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FCPA and Extortion: The NATCO Settlement

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Extortion as a defense to the FCPA? The SEC's NATCO Settlement

A US$65,000 settlement in January between the Securities and Exchange Commission ("SEC") and NATCO Group, Inc. ("NATCO") provides a possibility that "duress" or "extortion" may be recognized as a defense to bribery charges under the Foreign Corrupt Practices Act ("FCPA"). The payments in question were made to Kazakh government officials who had threatened to fine, jail, or deport the company's employees. Yet, while the alleged extortion of these payments was a possible defense to a charge under the anti-bribery provisions of the FCPA, and although the company self-reported the payments, cooperated with the staff's investigation, and engaged in remediation, the SEC still charged the company with violations of the FCPA's accounting provisions. The SEC alleged that the payments were recorded inaccurately and the company's internal controls failed to prevent the inaccurate entries. The settlement illustrates the continuing breadth of the accounting provisions of the FCPA and that voluntary disclosure may only result in a reduction of a penalty, rather than in avoiding charges entirely. To date, the Department of Justice ("DOJ") has not filed any charges against the company, and neither the DOJ nor the SEC has charged any individuals.

FACTS/ALLEGATIONS [1]:

TEST Automation & Controls, Inc. ("TEST"), based in Louisiana, is a wholly owned subsidiary of NATCO, an oil field services provider headquartered in Houston, Texas. TEST maintained a branch office in Kazakhstan ("TEST Kazakhstan"), where it had won a contract in 2005 to provide instrumentation and electrical services.

Kazakh law required TEST to obtain immigration documentation for its expatriate workers, and Kazakh immigration officials periodically audited this documentation. In February and September of 2007, Kazakh immigration officials claimed that TEST's non-Kazakh workers lacked proper documentation. The officials threatened to fine, jail, or deport the workers if TEST did not pay "fines" in cash. It appears that these "fines" had no legitimate basis and were actually extorted payments. TEST's senior management in Louisiana authorized the payments. The employees in Kazakhstan used personal funds to make the payments — totaling US$45,000 — and then were

reimbursed through wire transfers from TEST in the United States. The SEC characterized these as "extorted" payments, but did not specify whether it used that term in its lay or legal sense.

TEST inaccurately characterized the February 2007 wire transfer as a bonus or salary advance to its employees. The complaint alleges that the company provided an inaccurate description in its letter to the bank requesting the wire transfer to reimburse the employees, as well as in emails designed to "disguise the reason for the transfer." After the wire transfer, TEST "inaccurately recorded the payment in its books and records as a salary advance." TEST later characterized the September 2007 wire transfer as "visa fines." Both the wire transfer and journal entry in TEST's books used this description.

Payments to an "Immigration Consultant"

Also at issue in the settlement was TEST's use of Kazakh consultants to assist in obtaining immigration documentation for its workers. One of these consultants did not have a license to perform visa services, but did have connections at the Kazakh ministry responsible for the visas. Kazakh law requires companies to submit invoices when withdrawing cash from commercial bank accounts. The consultant submitted "bogus invoices" to TEST, which TEST then used to withdraw over US$80,000 from its Kazakh bank accounts to make the payments. TEST Kazakhstan then submitted the same false invoices to TEST for reimbursement. TEST reimbursed the requests, despite knowing that the invoices did not accurately characterize the purpose of the payments.

SEC Charges and Resolution

The SEC did not charge the company with FCPA bribery violations.[2] Instead, the SEC alleged that TEST "created and accepted false documents" in relation to the payments described above. Specifically, the Commission alleged that "NATCO's books, records and accounts did not properly reflect TEST's reimbursement of payments to the Kazakhstan immigration prosecutor or the immigration consultant." In addition, the SEC alleged that NATCO failed to "devise or maintain sufficient internal controls" to ensure TEST's compliance with the books and records provisions of the FCPA. Without admitting or denying the allegations in the complaint, NATCO consented to the entry of judgment requiring NATCO to pay US$65,000.[3][4]

Investigation and Remediation

NATCO discovered the potential issues arising from these payments during a routine internal audit review in 2007. The company conducted an internal investigation and voluntarily disclosed the results to the SEC. NATCO took remedial measures including disciplining and terminating the responsible employees. To enhance its internal controls and improve its worldwide FCPA compliance going forward, NATCO took a series of steps, including:

- creating a revised form for agent agreements
- establishing new due diligence procedures to vet third-party intermediaries
- increasing global compliance staffing and appointing a full-time Chief Compliance Officer
- joining a non-profit association that specializes in anti-bribery due diligence

- increasing FCPA compliance training worldwide
- investing in software to enhance internal controls and compliance
- restructuring and enhancing internal audit and compliance monitoring processes

LESSONS:

(1) The Settlement Opens the Possibility That Extortion Might Provide a Viable Anti-Bribery Defense

The issue of whether a defense of "extortion" or "duress" exists to an FCPA action remains unsettled. The statute itself makes no mention of such a defense, and the cautious client advice has always been not to rely on the availability of such a defense. The legislative history mentions it, but only briefly, noting that only "true extortion situations" such as "a payment to an official to keep an oil rig from being dynamited" should be outside the statute since the payment in that situation "should not be held to be made with the requisite corrupt purpose."[5] In the recent criminal FCPA case, *U.S. v. Kozeny*, the jury "was instructed that if it determined that Defendant Bourke and the others in the alleged conspiracy lacked the required intent — as would be the case if they were coerced to make payments — it would be required to acquit Bourke."[6] To negate the mental element of the underlying criminal offense, however, a defendant must face a threat significantly more severe than mere inconvenience. In *Kozeny*, Judge Scheindlin noted the distinction between a payment demanded by a government official "as a price for gaining entry into a market or to obtain a contract" and a payment made to an official "to keep an oil rig from being dynamited," as mentioned in the legislative history. Only the latter would constitute "true extortion."[7]

Between the "true extortion" that would negate a defendant's *mens rea* and the payment of a paradigmatic "bribe," however, lies a wide range of potential uncertainty. Though some commentators see the NATCO case as "confirm[ing] that civil FCPA charges can result from paying blackmail money to protect the welfare of employees overseas,"[8] it is also noteworthy that the SEC complaint did not allege that the extorted payments were *themselves* FCPA bribery violations. Instead, the SEC focused on the concealment of those payments in the company's books and records. The SEC's referral to the payments as "extorted" payments — combined with the omission of any FCPA claim based on the payments themselves — suggests that the SEC may have considered the extortion defense viable in this context.

However, it is equally plausible that the SEC did not consider that the payments sufficiently met the business nexus requirement that the payments assisted in obtaining or retaining business. Alternatively, the staff may have dropped the anti-bribery charge based on the company's voluntary disclosure and cooperation. Unfortunately, the complaint is silent on this point. Regardless of the true reason for this disposition, the case offers some hope that the Commission may be receptive to arguments that genuinely extorted payments do not violate the anti-bribery provisions.

(2) Extortion Does Not Prevent Books and Records and Internal Controls Charges

Although the company avoided the anti-bribery charge, it did not escape alleged violations of the

FCPA accounting provisions, which contain no scienter requirement and catch non-material inaccurate books and records maintained by a company and all of its subsidiaries. In fact, the NATCO settlement provides another example of the broad scope of the FCPA's accounting provisions. The SEC's complaint stated that "NATCO's books, records, and accounts did not properly reflect TEST's reimbursement of payments to the Kazakhstan immigration prosecutor or the immigration consultant." In other words, if the company had recorded the amount, date and amount of the payment, along with the recipient and purpose, it would likely have avoided the books and records charge. It remains unclear whether it could also have avoided an internal controls charge, but it would have been on far stronger ground.

(3) NATCO's Internal Investigation and Cooperation With the SEC

NATCO discovered the misconduct in an audit within months of its occurrence. It promptly disclosed the matter to the government and cooperated in the investigation. The misconduct appears to have been isolated to this subsidiary and, given the lack of a disgorgement claim, provided the company no obvious economic benefit. The company also took significant remediation steps, including terminating the employees and restructuring and enhancing its worldwide compliance efforts.

Yet, despite this exemplary conduct, NATCO still faced an enforcement action and paid a US$65,000 penalty. In recent weeks, the SEC has again urged companies to voluntarily disclose misconduct[9] but in light of this settlement the question can fairly be asked of whether the company would have been better off remediating the situation as it did, not disclosing to the government, and moving on. It is likely that the SEC staff focused on the involvement of NATCO executives in this case and considered their behavior as tipping the balance in favor of an enforcement action. However, the fact that NATCO was fined at all will fuel the ongoing debate over whether the benefits of cooperation with the government in these circumstances outweigh the costs.

[1] Though stated as factual, this description comes from the SEC's complaint, available here, and the SEC's Order Instituting Cease-And-Desist Proceedings against NATCO, available here. The SEC's Litigation Release is available here. NATCO consented to the judgment without admitting or denying the allegations of the complaint.

[2] Despite the absence of a direct anti-bribery charge, the NATCO case may reflect an extension of the *U.S. v. Kay* line of cases broadening the scope of the types of payments scrutinized under the auspices of FCPA enforcement. In *Kay* in 2004, the Fifth Circuit held that payments to customs officials for favorable tax treatment could constitute FCPA violations. *See U.S. v. Kay*, 359 F.3d 738, 740 (5th Cir. 2004) Prior to that decision, it had been widely believed by some in the defense bar, including by the *Kay* district court, that the FCPA prohibited only acts in furtherance of offers or payments designed to obtain contracts with government entities. *See U.S. v. Kay*, 200 F. Supp. 2d 681, (S.D. Tex. 2002) (finding that allegations of payments to foreign government officials for the

purpose of reducing customs duties and taxes were insufficient to state a claim under §§ 78dd-1(a) and 78dd-2(a) of the FCPA because they did not fall under the scope of "obtaining or retaining business" under the FCPA), *rev'd*, 359 F.3d 738 (5th Cir. 2004). The Fifth Circuit's opinion in *Kay* made clear that the anti-bribery provisions can also reach payments to obtain other kinds of government benefits (such as licenses, favorable tax treatment, and the like) so long as those payments and benefits assist in obtaining or retaining business from some party, whether or not a government official. In subsequent enforcement actions, the DOJ and SEC have obtained settlement agreements and guilty pleas in connection with payments to tax, customs, and other local officials. *See* O'Melveny & Myers, *Foreign Corrupt Practices Act Handbook* (6th ed. 2009) at 44-46. (Available at O'Melveny's website, here.) The NATCO settlement would seem to extend this trend to include payments to immigration officials within the scope of potential FCPA violations.

[3] NATCO's consent is available here.

[4] The court's final judgment is available here.

[5] S. Rep. No. 95-114, at 10-11 (1977), *reprinted in* 1977 U.S.C.C.A.N. 4098, 4108.

[6] *See U.S. v. Kozeny*, 664 F. Supp. 2d 369, 396 (S.D.N.Y. 2009).

[7] *See id* at 395.

[8] *See* NATCO Settles "Extorted" Bribe Case, The FCPA Blog (Jan. 12, 2010).

[9] On January 13, 2010, the SEC launched an initiative to "establish[] incentives for individuals and companies to fully and truthfully cooperate and assist with SEC investigations and enforcement actions." *See* SEC Press Release, *SEC Announces Initiative to Encourage Individuals and Companies to Cooperate and Assist in Investigations*, Jan. 13, 2010, available here.