2008, but unbeknownst to Bio-Rad, the distributor was partially owned by one of Diamed Thailand's local Thai owners.

35. Bio-Rad's Asia Pacific GM learned of Diamed Thailand's bribery scheme while attending a distributor's conference in Bangkok in March 2008. At the conference, Diamed Thailand's local manager informed him that some of Diamed Thailand's customers received payments, which the Asia Pacific GM understood to mean kickbacks. The Asia Pacific GM instructed Bio-Rad Singapore's controller to investigate the matter. The controller confirmed to the Asia Pacific GM that Diamed Thailand was bribing government officials through the distributor. Despite these findings, the Asia Pacific GM did not instruct Diamed Thailand to stop making the improper payments to the distributor.

36. From 2007 to early 2010, Diamed Thailand improperly paid a total of $708,608 to the distributor, generating gross sales revenues of $5.5 million to Diamed Thailand. These payments were recorded as sales commissions. The payment scheme did not involve the use of interstate commerce, and no United States national was involved in the misconduct.

Representative FCPA Enforcement Actions (cont.)

— Hewlett-Packard ("HP") and Subsidiaries (2014)

- In 2014, the DOJ and SEC announced FCPA enforcement actions against HP and its subsidiaries in Poland, **Russia**, and Mexico, with a total of $108 million in criminal and civil penalties.
- The DOJ entered into a plea agreement with HP's wholly-owned Russian subsidiary ("HP Russia") regarding various charges relating to, among others, HP Russia's inappropriate use of channel partners.
- The DOJ found that HP Russia created excess profit margins to finance a slush fund through an elaborate buy-back scheme.
  - As part of that scheme, HP Russia first sold hardware and other products to an apparently otherwise legitimate and often-used channel partner of HP, which sold goods to a German intermediary, which immediately sold the same goods back to HP Russia at a mark-up.

Representative FCPA Enforcement Actions (cont.)

— **HP and Subsidiaries (cont.)**

- The payments to the intermediary were then transferred through multiple layers of shell companies, some of which were directly associated with Russian government officials.
- The mark-up on the goods was at least partly directed into a slush fund later used to funnel bribes, including travel services, luxury automobiles, expensive jewelry, clothing, furniture, and other items to Russian government officials.
- To keep track of and conceal these corrupt payments, HP Russia employees kept two sets of books: secret spreadsheets that detailed the categories of bribe recipients, and sanitized versions that hid the bribes from others outside of HP Russia. They also entered into off-the-books side agreements to further mask the bribes.

Representative FCPA Enforcement Actions (cont.)

— Smith & Nephew (2012)

- In 2012, Smith & Nephew Inc., a U.S. subsidiary of an English medical device manufacturer, entered into a DPA with the DOJ while its parent, Smith & Nephew PLC, entered into a related settlement with the SEC. They paid a $16.8 million criminal penalty and $5.4 million in disgorgement and prejudgment interest to resolve allegations of FCPA violations involving business in Greece.
- The DOJ and SEC alleged that Smith & Nephew's subsidiaries used a distributor to create a slush fund to make illicit payments to doctors employed by government hospitals or agencies in Greece.
- To amass funds for the payments, Smith & Nephew established a scheme whereby certain of its executives, employees, and affiliates agreed to sell to its Greek distributor at full list price, then pay the amount of the distributor discount—between 20% and 45% of the sales made by the Greek distributor—to an off-shore shell company controlled by the Greek distributor. This amount created off-the-books funds for the Greek distributor to use to pay improper cash incentives.
- The payments to intermediary companies were falsely recorded as "marketing services" to hide the true nature of these payments.

smith&nephew

Representative FCPA Enforcement Actions (cont.)

— **Smith & Nephew (cont.)**

28. On or around March 8, 2002, Greek Distributor sent an email from Athens to VP International in Memphis, Tennessee, copying Greece Sales Manager, stating, "the [Shell Company A] commission cannot be reduced for the time being, since it is already not sufficient to cover my company's cash incentive requirements at the current market level, with major competitors paying 30-40% more than [Greek Distributor]. As I explained to you in Memphis (as well as during your last visit to Athens) I absolutely need this fund to promote my sales with surgeons, at a time when competition offers substantially higher rates. [Shell Company A]'s only reason for being is the need for cash incentives, a real pain in the neck but an unavoidable fact of Greek life;" Greek Distributor goes on to state, "In case it is not clear to you, please understand that I am paying cash incentives right after each surgery...." (Emphasis in original.)

Representative FCPA Enforcement Actions (cont.)

– **Eli Lilly & Co. ("Eli Lilly") (2012)**

- In 2012, Lilly agreed to pay $29.4 million to settle SEC allegations that it violated the FCPA in connection with improper payments made by its Chinese, **Brazilian**, Polish, and **Russian** subsidiaries to government officials in those countries. The misconduct in Brazil and Russia involved distributors.
- According to the SEC's complaint, Lilly's subsidiary in **Brazil** regularly provided standard discounts ranging between 6.5% and 15% to its distributors for selling Lilly products to private and public customers in Brazil, with the majority of distributors in Brazil receiving a 10% discount.
- In 2007, however, the Brazilian subsidiary "without adequate verification and analysis of the surrounding circumstances," gave one of its distributors an exceptionally large discount on two of its purchases.
- The distributor then allegedly used a portion of the inflated discount to provide payments to Brazilian government officials in exchange for their purchase of Lilly products. The SEC alleged that the Lilly Brazil sales and marketing manager who requested this discount knew about this arrangement.

Representative FCPA Enforcement Actions (cont.)

23. In early 2007, at the request of one of Lilly-Brazil's sales and marketing managers at the time, Lilly-Brazil granted a nationwide pharmaceutical distributor, unusually large discounts of 17% and 19% for two of the distributor's purchases of a Lilly drug, which the distributor then sold to the government of one of the Brazilian states. Lilly-Brazil's pricing committee approved the discounts without further inquiry. The policies and procedures in place to flag unusual distributor discounts were deficient. They relied on the representations of the sales and marketing manager without adequate verification and analysis of the surrounding circumstances of the transactions. In May 2007, Lilly sold 3,200 milligrams of the drug to the distributor for resale to the Brazilian state; in August 2007, Lilly-Brazil sold 13,500 milligrams of the drug to the distributor for resale to the Brazilian state. Together the sales were valued at approximately $1.2 million.

Representative FCPA Enforcement Actions (cont.)

Eli Lilly (cont.)

- In **Russia**, in connection with sales of products to Russian government entities through a network of distributors, Lilly's Russian subsidiary ("Lilly-Vostok") allegedly entered into sham "marketing" or "service" agreements with third parties outside of Russia that were chosen by Russian government officials or connected to distributors chosen by Russian government officials. Generally, these third parties were paid a flat fee or a percentage of the sale.
- Lilly-Vostok had very limited information about these third-party entities and rarely knew who owned them or whether the entities were actual businesses that could provide legitimate services.
- Through these marketing and service agreements, Lilly-Vostok allegedly made payments to third parties, which did not provide legitimate services and then used the money to make improper payments to Russian government officials.

Representative FCPA Enforcement Actions (cont.)

– **Eli Lilly (cont.)**

- According to the SEC, “contemporaneous documents reflect that Lilly-Vostok employees viewed payments [to these entities] as necessary to obtain business from the distributor or government entity, and not as payment for legitimate services.”

> For example, in November 1994, a senior manager at Lilly-Vostok emailed the commercial manager, the employee tasked with drafting and approving the language of the agreements, that the “standard Marketing Agreement [is] where the [service provider] delivers the service of getting this [purchase] contract for us . . . .” In August 1999, the commercial manager emailed senior managers that “if real services are provided the marketing agreement is not the appropriate form.” In other documents, Lilly-Vostok employees referred to the payments as “discounts” or “commissions” to the distributor or government purchaser.

Representative FCPA Enforcement Actions (cont.)

– **Eli Lilly (cont.)**

- Lilly conducted a business review of Lilly-Vostok's operations in 1997 and again in 1999. Both reports, which raised red flags about the use of marketing/service agreements with these third-party entities were sent to Lilly-Vostok's offices in Geneva, Switzerland and Lilly's headquarters in Indianapolis, United States.

29. In 1997, Lilly conducted a business review of Lilly-Vostok to identify business risks and assess the subsidiary's policies and procedures which resulted in a report. The report, which was sent to Lilly-Vostok offices in Geneva and to Lilly headquarters in Indianapolis, noted that "[b]usiness ethics [in Russia] are low" and that "[a] large base of opportunistic entrepreneurs, lacking national presence build the distribution network." The report concluded that "[t]he nature and complexity of customers require that 'consultants' be used to 'support' activities, leading to agreement signing" (quotation marks in the original). The report pointed out that the services provided by these consultants were broadly defined and duplicated activities usually performed by Lilly-Vostok's Russian staff, and that documentation of the services received was not available. The report recommended that Lilly-Vostok modify its internal controls to ensure that the services were documented and Lilly-Vostok was getting "value."

Representative FCPA Enforcement Actions (cont.)

Eli Lilly (cont.)

- The 1999 report was distributed to a number of individuals, including Lilly's Chief Financial Officer, President of Lilly International Operations and General Auditor. It stated that:

> Attention has been given to contain external unethical pressures through guidelines and training. The use of marketing agreements with third-parties has been tightened; agreements substance and permanent education program continue to require effort and refinements.
>
> 31. Regarding the agreements, the second report concluded that the "[n]eed exists to call on third-parties to create sales potential." It recommended that Lilly-Vostok modify its internal controls to assure itself that the agreements accurately and fairly reflect the services to be provided.

- Despite these two reports, the SEC alleged that Lilly did not curtail the use of marketing agreements by its Russian subsidiary or "make any meaningful efforts to ensure that the marketing agreements were not being used as a method to funnel money to government officials . . ." Instead, in 2000-04, Lilly-Vostok entered into three of the most expensive of these third-party entity arrangements.

Representative FCPA Enforcement Actions (cont.)

– **Eli Lilly (cont.)**

- One of the examples in the SEC settlement included a situation where Lilly-Vostok sold significant amounts of pharmaceutical products to a major Russian pharmaceutical distributor for resale to the Russian Ministry of Health. This distributor was at that time owned by an individual who was a close adviser of a member of Russia's Parliament and who later became a member of the Parliament himself. This official exercised considerable influence over government decisions relating to pharmaceutical industry in Russia.

> 38. As part of most of the sales arrangements with the distributor, the official demanded that Lilly-Vostok enter into separate "marketing" agreements with entities with addresses and bank accounts in Cyprus. Under the arrangement, Lilly-Vostok paid the Cypriot entities up to thirty percent of the sales price of the underlying sales contracts in return for the Cypriot entities entering into an agreement "to offer all assistance necessary" in various areas like storage, importation and payment.

Representative FCPA Enforcement Actions (cont.)

– **Eli Lilly (cont.)**

39. In conjunction with outside counsel, Lilly-Vostok conducted limited due diligence on these third-parties. However, the due diligence did not identify the beneficial owners of these third-parties or determine whether the third-parties were able to provide the contracted-for assistance. Nonetheless, Lilly-Vostok concluded that it could proceed with the transactions and paid the Cypriot entities over $5.2 million. In fact, the Cypriot entities were owned by an individual associated with the distributor controlled by the member of the upper house of Russia Parliament. The Cypriot entity transferred the payments from Lilly-Vostok to other off-shore entities.

- A second example involved a situation where Lilly-Vostok sold products to a Russian distributor, which was wholly-owned by a Russian government entity. As part of the arrangement, the government-owned distributor similarly inserted a British Virgin Islands ("BVI") third-party entity to provide "services" into the transaction for no apparently legitimate reason. There was no evidence that the entity provided any services or that Lilly-Vostok conducted any due diligence on the beneficial owner of the BVI entity.

Representative FCPA Enforcement Actions (cont.)

— Eli Lilly (cont.)

- The Eli Lilly SEC settlement demonstrates the risks involved in conducting business using third parties, including distributors, abroad. In fact, in announcing this settlement, the SEC cautioned against company executives averting their eyes "from what they do not wish to see" and eschewing a "check the box" approach to compliance and third-party due diligence.

> "When a parent company learns tell-tale signs of a bribery scheme involving a subsidiary, it must take immediate action to assure that the FCPA is not being violated," said Antonia Chion, Associate Director in the SEC Enforcement Division. "We strongly caution company officials from averting their eyes from what they do not wish to see."

> Kara Novaco Brockmeyer, Chief of the SEC Enforcement Division's Foreign Corrupt Practices Unit, added, "Eli Lilly and its subsidiaries possessed a 'check the box' mentality when it came to third-party due diligence. Companies can't simply rely on paper-thin assurances by employees, distributors, or customers. They need to look at the surrounding circumstances of any payment to adequately assess whether it could wind up in a government official's pocket."

Representative FCPA Enforcement Actions (cont.)

— Oracle Corporation ("Oracle") (2012)

- In 2012, the SEC charged Oracle with violating the FCPA's books and records and internal controls provisions by failing to prevent a subsidiary from secretly setting aside money off the company's books that was eventually used to make unauthorized payments to phony vendors in India. Oracle paid a $2 million penalty to settle these charges.
- Specifically, the SEC alleged that certain employees of Oracle's India subsidiary structured transactions with India's government on more than a dozen occasions in a way that enabled Oracle India's distributors to hold approximately $2.2 million of the proceeds in unauthorized side funds.
- Those Oracle India employees then directed the distributors to make payments out of these side funds to purported local vendors, several of which were merely storefronts that did not provide any services to Oracle. Oracle's subsidiary then documented certain payments with fake invoices.

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Representative FCPA Enforcement Actions (cont.)

– **Oracle (cont.)**
  - One specific scheme described by the SEC involved a $3.9 million deal with India's Ministry of Information Technology and Communications.
  - Oracle India's then-sales director instructed that only $2.1 million be sent to Oracle to record as revenue on the transaction, with the distributor keeping $151,000 for services rendered. Other Oracle India employees further instructed the distributor to park the remaining $1.7 million for "marketing development purposes."
  - Two months later, one of those same Oracle India employees created and provided to the distributor eight invoices for payments to purported third-party vendors ranging from $110,000 to $396,000.
  - None of these storefront-only third parties provided any services or were included on Oracle's approved vendor list.
  - The SEC alleged that the third-party payments created the risk that the funds could be used for illicit purposes such as bribery or embezzlement.
  - Significantly, the SEC's charging papers did not allege that any bribes were actually paid.

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Representative FCPA Enforcement Actions (cont.)

– InVision Technologies, Inc. ("InVision") (2004)

- In 2004, InVision paid $1.1 million and entered into a NPA with the DOJ and settled related FCPA charges with the SEC in connection with its business in **China**, **Thailand** and the Philippines.
- In **China**, InVision sold two explosives detection machines to a local distributor for resale to a Chinese airport and associated governmental agencies. The delivery of the machines was delayed and the distributor advised InVision's Regional Sales Manager and another senior executive that the airport planned to impose a financial penalty as a result of the delay. To avoid the penalty, the distributor advised the Regional Sales Manager that it intended to offer foreign travel and other benefits to airport officials. The Regional Sales Manager informed the senior executive of the distributor's intention.
- The distributor then requested financial compensation from InVision to pay for penalties and costs that it claimed would be incurred as a result of the delay in shipment of the machines to the airport. The distributor's request included compensation for benefits that the distributor intended to offer to airport officials.

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Representative FCPA Enforcement Actions (cont.)

— InVision (cont.)

- In response to that request, a $95,000 payment was approved by the senior executive and subsequently authorized by InVision's finance department. The DOJ and SEC alleged that based on the information provided to two InVision employees, InVision was aware of a high probability that the distributor intended to use part of the funds it received from InVision to pay for foreign travel and other benefits for airport officials.
- In **Thailand**, InVision also used a distributor to supply explosives detection machines to an airport in Bangkok, which was overseen by a corporation controlled by Thai government. InVision sold the machines to the distributor at a discount, with the distributor making a profit by reselling the machines at a higher price to the airport.
- For at least a year, the distributor indicated to the InVision Regional Sales Manager and another senior executive that it had offered to make gifts or payments to officials with influence over the airport corporation. Despite these statements, InVision authorized the distributor to continue with the transactions.
- The DOJ and SEC alleged that InVision was aware of a high probability that the Thai distributor intended to fund gifts or offers out of the difference between the price the distributor paid InVision to acquire the machines and the resale price.

Challenges in Detecting Potential Misconduct

- Some of the FCPA enforcement actions discussed earlier present clear examples of misconduct knowingly perpetuated by certain employees and/or instances where the improper payment schemes could have been potentially detected if stronger internal controls, including third-party due diligence programs, were in place.
- However, bribery schemes involving distributors can present unique challenges for companies trying to detect potential misconduct.

Challenges in Detecting Potential Misconduct (cont.)

- With regard to discounts, the following considerations can make it difficult to detect foul play.
  - Inherently subjective nature of discounts makes it difficult to determine what constitutes an “excessive” or unreasonably large discount
  - Contemporaneous documentation of discount approvals and rationale may be incomplete or difficult to follow
  - Lack of visibility into end customer pricing
  - Difference in discounts between products and services booked for the same customer
- That said, the mere use of large discounts, particularly in certain industries, is not necessarily nefarious.

Challenges in Detecting Potential Misconduct (cont.)

— Other challenges include:

- Difficulty tracking travel, gifts, and meals and entertainment provided to government officials if third parties such as distributors are paying for portions of such trips, gifts, or meals and entertainment
- For companies using a channel partner approach to their sales abroad, it may be difficult to identify specific value add for sub-distributors
- In addition, not all compliance programs at such companies require due diligence for sub-distributors; lack of due diligence results in not knowing your partner
- Rebate programs (*e.g.*, number of rebate programs and variations may add to difficulty of tracking compliance with rebate program terms and create room for manipulation)

Corporate Compliance Program Expectations

– Example from DOJ DPA with Smith & Nephew as it relates to third-party oversight:

10. Smith & Nephew will institute appropriate due diligence and compliance requirements pertaining to the retention and oversight of all agents and business partners, including:

a. Properly documented risk-based due diligence pertaining to the hiring and appropriate and regular oversight of agents and business partners;

b. Informing agents and business partners of Smith & Nephew's commitment to abiding by laws on the prohibitions against foreign bribery, and of Smith & Nephew's ethics and compliance standards and procedures or other measures for preventing and detecting such bribery; and

11. Where appropriate, Smith & Nephew will include standard provisions in agreements, contracts, and renewals thereof with all agents and business partners that are reasonably calculated to prevent violations of the anti-corruption laws, which may, depending upon the circumstances, include: (a) anti-corruption representations and undertakings relating to compliance with the anti-corruption laws; (b) rights to conduct audits of the books and records of the agent or business partner to ensure compliance with the foregoing; and (c) rights to terminate an agent or business partner as a result of any breach of anti-corruption laws, and regulations or representations and undertakings related to such matters.

Compliance Framework to Address Risks

Internal:

- Provide regular anti-corruption training to employees of foreign subsidiaries
- Monitor discounts given to distributors (*e.g.*, delegation of authority based on amounts, keep paper trail of commercial justifications for discounts)
- Conduct due diligence on third parties, including distributors (consider introducing regular cadence for renewed due diligence)
- Incorporate FCPA issues into the scope of internal audits and conduct periodic audits of foreign subsidiaries
- Consider transaction-specific due diligence (where appropriate)

External:

- Require completion of anti-corruption questionnaire by distributor prior to entering into business relationship
- Include a “compliance with laws” (including compliance with anti-corruption laws) and audit rights provisions in the agreement
- Require distributor to agree to certify to compliance with laws, including anti-corruption laws, when requested by the company
- Provide a copy of the company’s Code of Conduct and/or Anti-Corruption Policy to the distributor
- Offer anti-corruption training (where appropriate)

Conclusion

David A. Berman

Wilmer Cutler Pickering Hale and Dorr LLP

(212) 295-6288

david.berman@wilmerhale.com

Drafting Foreign Corrupt Practices Act Compliance Provisions in Cross-Border Distribution Agreements

Adam Munitz
amunitz@fhhfirm.com

Drafting Effective Anti-Corruption Provisions

- Effective anti-corruption provisions are nuanced and require an assortment of complex representations and warranties.
- This section of the presentation will provide ten recommendations on how to develop an anti-corruption provision for a cross-border Distribution Agreement that reduces the likelihood that (a) the distributor will make a corrupt payment in violation of the FCPA; and (b) minimizes the risk that the U.S. entity (the "Company") will be implicated in the corrupt activities of its distributor.

Recommendation 1- Include a Broad Legal & Regulatory Compliance Provision

- At the outset, include a broad provision that requires the distributor to comply with **ALL** applicable U.S. and local laws and regulations, including, without limitation, the FCPA, the International Traffic in Arms Regulations, the Export Administration Regulations, and all U.S. and U.N. sanctions.
- This establishes a **baseline level** of risk mitigation, and clearly notifies the distributor that, in no uncertain terms, legal and regulatory compliance is a pre-condition to payment.

Recommendation 2- Use the Distribution Agreement as an Information Gathering Vehicle

- In addition to securing valuable representations and warranties from the distributor, an essential objective of the Distribution Agreement is to **<u>collect information</u>** on the distributor.
  - ➢ Attach an **<u>International Party Questionnaire</u>** (“IPQ”) and **<u>Compliance Certification</u>** to the Distribution Agreement and require their completion and execution.
  - ➢ Require that **<u>any potential subcontractors, agents, or representatives</u>** of the distributor complete and execute the IPQ and Compliance Certification and require that such documents be presented to the U.S. Company for review and analysis before the subcontractor, agent, or representative is retained.

Recommendation 3- Include Substantive Representations and Warranties

- A broad legal and regulatory compliance representation is necessary but **not sufficient**.
- The U.S. Company should also include **substantive provisions** under which the distributor represents that it will not participate in **specific activities** that, themselves, would constitute violations of the FCPA (i.e., it will not make any payments to foreign officials in exchange for preferential treatment).
- Of course, in order for this specific provision to have the intended effect its key terms must be carefully (and broadly) defined.

Recommendation 4- Clearly Define “Foreign Official”

- The term “foreign official” should not be subject to interpretation, but rather should be **clearly defined**.
- For example, a “foreign official” can be defined as:
  - any officer, employee, or representative of a foreign government (i.e., other than the U.S. Government) or any department, agency, or instrumentality thereof, or of a public international organization;
  - any person acting in an official capacity for or on behalf of a foreign government, foreign government entity, or public international organization;
  - any foreign political party or party official; any member of a royal family; or
  - any candidate for political office.
- The definition should also include both **unelected officials** and employees of companies **owned or controlled by foreign governments**.

Recommendation 5- Broadly Define "Payment" and "Preferential Treatment"

- The distributor should be under no illusion that the term "payment" only includes cash deliveries.
  - Rather, the term "payment" should include any monetary payment, loan, donation, gift, in-kind service, or **any other thing of value**.
- Similarly, the term "preferential treatment" should be defined **expansively**, and should include any contract, business opportunity, or other benefit.

Recommendation 6- Address Third Party Payments

- A U.S. company's greatest vulnerability in cross-border distribution arrangements is not direct payments by the distributor to foreign officials, but rather **indirect payments** to foreign officials via third parties.

- Accordingly, the distributor should also be required to represent that it will not make payments to **any person** where it **knows or has reason to know or suspect** that any part of such payment will be directly or indirectly given or paid by such other person, or will reimburse such other person for any payment previously made or given, to any foreign official, when such payment could not be made directly in accordance with the provision.

Recommendation 7- Secure Confirmation of Past and Present Status

- Anti-corruption provisions are also valuable opportunities to secure confirmation of a distributor's **past and present status**:
  - ➢First, secure confirmation that neither the distributor nor any of its affiliates **have been convicted of, plead guilty to, or have been charged with** any offense involving fraud, corruption, or bribery in any jurisdiction or country.
  - ➢Second, secure (a) confirmation that, unless previously disclosed to the U.S. Company in a separate written statement, neither the distributor nor any of its affiliates **qualify as "foreign officials"** or **have qualified as "foreign officials"** in the last five years; and (b) a commitment that the distributor will **immediately notify** the U.S. Company if it or its affiliates become a "foreign official" during the term of the Agreement.

Recommendation 8- Secure Confirmation of the Value of the Goods

- In the event that, despite the U.S. Company's best efforts, the distributor violates the FCPA, it is crucial that the U.S. Company fully insulate itself against prosecution and demonstrate that the distribution arrangement was not simply a **convenient vehicle** for a corrupt payment.
- One step it can take to do so is to secure a representation from the distributor that the value of the remuneration it is receiving from the U.S. Company is **commensurate with the value of its services**.

Recommendation 9- Incorporate a Notification Requirement

- It is crucial that the U.S. Company be positioned to immediately investigate, address, and, if necessary, disclose a potential violation of the FCPA.
- Accordingly, the U.S. Company should incorporate a provision into the Distribution Agreement that requires the distributor to **<u>immediately notify</u>** it in writing if (a) a potential violation of the FCPA (or an equivalent local law) has occurred; or (b) a foreign official or a relative of a foreign official solicits, ask for, or attempts to extort, any payment.

Recommendation 10- Emphasize Consequences

- In order for an anti-corruption provision to be taken seriously by a distributor, the consequences of non-compliance must be explicit.
  - First, the provision should make clear that non-compliance with the provision will result in **<u>immediate termination</u>** of the Distribution Agreement.
  - Second, the provision should make clear that the U.S. Company is entitled to **<u>fully disclose</u>** information pertaining to a potential violation of the FCPA (or any other applicable anti-bribery law) to the U.S. Government and/or any foreign government.
  - Third, the Distribution Agreement's indemnification provisions must include a stipulation that the distributor will indemnify the U.S. Company against any claims by the U.S. Government or any foreign government that it violated the FCPA or any other applicable anti-bribery law where such claim is a result of the distributor's negligent or intentional conduct.

Arnall Golden Gregory LLP

Attorneys at Law

FCPA Provisions in Cross-Border Distribution Agreements

Michael E. Burke, Partner

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Post-Signing Diligence

- Distribution Agreement should provide for:
  - Annual compliance certification executed by distributor, sub-distributors and other relevant parties
    - ‘Form of’ usually provided by principal
  - Appropriate books and records and audit/inspection provisions
    - Usually at cost/discretion of principal company
    - Limited to a set number of times during term, and ‘normal’ business hours
    - Accurately keep all records related to distribution services
    - Allow for accountants and lawyers to participate in inspection
    - Consider ability to inspect for ‘emergency’ issues
    - Ensure consistency with principal’s risk matrix
    - Survival past expiration/termination of distribution agreement

Post-Signing Diligence

- Distribution Agreement should provide for:
  - Confidentiality
    - How are principal's accountants/lawyers treated
    - Scope of confidential information
    - What about potential voluntary disclosures?
    - Impact of local law
  - Indemnification
    - Provisions should cover expense/cost of full-blown investigations, if needed
  - Notification
    - Should distributor be obligated to report 'adverse' information?
  - Appropriate termination provisions

Post-Signing Diligence: Why?

- The “why” of post-signing diligence is clear: representations tend to be static, while performance of an agreement over time introduces new FCPA risks
- Annual certifications should be viewed as one, basic, tool in your post-closing diligence arsenal
  - May be comparatively more useful in lower-risk jurisdictions or with lower-risk distributors/resellers/agents
  - Never use alone, but use consistently
- Periodic inspections should be viewed as another, basic, tool in your post-signing diligence arsenal
  - Start with books/records relevant to distribution agreement and include all distributor financial records reasonably related to performance of distribution agreement
- Periodic training

Post-Signing Diligence: Third Party-Driven Exposure

- Remember the ‘should have known’ standard:
  - Your company will be responsible for the conduct of a distributor/reseller/agent if you ‘should have known’ a problem had developed
    - You have actual knowledge
    - You are aware that distributor is engaging in such conduct, that such circumstance exists, or that such result is substantially certain to occur
    - You have has a firm belief that such circumstance exists or that such result is substantially certain to occur
    - You are aware of the “high probability” of a circumstance that is required for a violation of the anti-bribery provisions
    - A reasonable person, conducting a reasonable inquiry, would have uncovered
  - Can’t willfully ignore potential problems
  - No ‘materiality’ requirement under the FCPA

Post-Signing Diligence: Audits/Inspections

- When to audit/inspect:
  - Obtain compliance attestations annually
  - Conduct audits/inspections using a risk-based timeline:
    - Riskier jurisdictions (per the Transparency International ‘heat map’ or other reasonable standard) should get more frequent attention
      - Not at expense of less risky jurisdictions
    - Move a distributor/jurisdiction up the timeline in response to ‘noise’ about corruption issues
    - Larger distributors, based on volume of work performed for your Company, might get more frequent attention
    - Consider an out-of-cycle inspection in response to reported violations/suspicious activity

Post-Signing Diligence: Red Flags

- Red Flags that may appear:
  - Payments to offshore accounts (offshore as to Company and distributor) or to unusual addresses
  - Frequent, large, cash disbursements
  - Over-utilized accounts
  - Lack of proper approval process
  - Arrangements with complex legal structures
  - Payments in round dollar amounts
  - Frequent recipient(s)
- Any information raising suspicions of bribery must be addressed, even if the suspicions relate to an area the Company is not responsible for under the distributor agreement

Post-Signing Diligence: Distributor Discounts

- Create procedures to audit and flag unusual distributor discounts
  - develop an informed understanding of normal discount levels in the particular market, and implement additional procedures to review and approve any request to depart from such discounts
- The more significant the discount requested the greater the level of scrutiny and review
  - All requests for discounts (accompanied by the appropriate justification for the request) and decisions related thereto should be memorialized in writing
  - Steps also should be taken to routinely compare the distributor's margin against the end user price to ensure that third parties are not building in excessive margins that can then be used to pay improper bribes.

Post-Signing Diligence: "Bad Information"

- Company will, from time to time, be provided or otherwise obtain 'bad information' indicating a possible FCPA breach
  - Information can come from outside sources, whistleblowers or from a routine audit
  - Regardless of source, each potential piece of bad news should be investigated
    - Some pieces of information are spurious or are intended to distract the company; carefully document reasons for 'closing' an inquiry
    - Other pieces of information or results of an audit should trigger an internal investigation

Post-Signing Diligence: Basic Framework for Internal Investigation

- Determine nature of allegations
- Develop facts
  - Document reviews
  - Interviews
  - Develop a working chronology
  - Retain outside experts as needed
- Review jurisdictional and legal elements of each potential offense
- Report to Company/Board/Committee
- Prepare and implement remedial measures

Arnall Golden Gregory LLP

Attorneys at Law

For more information, please contact:

Michael E. Burke

Mike.Burke@AGG.com

202.677.4046

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