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Edward E. Dyson

The Foreign Corrupt Practices Act of 1977 and Commission Payments to Agents in Export Transactions

by Edward E. Dyson*

I. Introduction

Over the past few years there has been much publicity concerning the disclosure by many U.S. corporations of payments to foreign officials to secure favorable business treatment. The Securities and Exchange Commission (the "SEC") initiated the Voluntary Disclosure Program in which some 400 companies under SEC jurisdiction participated. Such disclosures supposedly would satisfy the main goal of the SEC, namely, to insure that companies adequately accounted to their shareholders for all off-the-book funds and payments relating to dealings with foreign governments.

We have seen, however, from recent developments that voluntary disclosure was not enough to satisfy both the SEC and the Department of Justice. The latter is currently investigating those companies that volunteered to disclose for purposes of determining if criminal violations exist. Since the Foreign Corrupt Practices Act of 1977[1] (the "FCPA") was not in force at the time that many of the activities which are being investigated took place, the Justice Department has resorted to the use of the Currency and Foreign Transactions Reporting Act,[2] and the Mail and Wire Fraud statute[3] in bringing actions against companies.

The FCPA consists primarily of two parts. The first,[4] and to some the most significant part, imposes substantial accounting standards on issuers subject to the Securities Exchange Act of 1934.[5] Under the sec-

* Member, Virginia and District of Columbia Bars; Partner, Baker & McKenzie; B.B.A. 1962, LL.B. 1966, George Washington University.

[1] Pub. L. No. 95-213, 91 Stat. 1494 (1977) (codified in scattered articles of 15 U.S.C. § 78, *reprinted in* 17 INT'L LEGAL MATERIALS 214 (1978).

[2] 31 U.S.C. §§ 1051-1062, 1081-1083, 1101-1105, 1121-1122 (1976). Sections 1058, 1059, and 1103 provide the sanctions for noncompliance.

[3] 18 U.S.C. §§ 1134-1343 (1976). Sections 1341 and 1343 are applicable in this context.

[4] Pub. L. No. 95-213, § 102, codified in 15 U.S.C.A. § 78m(b)2, 3 (1978 Supp.).

[5] 15 U.S.C. § 78 (1976).

ond part,[6] or corrupt payment section, issuers and other "domestic concerns" not under SEC jurisdiction, are prohibited from making payments to "foreign officials."

This speech will examine the main provisions of the FCPA including its jurisdictional scope. It will then analyze what is perhaps the most worrisome provision under the FCPA for most U.S. companies exporting abroad, *i.e.*, the "reason to know" requirement with respect to payments.[7] Under this requirement the FCPA holds a U.S. company accountable for payments made by a commission agent of a U.S. company to a foreign official, even though the U.S. company did not have actual knowledge of the payment but did have "reason to know" of it.

II. Federal Legislation

A. The Foreign Corrupt Practices Act of 1977

1. Accounting Standards—Generally, a company under the jurisdiction of the SEC is required to maintain its records in reasonable detail to reflect disposition of assets accurately.[8] The obvious purpose of the requirement is to prevent the creation of "off-the-books funds" that may be used for making illegal payments. Issuers are also required to establish internal accounting controls to insure that the transactions are carried out under proper authorization and are properly recorded to account for assets adequately.[9] Access to assets also must be controlled.[10]

The FCPA specifically includes an exception to the accounting standards requirements on the basis of national security;[11] that is, there may be instances where companies are expressly excused from maintaining records of certain assets, presumably used to establish slush funds, if this practice is done at the direction of the U.S. government for national security purposes. It is not quite clear how this provision would work. It goes without saying that any issuer that attempts to come under this provision should initially take all steps necessary to insure that the government cannot later take a contrary position, especially in view of the aftermath of the Voluntary Disclosure Program.

Finally, there is some question as to whether the accounting standards apply to foreign subsidiaries of U.S. companies. The SEC has taken the position that they do, although this is not clear from the legislation itself. If the SEC position is maintained, it would appear reasonable to apply the requirements only to those foreign subsidiaries who materially contribute to consolidated financial statements of a U.S. issuer.

It is important to note that the establishment of internal accounting

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[6] Pub. L. No. 95-213, §§ 103, 104, codified in 15 U.S.C.A. §§ 78dd-1,2 (1978 Supp.).
[7] *Id.* § 103(a)(3), codified in 15 U.S.C.A. § 78dd-1(a)(3) (1978 Supp.).
[8] *Id.* § 102(2)(A), codified in 15 U.S.C.A. § 78m(b)(2)(A) (1978 Supp.).
[9] *Id.* § 102(2)(B)(i), (ii), codified in 15 U.S.C.A. § 78m(b)(2)(B)(i),(ii) (1978 Supp.).
[10] *Id.* § 102(2)(B)(iii), codified in 15 U.S.C.A. § 78m(b)(2)(B)(iii) (1978 Supp.).
[11] *Id.* § 102(3)(A), codified in 15 U.S.C.A. § 78m(b)(3)(A) (1978 Supp.).

controls may have a significant bearing on the "reason to know" standard with respect to payments made to foreign officials by the commission agents of U.S. exporters. If, for example, internal controls have been established and if pursuant to such controls commission payments are closely monitored and nothing out of the ordinary becomes apparent, then this may contribute to a finding that the U.S. exporter does not have reason to know of an illegal payment actually made out of such commissions.

2. Corrupt Payments

a. Jurisdiction—The FCPA prohibits corrupt payments to foreign officials. The SEC and the Justice Department share the responsibility for enforcement of the FCPA. The SEC has jurisdiction with respect to any issuer who has registered securities pursuant to Section 12 of the Securities Exchange Act of 1934[12] or who is required to file reports under Section 15(d).[13] This enforcement responsibility also extends to any officer, director, employee or agent of an issuer, or any stockholder of the issuer acting on its behalf.[14]

The Department of Justice has enforcement responsibility over any other "domestic concern" that is not an issuer subject to the jurisdiction of the SEC.[15] A "domestic concern" under the FCPA means any individual who is a United States national or any resident of the United States, or any corporation, partnership, association, joint stock company, business trust, incorporated organization or sole proprietorship which has its principal place of business in the United States or which is organized under the laws of a state of the United States.[16]

The FCPA does not extend to foreign subsidiaries of domestic concerns.[17] The legislative history specifically recognizes the jurisdictional difficulty inherent in attempting to enforce the provisions of the FCPA with respect to the activities of foreign subsidiaries.[18]

On the other hand, the legislative history recognizes that a domestic concern may be closely involved in an international transaction carried out by its foreign subsidiary and that this involvement itself may subject the domestic concern to liability.[19] Accordingly, the exclusion of foreign subsidiaries may not be as significant as first thought. Very seldom does a domestic concern completely divorce itself from the activities of a foreign subsidiary. If, for example, a foreign subsidiary, as a matter of rou-

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[12] Pub. L. No. 95-213, § 103(a), codified in 15 U.S.C.A. § 78dd-1(a) (1978 Supp.).

[13] *Id.*

[14] *Id.*

[15] *Id.* § 104, codified in 15 U.S.C.A. § 78dd-2 (1978 Supp.).

[16] *Id.* § 104(d)(1), codified in 15 U.S.C.A. § 78dd-2(d)(1) (1978 Supp.).

[17] *Id.* by omission.

[18] S. REP. NO. 114, 95th Cong., 1st Sess. 11 (1977). The Senate version of the bill was passed; *see also* the conference reports H.R. REP. 831, 95th Cong., 1st Sess. (1977); H.R. REP. 95th Cong., 1st Sess. (1977); H.R. REP. 640, 95th Cong., 1st Sess. (1977).

[19] S. REP. NO. 114, *supra* note 18, at 11.

tine, requests authorization from its U.S. parent to proceed with transactions and those transactions involve unreasonable commissions, acquiescence by the U.S. parent may make it liable under the FCPA. Furthermore, although foreign subsidiaries are not covered, individuals who are U.S. residents, citizens or nationals will be liable when they act in relation to the affairs of any foreign subsidiary of a U.S. company.

The legislative history clearly indicates that employees (other than officers, directors or stockholders acting on behalf of the company) and agents of a domestic concern or issuer cannot be found liable unless the company is also found liable.[20] The purpose of this requirement is to insure that a low-level employee or other agent of the company is not made the scapegoat for the corporation. This provision is intended to insure that the agent or employee has an adequate legal defense by utilizing some of the resources used by the issuer or domestic concern in its own defense.

The SEC and the Justice Department are encouraged in the legislative history to cooperate closely in the development of a uniform enforcement program.[21] The SEC's responsibilities extend to conducting investigations, bringing civil injunctive actions and commencing administrative procedures. The Justice Department retains sole investigative and prosecutorial jurisdiction over domestic concerns. In all cases, responsibility for criminal prosecution rests with the Justice Department.

This unusual division of enforcement responsibility may confuse those companies attempting to comply with the FCPA and most certainly will give rise to different interpretations with respect to permissible activities. For example, the President recently issued a statement, intended to liberalize export policies, which included a directive to the Justice Department to issue guidelines under the FCPA. To date, however, both the Justice Department and the SEC have remained tightlipped and have refused to provide any guidance whatsoever. This, of course, has left companies in a very uncertain state, and exporters, when in doubt, have tended to refrain from doing business, to the detriment of our balance of payments problem.

b. Prohibitions—Under criminal penalty, the FCPA prohibits issuers, domestic concerns or any officer, director, employer, or agent of issuers or domestic concerns from making use of the mails or any instrumentality of interstate commerce *corruptly* in furtherance of an offer, payment, or promise to pay *anything of value* to any *foreign official*, any foreign political party or any candidate for foreign political office, or *any person*, while knowing or having *reason to know* that a payment will be made to a foreign official, political candidate, etc., in order to *obtain, retain*

[20] *Id.*
[21] *Id.* at 12.

or direct business to any person.[22] All of the above elements are necessary for a conviction under the FCPA.

(i) Corruptly—As set forth in the legislative history,[23] the payment must be intended to induce the recipient to misuse his official position in order to wrongfully direct business to the payor or his client or to obtain beneficial legislation or a favorable regulation for him. The term "corruptly" connotes an "evil motive" or purpose but it does not require that the act be fully consummated or succeed in producing the desired outcome. The required intent may be inferred from all of the surrounding facts and circumstances.

Thus, persons subject to the FCPA will be liable for payments made with a corrupt intent. In addition, an individual who is a domestic concern and any officer, director, stockholder (acting on behalf of an issuer or domestic concern), employee or agent of an issuer or domestic concern will be liable for *willful* violations of the prohibition against payments to foreign officials (*i.e.*, a realization that one is engaging in wrongful conduct and deliberate and intentional acts or omissions in connection therewith).

(ii) Anything of Value—An actual payment is not required. Offers of or promises to pay anything of value are covered. The term "anything of value" is broad enough to include not only cash payments or gifts of personal property but may include a request by the foreign official that a friend or relative be appointed as agent in a particular transaction or that a contribution be made to a charitable organization controlled by the official or to a family member. In general, "anything of value" can be construed to mean any gain or advantage or anything regarded by the beneficiary as a gain or advantage.

(iii) Business Purpose—In order to come within the prohibitions of the FCPA, the payment made to a foreign official must be for the purpose of assisting the payor in obtaining or retaining business or in directing business to someone else, such as the payor's client. In this context, payments to obtain favorable government contracts are clearly covered. Likewise, payments to obtain preferential legislation would be covered. A payment may also be prohibited where its purpose is to increase the company's profits in a particular transaction, such as by unauthorized tax payment reductions or a customs reclassification to a lower duty.

These activities must be contrasted with facilitating payments (to be discussed below) and distinguished from extortion situations. As illus-

[22] Pub. L. No. 95-213, § 30A, 104, codified in 14 U.S.C.A. § 78dd-1,2 and § 78L (1978 Supp.).

[23] *Supra* note 18, at 10.

trated in the legislative history of the FCPA,[24] a payment to an official to keep an oil rig from being dynamited should not be held to be made with the requisite corrupt purpose.

(iv) Foreign Official—A "foreign official" means any officer or employee of a foreign government or of any department, agency, or instrumentality thereof, or any person acting in an official capacity for or on behalf of a foreign government or any department, agency or instrumentality thereof. The definition does not include low-level government employees whose duties are primarily ministerial or clerical in nature. A government employee who has the discretionary authority to award government contracts, however, is clearly a foreign official for purposes of the FCPA.

A question exists as to whether state-owned businesses, such as Eastern Bloc trading companies, are government instrumentalities. State-owned trading companies, for all outward purposes, operate in essentially the same manner as any other commercial establishment. Because of the uncertain status of state-owned companies, however, U.S. companies are obliged to treat employees of those companies in a manner different from the way they treat employees of purely commercial establishments. It may be acceptable to buy employees of state-owned businesses a lunch during the course of a sales negotiation, but anything that smacks of a corrupt payment should be avoided.[25]

In some countries, a government employee can act in a private capacity as an agent. Care must be taken when dealing with such a person to ascertain which hat he is wearing. The definition of a "foreign official" is also broad enough to cover persons acting on behalf of the government, such as government consultants who may be in a position to evaluate and recommend business proposals to the government. Another questionable situation involves Middle East countries where many members of the various royal families serve as commercial agents. Are these persons foreign officials because of their royal affiliations? The legislative history offers no explanation for the failure to answer these questions and, to date, the Department of Justice and the SEC have been unwilling to provide guidance in this area.

(v) Exclusions —Commercial bribery is not covered by the FCPA, which is limited to payments of "foreign officials." Facilitating payments, or so-called "grease" payments, are also excluded under the FCPA. The statute excludes from its definition of foreign official those employees whose duties are essentially ministerial or clerical. The legislative history cites as examples of facilitating payments those which are made for the purpose of expediting shipments through cus-

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[24] *Id.* at 11.

[25] Pub. L. No. 95-213, § 30A(b) and § 104(d)(2), codified in 15 U.S.C.A. § 78dd-1,2 and § 78L (1978 Supp.).

toms, placing a transatlantic telephone call, securing required permits or obtaining adequate police protection.[26] In all such cases, the duties are properly performed, although perhaps performed in a more expeditious manner. In contrast, however, a payment to a customs official made for the purpose of fraudulently reclassifying commodities to a lower duty classification would fall outside of the facilitating payments exclusion.

While the FCPA exempts such facilitating payments, at least one Justice Department spokesman has not ruled out the possibility of bringing an action under other Federal statutes (such as the Mail and Wire Fraud statute) when such facilitating payments are made on a continuing basis, are extensive, have a significant effect on the business, and are paid with the knowledge of top officials of the company.

B. Other Federal Statutes

The Justice Department has brought criminal enforcement actions in the questionable payments area under the statute against making false statements to the government,[27] the Currency and Foreign Transactions Reporting Act[28] and the Mail and Wire Fraud statute.[29] The Currency and Foreign Transactions Reporting Act requires a report from persons carrying more than $5,000 in any monetary instrument to or from the United States. Actions have been brought under the Mail and Wire Fraud statute on the basis that payments made by a U.S. company in violation of a local country's laws are a fraud perpetrated on the people of that country. Moreover, the Internal Revenue Service is conducting its own investigation of foreign payments. It asks a series of five questions, some of which are broader in scope than the prohibitions under the FCPA.

III. Commission Payments to Agents

Undoubtedly, the section of the FCPA that is the most troublesome to exporters is that which prohibits payments to others while knowing or having reason to know that all or a portion of such payments will be paid to a foreign official. Some authorities have contended that this reason-to-know standard is too vague to support a criminal prosecution. Suffice it to say, however, that companies will at least be required to take certain steps and institute certain procedures designed to uncover situations which, from outward signs, are out of the ordinary. While the legislative history recognizes that companies cannot be responsible for agents who run "amuck,"[30] a conscious disregard of obvious signs puts the company in a tenuous position.

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[26] *Supra* note 18, at 10.
[27] 18 U.S.C. § 1001 (1948).
[28] *Supra* note 2.
[29] *Supra* note 3.
[30] *Supra* note 18, at 11.

One may posit an overly simplified hypothetical: a company may have been dealing for some years with a particular agent who customarily charges a five percent commission on the net invoice price to purchasers in a foreign country. The seller desires to sell to a particular government agency with which it has not done business before, and it seeks the agent's assistance. The agent indicates that he can put the deal together but, in a departure from previous practice, requests a ten percent commission. Why the additional five percent? Is such increase in commission, where the commission has been stable for years, a sign that would give the company "reason to know" that a payment may be made to a foreign official?

Several factors may provide the company with reason to know: size, the services to be performed by the agent, the relationship of the agent to the governmental buyer and the method of payment. The size of the payment may be an indication that something is amiss. We have seen, however, especially in transactions in the Middle East, that commissions can be extremely high and exhorbitant. This, in itself, does not necessarily mean that payments are being made to foreign officials. The company paying the commissions, however, should ascertain whether the payments are substantially in excess of the going rate for similar services in the particular country. The company should further ascertain whether the country involved has regulations imposing a ceiling on the commission rate for agents and, if so, whether that rate has been exceeded.

The nature and extent of the services rendered by the agent are significant factors in determining whether a commission payment is reasonable and justifiable. A comparison can be made between intermediation services, that is, payment of a substantial fee to the agent merely for locating a customer, and conventional services, such as advertising and installation services usually provided by agents in the normal course of selling a product. Payments for intermediation services are more suspect than payments for conventional services rendered by an agent. It should be noted, however, that intermediation services are clearly permissible in many foreign jurisdictions. On the other hand, some countries do not permit agents to act as intermediaries between a supplier and a governmental purchaser. A company should take care to assure that the services rendered by the agent are commensurate with the size of the commission and the payment is, therefore, economically justifiable.

It goes without saying that the company should determine whether the agent is in any way connected with the foreign government, either as an employee or consultant. As mentioned earlier, a government official is permitted under the laws of some countries to act as a private agent in an individual capacity. For obvious reasons the company should exercise extreme care under these circumstances.

An agent's direction to make payment to a third party, such as a

bank outside of the country in which the agent resides, should also cause the company to question the legality of the payment. By making such a payment outside of the country the U.S. supplier may be aiding and abetting a violation of the currency exchange controls or tax laws of the agent's country. While this activity does not involve a payment to a foreign official, it may be actionable under the Mail and Wire Fraud statute on the grounds that a fraud is being perpetrated on the government or the people of the agent's country.

Another common payment practice is "overinvoicing." Under this practice, the invoice prepared by the U.S. supplier shows the goods at a higher price than the actual contract price. The higher price is paid by the buyer and the difference between the actual price and the higher price is held in reserve for the buyer for subsequent deposit in a foreign bank of the buyer's choice. In this manner, the buyer is able to avoid his country's currency controls or income tax laws. The U.S. supplier may be liable under the Mail and Wire Fraud statute for aiding and abetting the distributor in evading his country's laws and may also be liable for misstatements in completing shipping declarations or license applications required under U.S. export laws. Additionally, in the case of an issuer subject to the jurisdiction of the SEC, such a practice may be in violation of the accounting standards of the FCPA to the extent that the corporate books fail to reflect the underlying transaction accurately.

These dealings with a commission agent should be distinguished from dealings with a distributor. In most cases, title to the goods passes to the distributor and he sells to third parties at his own discretion. He generally acts independently. Absent evidence which shows that the distributor arrangement is merely a sham to enable the supplier to do something indirectly which he could not do directly, the supplier should not in the normal course of action be responsible for the acts of the distributor.

A company can take steps to protect itself when dealing with an agent by using contractual provisions that obligate the agent to refrain from making payments to foreign officials, to comply with local laws, to disclose to the U.S. supplier any instances when the agent is placed in a compromising position and to forfeit commissions in the event of misconduct on his part.

The company should check into the background of all agents it employs; such an investigation should include making credit checks and obtaining references from other companies using the agent. Reasonableness of the commissions demanded by the agent should be documented in light of the customary practice in the country involved and in view of the services rendered by the agent. In some circumstances, the U.S. supplier may resort to the opinion of local counsel with respect to whether the agent is a foreign official, whether he is properly

registered and whether the commission he is demanding is legally within any limits that may be set under local law. Representations by company employees in the field as to the trustworthiness and competence of an agent would be helpful in completing the file on the agent.

Finally, the institution of internal accounting controls (regardless of whether or not required) and board monitoring of any transactions that may be material to the company are desirable. The use of all of the foregoing procedures will be helpful in showing that the company had no "reason to know" of the subsequently discovered illegal payments by an agent to a foreign official.

In general, companies should adopt codes of conduct which set forth the company policy of full compliance with U.S. laws relating to foreign payments. They should request periodic certifications by key employees and should conduct educational seminars and distribute memoranda explaining U.S. legislation governing such payments.

Question and Answer

Question: How would you counsel a client concerning payments to officials of state-owned companies? What if a foreign subsidiary makes the payment?

Mr. Dyson: Payment to a state-owned company may be a payment to a foreign official, because a state-owned company is an instrumentality of the government. Technically, payment by a foreign subsidiary is outside the Foreign Corrupt Practices Act, however, the U.S. operation may be considered to have acquiesced in the payment.

Question: Do you think that the U.S. government will take local custom into account when deciding to prosecute U.S. companies for questionable payments?

Mr. Dyson: I don't. The statute does not provide exemptions on a territorial basis, so I assume that it will be enforced evenhandedly. There is no exclusion based on the legality of payment under local law.

Question: How will the accounting procedures affect corporate structure? Will it cost more and will the SEC promulgate bookkeeping guidelines?

Mr. Dyson: Only companies under the jurisdiction of the SEC will be affected, and most of these have been submitting financial statements to the SEC for some time. The primary effect will be the institution of internal controls designed to catch a flagrant payment to an official or a large slush fund. The legislative history indicates that the company need not spend more money on installing the internal controls than they

are worth. The controls should be geared to the particular operation, which will affect the corporate structure. There are various guidelines which have been promulgated.

Question: Comment on the pitfalls of directing a foreign agent to deposit commissions in a Swiss bank.

Mr. Dyson: The problem here is one of aiding and abetting. Is the agent avoiding the payment of income tax in his local jurisdiction? Is he getting money out of the country illegally? By helping him are you committing a fraud on the government and thereby a fraud on the people? There may be situations where this arrangement is merely a matter of convenience and there are no problems. If no law is violated, there should be no particular problem.