

US Law Enforcement Update: Director and Officer Liability and Current Enforcement and Compliance Challenges in India

*A Special Roundtable Discussion on the
FCPA and Director & Officer Liability
Under U.S. Laws*



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Director & Officer Liability

Issues to Consider in Joint Ventures

What Form Should a Joint Venture Take



- Joint Ventures are typically in three forms
 - Partnership
 - Simplest form, typically for short-term projects
 - Joint and Several Liability of partners
 - Tax considerations for foreign partners
 - Corporation
 - Limited Liability
 - Directory responsibility
 - Limited Liability Company (LLC)
 - Limited liability
 - Creature of contract

Corporation Versus LLC



- Corporation is a common form especially where the parties intend to bring in other investors or sell the entity at some point in the future
- LLC provides greater flexibility to define the rights and obligations of the parties
- Both are formed under state law and typically parties chose Delaware law regardless of where the business will be

Liability of Directors and Officers



- Directors of corporations, members or managers of LLCs and general partners in a Limited Partnership (LP) owe a fiduciary duty to its equity holders (shareholders, members or limited partners)
- Duty of a director or manager appointed by one party does not limit the fiduciary duty of such director or manager to the other party
- Every director or manager must act of his or her own free will and judgment and not simply as directed by the party appointing the director or manager
- Scope and existence of such duty can be contractually modified in LPs and LLCs

Fiduciary Duties of Directors in an LLC



- While a member or manager of LLC owes a fiduciary duty to all members of the LLC, that duty can be varied by contract between the parties
- LLC Operating Agreement can state that managing members or managers have no fiduciary duty to the members
- However, implied duty of good faith and fair dealing cannot be eliminated
- Thus, members may compete with the LLC through other vehicles, they may make decisions that are in the best interest of the member designating him or her and not all of the members and they may designate alternates to act in their stead, something a corporate director cannot do.

Fiduciary Duties of Directors in an LP



- While general partners in an LP owe a fiduciary duty to all partners of the LP, passive limited partners do not owe any default fiduciary duties unless they take on an active role in the management of the entity
- Like in an LLC, the fiduciary duties of a general partner can be varied by contract between the parties
- The Partnership Agreement can state that the general partners have no fiduciary duty to the partners
- However, implied duty of good faith and fair dealing cannot be eliminated
- Thus, partners may compete with the LP through other vehicles, they may make decisions that are in the best interest of the partner designating him or her and not all of the partners and they may designate alternates to act in their stead, something a corporate director cannot do.

Fiduciary Duties of Directors in a Corporation



Fiduciary Duties of Directors and Officers

- Duty of loyalty
- Duty of care
- Duty of good faith



Potential Dangers to Directors and Officers

- Securities fraud class actions
- Shareholder direct actions
- Shareholder derivative actions alleging breach of a director and/or officer's duty of care or duty of loyalty
 - Duty of care claims generally fail due to the Business Judgment Rule
- Department of Justice (DOJ) criminal investigations and/or charges
- Securities and Exchange Commission (SEC) civil investigations and/or actions

The Layers of Protection



The Layers Protecting Directors and Officers

- (1) The Business Judgment Rule
- (2) Exculpation provision in charter
- (3) Indemnification provisions in charter and bylaws
- (4) Indemnification agreements
- (5) Director & Officer liability (“D&O”) insurance

Notice that none of the above change the duties of a director appointed by one shareholder to the other shareholder

Layers of Protection: Business Judgment Rule



The Business Judgment Rule

- Directors of a corporation are presumed to be acting in the interests of a corporation
- Plaintiff has burden of proving that directors breached one of their duties – must show self-dealing or bad faith
- If plaintiff cannot so prove, not entitled to any remedy unless the transaction was so one-sided as to constitute loss (waste)
- “The business judgment rule exists to protect and promote the free exercise of managerial power granted to Delaware directors” – to protect directors from hindsight review of business decisions (*Smith v. Van Gorkom*, 488 A.2d 858, 875 (Del. 1985))
- In practice, the effect is to make it extremely difficult for plaintiffs to prevail on claim that directors breached duty of care



Exculpation Provision

- Delaware General Corporation Law (DGCL) permits inserting a clause in the company's charter that eliminates or limits directors' monetary damages for breach of fiduciary duty as a director, provided such breach is not (i) for a breach of the duty of loyalty; (ii) for acts "not in good faith"; (iii) for payment of illegal dividends or (iv) from any action from which director derived an improper personal benefit. (DGCL § 102(b)(7))
- Delaware case law has interpreted "not in good faith" narrowly (see *Disney* – exculpation may be available where director's conduct was merely grossly negligent, but not in bad faith, whereas conscious disregard of directorial duties does constitute bad faith and in such a case, exculpation would not be available)
- **Best practice:** Include an exculpation provision in the charter



Delaware General Corporation Law Section 145

- Permissive indemnification: A corporation may indemnify any director or officer against expenses (including attorneys' fees) if the person acted in good faith and in a manner the person reasonably believed to be in the best interests of the corporation
 - Corporation may not indemnify directors or officers in shareholder derivative suit if director or officer is found liable to the corporation
- Mandatory indemnification: A corporation must indemnify a director or officer to the extent such director or officer has been successful on the merits or otherwise
- **Best practice**: Charter should provide for indemnification of directors and officers to the greatest extent permitted by law

Layers of Protection: Indemnification



But why is an indemnification provision in the charter providing for indemnification of directors and officers to the fullest extent permitted by law (such as DGCL § 145) not sufficient?

- Charter and bylaws can be amended
- Indemnification provision is not a contractual obligation
- Former director could be left out in the cold after amendment of charter and/or bylaws
- Indemnification provisions exclude indemnification for settlements and judgments (but not attorneys' fees) in shareholder derivative actions; actions that directors or officers undertake believing they are illegal; and actions taken in “bad faith” or that constitute self-dealing
- If and when a company files for bankruptcy, it may not have sufficient funds to indemnify directors and officers

Layers of Protection: Indemnification Agreements



Indemnification Agreements

- Indemnification agreements create contractual obligations that cannot be amended unilaterally
- There should not be such discretion for the board to determine whether payments are appropriate in an indemnification agreement
 - Thus, greater comfort and certainty for the director or officer
- Note that indemnification agreements protect only directors and officers, not the corporation (monies come out of corp's pocket)
- **Best practice:** A corporation should provide detailed indemnification agreements to its directors and officers



D&O Insurance

- DGCL § 145(g) allows corporations to carry insurance for any director or officer against liability or expense “whether or not the corporation would have the power to indemnify such person against such liability under this section”
- D&O insurance can cover many other types of liability or expense than that which may be indemnified pursuant to an indemnification provision
- D&O insurance can also protect the corporation, not just the individual directors and officers

Best Practices for Corporations



- Include exculpation provision in charter
- Include indemnification provision in charter and bylaws to the fullest extent permitted by law
- Indemnification agreements with directors and officers
- D&O insurance
 - Get Side A, Side B, and Side C, or equivalents thereof
 - Consider excess coverage depending on size of potential claims and expenses incurred
 - Read policies carefully and beware of common pitfalls and exclusions



- Exclude fiduciary duty for managers/general partners of the LLCs or LPs in the Operating or Partnership Agreement (as applicable), especially in 50-50 joint ventures
- Designate contractually those circumstances where managers/general partners owe a fiduciary duty such as interested person contracts
- Retain some level of insurance in cases where third parties sue managers/general partners for certain wrongful acts

The Take-Aways



- Various types of lawsuits are relatively common against corporations, directors and officers in the U.S.
- However, numerous levels of protection are available to directors, officers, corporations, LLC's, and LP's
- Be savvy in crafting indemnification provisions, drafting indemnification agreements, and negotiating D&O insurance policies
 - Take advantage of the ability to provide protection to directors and officers on multiple levels
 - Reexamine policies on an annual basis
 - Let multiple insurers compete for your business

Current FCPA Enforcement and Compliance Challenges in India



Compliance Challenges in India



- Endemic corruption in India
 - 94 out of 176 countries in 2012 Global Corruption Perceptions Index
 - Corruption index of 36 on a scale of 0 (highly corrupt) to 100 (highly clean) – corruption is a serious challenge in India
 - Frequent bribe requests
 - Relatively low value
 - 84% under \$5,000 - Unlike China, where 36% were \$5,000 or more
 - Most frequent bribe requests come from police, but also often requested by customs, taxation, water and land record officials
 - Bribes most frequently relate to obtaining a service already due
 - Unlike China, where bribes to obtain business are four times more likely than in India

The Trends

- General increase in FCPA enforcement cases (including cases involving India)
 - 2012 – 23 cases brought under the FCPA by the SEC and DoJ; over 120 open cases worldwide
- Increasing size of monetary and other penalties under the FCPA
 - 8 of the top 10 largest FCPA penalty awards were imposed in 2010 (including Pride International's \$56 million FCPA penalty award – the largest to date involving India)
- Increasing prosecution of individuals – top executives and agents
 - In 2012, individuals were charged in 6 enforcement actions
- Increased international cooperation amongst regulatory enforcement authorities
 - India ratified the UN Convention Against Corruption in May, 2011
 - India has not yet ratified the OECD Convention on Combating Bribery of Foreign Public Officials in International Business

The Cases – A Growing Number



- Growing trend of U.S. companies getting caught in the FCPA net while doing business in India, including:
 - Baker Hughes (2001)
 - Electronic Data Systems Corp (2007)
 - Dow Chemical (2007)
 - Textron Inc. (2007)
 - Control Components Inc. (2008)
 - Westinghouse Air Brake Technologies (2008)
 - Pride International Inc. (2010)
 - Diageo plc (2011)
 - Oracle Corporation (2012)
 - Tyco (2012)
 - Walmart’s Internal Investigation (2012 – Present)

FCPA – Prohibition of Bribes with a US Nexus



- The FCPA is designed to prohibit bribery around the world so long as it has a U.S. nexus
- Payment - Prohibits payments or authorization or promises to pay anything of value
- Recipient - to a foreign official, foreign political party or public international organization (World Bank, IMF)
- Purpose - for the purpose of
 - procuring business (e.g., secure a government contract)
 - retaining business (e.g. , renew a government contract)
 - influencing or securing an improper advantage (e.g., reduce tax liability, obtain a permit, resolve a dispute)



FCPA will apply where there is a U.S. nexus:

- U.S. entity
- U.S. citizen or U.S. resident
- U.S. or foreign entity having a U.S. principal place of business
- U.S. or foreign entity having securities listed on a U.S. stock exchange or traded in the U.S. over the counter markets
- any officer, director, shareholder, employee or agent of these entities,
- U.S. or foreign entity where elements of the bribery were conducted on U.S. territory for any reason
 - Communications with U.S. persons
 - financial transactions through U.S. banks
 - entertainment in the U.S.



- The FCPA also prohibits payments to other persons with the “knowledge” that they would ultimately be paid to foreign officials or foreign political parties
 - beware of third party intermediaries, consultants
 - payments to relatives of foreign officials
 - payments to charitable organizations or otherwise related to foreign officials
- “Knowledge” is defined by reference to a person’s state of mind and awareness or firm belief that the circumstances exist or that such result is substantially certain to occur
 - no “actual knowledge required, conscious avoidance is sufficient

Use of Third Parties – Red Flags



- Excessive commissions
- Unreasonably large discounts to third parties
- Consulting agreements that are very vague
- Consultants engaged in a different line of business than that for which they are being engaged to provide services
- Third parties closely associated with the foreign official
- Third parties engaged at the request or insistence of the foreign official
- Third parties that are offshore shell companies
- Requests for payments to offshore bank accounts

FCPA – Books and Records Provision



- All publicly traded companies in the U.S. must keep books, records and accounts that reflect accurately and fairly the transactions and dispositions of assets in reasonable details
- All publicly traded companies in the U.S. must maintain a system of internal accounting controls sufficient to provide assurances as to the transactions effected by the company
- Liability of the U.S. publicly traded parent becomes almost inevitable under this “books and records” provision as illicit payments of Indian subsidiaries will not generally be properly accounted for in the consolidated accounts of the parent

FCPA – Exceptions



- “Grease payments” – small amounts paid for services already owed – no discretion may be involved
 - note that the grease payment must still be recorded as such in the books and records
- Reasonable and bona fide corporate gifts, travel, entertainment, lodging and similar expenses related to the promotion or explanation of products and services or performance of a contract
- Payments that are lawful under the laws of the foreign officials’ country
- FCPA does not apply to commercial bribery not involving a foreign official, political party or public international organization



- Parent corporations may be held liable under FCPA with regards to actions of subsidiaries:
 - direct involvement by parent in the bribe
 - agency principles where parent controls the subsidiary
 - books and records liability
- Liability limited to actions of majority-owned subsidiaries only
- Parent required to exercise good faith use of its influence over the subsidiary to the extent reasonable under the circumstances to cause the foreign subsidiary to devise and maintain an effective system of internal accounting controls



- Statute of limitations – generally 5 years
- Bribery:
 - for individuals, up to 5 yrs imprisonment and fines up to \$250,000
 - for entities, fines up to \$2mm
- Books and records/internal control violations:
 - for individuals, up to 20 yrs imprisonment and fines up to \$5mm
 - for entities, fines up to \$25mm

SEC Whistleblower Rules



- New SEC whistleblower rules allow whistleblowers to report FCPA violations and claim cash rewards under the new Dodd-Frank Act of 2010 – will likely lead to more FCPA prosecutions as whistleblowers come forward with potential violations
 - A whistleblower who voluntarily provides “original information” that leads to successful government enforcement action with \$1mm or more in monetary sanctions may receive up to 30% of the government’s recovery
 - SEC made its first award of 30% on August 21, 2012
- In 2012- 3001 whistleblower tips were received of which 324 (10.8%) originated from abroad. Of the 324 foreign whistleblower tips, 33 tips were received from India. Most were received from UK (74) followed by Canada, China and then India



Tyco International (2012)

- Tyco International and seven subsidiaries (including Indian subsidiary) were charged with 12 bribery schemes in 17 countries including India
- The alleged conduct in India included payments to employees of government customers to secure contracts. These payments were recorded as commissions in Tyco's books and records
- Tyco settled criminal charges brought by DOJ and civil charges brought by SEC for over \$26 million



Oracle Corporation (2012)

- Oracle India Pvt. Ltd., the Indian subsidiary of Oracle Corporation, a California based computer technology corporation, was charged by the SEC with failure to devise and maintain a system of effective internal controls that would have prevented the improper use of company funds
- Between 2005-2007, the Indian subsidiary structured transactions to set aside money off the company books that was used to make payments to phony vendors
- The transactions were structured in a way that enabled Oracle India's distributors to create side funds that were used to pay bribes to Indian officials
- On August 16, 2012, Oracle agreed to settle the matter for \$2 million
- Oracle also agreed to fire all guilty employees and to make significant enhancements to its FCPA compliance program



Wal-Mart (2012- Present)

- A New York Times report published in April, 2012, accused Wal-Mart de Mexico (Wal-Mart's largest foreign subsidiary) of paying bribes to Mexican officials
- These bribes were paid via local fixers called g estores in order to obtain construction permits, information, and other favors with the aim of ensuring speedier opening and setting up of Wal-Mart stores.
- Wal-Mart began an internal investigation of its Mexican subsidiary to check for conformance with the FCPA
- This investigation was extended to its Brazil, India and China subsidiaries in November, 2012
- Wal-Mart has spent approximately USD 99 million on these investigations as of November, 2012 and they are still going on
- In November, 2012, Wal-Mart's Indian JV suspended some of its senior executives as part of the same investigation

Diageo plc (2011)

- Diageo, the UK alcoholic beverages company headquartered in London, has American Depositary Receipts registered with SEC and traded on NYSE – thus, an “issuer” for purposes of FCPA
- Diageo India Pvt. Ltd., an Indian subsidiary of Diageo, made over \$1.7mm in illicit payments to 900 or more Indian government officials between 2003-2009
- Increased sales from these payments amounted to more than \$11mm in ill-gotten gains
- SEC books and records and internal controls enforcement action via an administrative cease and desist order (July 2011)
- Diageo plc disgorged \$11.3mm; plus prejudgment interest of \$2.1mm; plus \$3mm civil monetary penalty = total \$16.4mm paid*

(*Note: This settlement includes misconduct by Korean and Thai Diageo subsidiaries, in addition to misconduct of the Indian subsidiary)



Pride International Inc. (2010)

- Houston-based drill rig provider to the oil and gas industry
- Illicit payments of over \$2 million in various countries including India
- A French subsidiary of Pride paid \$500,000 in bribes to an Indian judge to resolve a customs dispute
- Certain Pride US employees knew about the payments
- Pride disgorged \$19.3 million in profits, paid prejudgment interest of \$4.2 million in a civil SEC action and \$32 million to resolve the criminal proceedings brought by the Justice Department
- Employees of Price were also charged by the SEC and fined



Westinghouse Air Brake Technologies (2008)

- US-based manufacturer of brake subsystems for freightcars and passenger transit vehicles
- Employees of Indian subsidiary (Pioneer) made illicit payments to officials of the Indian Railway Board to obtain business, expedite product delivery certificates and curb excessive tax audits
- Pioneer used marketing agents to generate cash kept in locked metal boxes not subject to the audit
- Westinghouse agreed to pay a \$300,000 fine, disgorge about \$288,000 in profits, pay about \$89,000 in civil penalties
- Westinghouse agreed to adopt rigorous internal controls



Electronic Data Systems Corp (2007)

- A.T. Kearney India (EDS subsidiary) made illicit payments of \$720,000 to employees of Indian state-owned enterprises to retain their business
- Payments made at the direction of the President of ATKI who feared the loss of the contracts would result in the closing of the business
- EDS recognized \$7.5 million in revenues from the contracts
- EDS agreed to disgorge \$490,000 in profits
- Proceedings were brought against the president of ATKI who agreed to pay a \$70,000 fine

UK Bribery Act 2010 – Broader than FCPA



- Prohibits bribes paid to any person to induce them to act “improperly” (not limited to foreign officials)
- Focus is on improper action rather than business nexus/ advantage (except in case of strict corp. liability)
- Creates two offenses: (i) offense of bribing another (“active offense”) and (ii) offense of being bribed (“passive offense”)
- Creates a new strict liability corp. offense for failure of a commercial organization to prevent bribery (subject to defense of having “adequate procedures” in place designed to prevent bribery)
- No facilitating payments or business promotion expenditures exception (but arguably such expenditures are not “improper” and therefore not a Bribery Act violation)
- No violation if permissible under written laws of foreign country (applies only in case of bribery of foreign public official; otherwise a factor to be considered)

UK Bribery Act 2010 – Broader than FCPA



- Jurisdiction over individuals who are UK nationals or are ordinarily resident in the UK and organizations that are either (i) established in the UK or (ii) conduct some part of their business in the UK
- Criminal enforcement only by the UK Serious Fraud Office (SFO)
- Potential liabilities:
 - For individuals, up to 10 yrs imprisonment and potentially unlimited fines
 - For entities, potentially unlimited fines

Prevention and Mitigation



- Corruption compliance is needed for ALL multi-national companies entering the Indian market
 - Compliance program
 - Monitoring
 - Training
- Due Diligence
 - Partners, business agents, joint ventures
 - M&A deals
- Legal Protections
- Post Acquisition Integration

Best Practices – Due Diligence



- What to know:
 - Target business players and history
 - How the business operates
 - Customers/contracts
 - Finances and Multiple books
 - Tax avoidance
 - Business environment
- Know exposure to regulatory layers
 - Police
 - Customs
 - Property offices
 - Taxation
 - Judiciary

Best Practices – Due Diligence



- Know how the money is being spent
 - Follow the money in accounting system
 - Awareness of tax avoidance schemes
 - Enhanced scrutiny of “agents”
- How to Learn It:
 - forensic accounting
 - background investigations
 - Having feet on the ground
 - experienced lawyers
 - International consulting firms

Legal Protections – Representations and Warranties



- Representations and Warranties:
 - All transactions appropriate under local law
 - No portion of the deal proceeds will be used to fund payments to secure government approvals or gain some improper business advantages
 - No corrupt payments were made to government officials to obtain or retain company business
 - No government officials is a company owner, or holds any interest in the company
 - Company's books and records are accurate and complete



- Structure transactions to reduce exposure to liability
 - asset v. stock transaction
 - “greenfield operation”
- no retroactive application of FCPA in acquisitions

Post-Acquisition Integration



- Promptly incorporate the acquired operations into your internal control system including the compliance program
- Train new employees
- Reevaluate third parties under compliance standards
- Conduct audits on new business where appropriate

Compliance Programs



- Create strong culture of compliance and internal controls
- Policies/monitoring/training
- Anonymous employee reporting
- Cookie cutter approach does not work! Understand and respect your setting-
 - Know your local environment
 - Recognize the good corporate policy nevertheless can put employees in difficult social positions
 - Respect cultural issues when conducting interviews
 - Translate into local languages
 - Keep the language plain
 - Stress more than a U.S.-centric law
 - Not FCPA but anti-corruption
 - Get out to the field
 - Enlist local leadership on compliance issues



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