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A New Tool and a Twist? The SEC's first Deferred Prosecution Agreement and a Novel Punitive Measure

On May 17, 2011, Tenaris S.A entered into deferred prosecution agreements (DPAs) with *both* the Department of Justice and the Securities and Exchange Commission to settle FCPA charges involving payments to officials of a Uzbekistan state-owned entity. Although such agreements have become commonplace in DOJ criminal enforcement actions, this settlement represents a first for the SEC. The utility of such agreements in the civil context appears much less obvious than in the criminal context. Similar to the criminal DPAs, the SEC's civil DPA allows the company to avoid a judicial or administrative adjudication of its conduct even though the rest of the consequences – financial penalties, compliance requirements, and monitoring obligations – may remain the same. However, in an apparent departure from the SEC's own past practice and some DOJ precedents, this agreement contains a provision restricting Tenaris' tax benefits. Nevertheless, we would expect, and indeed would advise our clients, if similarly situated, to seek such a resolution.

Background

Tenaris, a Luxembourg company, supplies pipes, tubes, and related materials for use in the energy industry throughout the globe. As its Depository Receipts are listed on the New York Stock Exchange, it is an "issuer" under the FCPA. The settlement agreements arise out of Tenaris's bids in 2006 and 2007 for contracts solicited by an Uzbekistan state-owned oil and gas production company, OJSC O'ztashqineftgaz ("OAO") for the provision of pipeline used in the development and production of oil and natural gas. According to the agreements signed with the DOJ and SEC, Tenaris paid OAO officials for access to its competitors' confidential bidding information and, when an investigation into these payments drew nigh, Tenaris authorized payments to the investigating governmental agency to refrain from conducting the investigation.

In the DOJ DPA, Tenaris agreed to pay a $3.5 million penalty, implement rigorous compliance measures, toll the statute of limitations, and adhere to enhanced reporting obligations for the two-year term of the agreement. In the SEC DPA, Tenaris agreed to pay disgorgement and pre-judgment interest of $5.4 million, implement compliance measures, and toll the statute of limitations. The SEC DPA thus shares many of the same characteristics as the DOJ DPA. One important distinction, however, is that, consistent with past practice, the DOJ required that Tenaris admit to the relevant facts while the SEC, as has been its practice for many years, allowed Tenaris to "neither admit nor deny" with only the usual proviso that it could not dispute the facts in any subsequent SEC proceeding.

The SEC's Enforcement Options

Prior to this settlement, the SEC had employed only two enforcement options: civil complaints seeking injunctive relief or administrative cease-and-desist orders. In both cases, even though the company could settle without admitting or denying the SEC's allegations, the relevant adjudicator (either a judge or the Commission) necessarily made a formal finding that the company had indeed violated the law and that the injunction or order was necessary to prevent it from doing so again.

In January 2010, Rob Khuzami, the newly appointed Director of the Division of Enforcement and fresh out of the U.S. Attorney's Office for the Southern District of New York, announced that the SEC would begin to consider using tools similar to those of the DOJ, namely DPAs and Cooperation Agreements. In his address, he referred to this new Enforcement Cooperation Initiative as a "potential game changer for the Division of Enforcement." Khuzami explained that when seeking to identify the scope, participants, victims, and gains of a fraudulent scheme, there is "no substitute for the insiders' view . . . that only cooperating witnesses can provide." Thus, in his view, evidence supplied by cooperating witnesses as a result of alternative resolutions, would help the SEC move more swiftly in conducting investigations, filing charges, freezing assets, and protecting investors. To that end, the SEC's initiative also provided, in addition to DPAs and Cooperation Agreements, for a more streamlined process for witness immunity requests and a new rubric detailing the factors that would be considered when evaluating an individual's cooperation.

In the criminal context, DPAs and non-prosecution agreements, their slightly less formal cousins which do not involved filed charges, were first used in FCPA cases beginning in 2004. They are designed to allow a company to resolve a FCPA matter without having an adjudication of guilt while allowing the DOJ to ensure that the company is held accountable for its actions. However, since there is no adjudication of guilt, such agreements mitigate the risk potential collateral consequences, such as debarment from public contracting, that could be even more onerous than the criminal penalties. DPAs, however, do not come cheap, as the company is often required to pay a significant financial penalty (albeit lower in most cases than a Guidelines sentence), agree to impose compliance measures, and either retain an independent monitor or agree to self-monitoring and reporting during the term of the agreement. Further, since the DOJ DPAs require the companies to admit the relevant facts, the companies are barred not only from challenging the facts in any future enforcement action (should they breach the agreement) but also in private civil litigation. Finally, the agreements contain a tolling provision extending the statute of limitations for the term of the agreement, thus maintaining the company's exposure to prosecution.

It is not clear whether the benefits afforded by a civil DPA in a SEC enforcement action confer similar benefits. With due respect to the SEC, a civil enforcement adjudication is a much less fearsome matter than a criminal conviction. Further, although the issuance of an injunction or an order undoubtedly represents some finding of wrongdoing, since they are settled without the defendant company admitting or denying the relevant facts, they do not bar the company from contesting such facts in non-SEC proceedings. Further, they do not have the automatic collateral consequences of a criminal conviction.

Thus, one must question what benefits a SEC DPA really affords. In the Tenaris DPA, the company was required to (i) disgorge profits and prejudgment interest, (ii) agree to implement compliance measures, (iii) cooperate with ongoing investigations, and (iv) observe enhanced reporting obligations, all of which are standard requirements in the SEC's previous civil enforcement measures. Although the company was not required to pay a civil fine, the SEC has similarly forgone fines in some previous traditional settlements in the past, requiring the defendant company only to disgorge its illicit gains. Moreover, by tolling the statute of limitations, the company potentially extends its exposure and subjects itself to potential civil enforcement for a greater period of time than if it had settled the SEC matter in the traditional way.

Finally, it is not clear that the company received any financial benefit from entering into a DPA as opposed to the usual consent judgment or administrative settlement. In criminal DPAs, the DOJ has regularly promised and often delivered a significant financial benefit to companies that cooperated and negotiated a DPA, often giving the company a significantly lower penalty than might have been imposed had the company gone to court. Indeed, in recent settlements, this benefit appears to have ranged from 10% to over 50% less than the fines that would have been imposed by courts under the Sentencing Guidelines. In contrast, the SEC appears to have exacted the full amount of disgorgement and interest in this matter. Thus, although the DOJ penalty of $3.5 million appears to represent up to a 50% departure for the Guidelines fine (depending on which Sentencing Guidelines factors applied), the SEC penalty of $5.4 million is arguably the same penalty it would have imposed in a traditional settlement. This result is, unfortunately, inevitable if the SEC chooses to based the penalty on disgorgement because it would be hard-pressed to explain why it allowed the company to keep any "ill-gotten gains."

Concealed Penalties

The Tenaris DPA also reflects a disturbing development relating to the financial penalty, which may not be restricted to DPAs. Specifically, the SEC's DPA with Tenaris provides that the company must "refrain from seeking or accepting a US federal or state tax credit or deduction for any monies paid pursuant to this Agreement." Since the only monies paid related to disgorgement and prejudgment interest, this effectively precludes the company from recouping any taxes it might have paid on the profits it now has to disgorge, resulting in a hidden additional penalty.

Historically, SEC settlements and DOJ DPAs were deliberately tax neutral. The tax code specifically prohibits companies from taking a tax deduction for criminal fines and civil penalties, and, to the extent there was any ambiguity as to the nature of a penalty imposed by a DPA, the DOJ's DPAs have long contained a provision requiring the company to agree not to take a deduction for such penalties either. We understand, however, that SEC consent judgments have been silent as to the tax treatment of disgorgement, and the corporate taxpayer could—and typically did—take the position that it was eligible for a tax deduction or credit to offset the taxes it had previously paid on the profits it no longer had in Tenaris's DPA, however, the SEC explicitly prohibited Tenaris from seeking a US federal or state tax credit or deduction on the disgorgement and prejudgment interest payment. In other words, to the extent that Tenaris paid taxes on those profits, the SEC's DPA requires Tenaris to forfeit those taxes, the equivalent of a fine above and beyond the disgorgement payment.

As a foreign taxpayer, this clause may not have been important to Tenaris, but it could have significant consequences for other companies. Tenaris is headquartered in Luxembourg, and there is no indication in the pleadings whether any of its US subsidiaries were involved in the Uzbekistan contracts at issue. (The DPAs simply refer generically to acts by "Tenaris" and identify only employees who were uniformly non-US citizens.) Thus, it is unclear whether Tenaris declared and paid taxes on any of the profits from these contracts on U.S. federal or state tax returns.

It may be that the SEC thought it was evening the field by prohibiting companies from being able to offset the penalty by a tax deduction. In fact, however, this creates a significant and almost arbitrary disparity between companies. For example, posit three companies—a foreign company that paid no US taxes on $10M profits derived from a corrupt transaction, a global company with some US subsidiaries that paid US taxes on the US portion of the $10M profits, and a US company that paid US taxes on all $10M of the profits. If the companies were permitted to deduct the disgorgement and recoup the taxes paid on the profits they no longer have, then all three companies would be in the same position—they would each have been returned to the *status quo ante*. If they are not permitted to seek a deduction, however, the US and partially-US companies wind up paying more than the wholly foreign company because the two companies with US tax obligations will have both disgorged their profits *and* paid taxes on those profits. The foreign company, on the other hand, pays an effectively lower penalty because it did not pay such US taxes and, moreover, remains free to seek a post-disgorgement deduction from wherever it did pay taxes. Moreover, even if the SEC expanded this clause to prohibit seeking deductions from foreign taxes, this provision would still result in disparate penalties on similarly situated companies due to differences in applicable tax rates.

Jurisdiction

The Tenaris DPA is also significant as it illustrates the SEC and DOJ's perspective on the growing reach of the FCPA over non-U.S. companies.

U.S. companies have been subject to extraterritorial jurisdiction under the FCPA since 1998. Non-U.S. companies, even "issuers" such as Tenaris, on the other hand, are subject only to territorial jurisdiction, which requires the government to prove that a non-U.S. company "while in the territory of the United States, corruptly [made] use of the mails or any means or instrumentality of interstate commerce or [did] any other act" in furtherance of offering, promising, or paying a bribe to a foreign official. As we have discussed previously, the U.S. government interprets this jurisdictional requirement very broadly.

For many years, U.S. officials have stated that the requisite contact with the U.S. exists where a non-U.S. individual "causes" an act to be done in the U.S. In the last several years, the government has asserted that this theory extends not only to the use of a company's own U.S. deposit accounts but to the use of U.S. dollar wire transfers through foreign banks, which almost uniformly will involve the use of "correspondent" accounts held by a foreign bank at U.S. banks to clear foreign U.S. dollar transactions. In most cases, however, the government included allegations or counts premised on correspondent bank account jurisdiction as add-ons to other counts alleging more concrete and foreseeable conduct in the United States. For example, in the *TSKJ* case (*Halliburton/KBR, Technip, Snamprogetti* and *JGC*), the correspondent banking account charges were coupled with a conspiracy charge alleging conspiratorial acts that took place at KBR's headquarters in the U.S. See "The Other FCPA Shoe Drops: Expanded Jurisdiction over Non-U.S. Companies, Foreign Monitors, and Extending Compliance Controls to Non-U.S. Companies," Shearman & Sterling LLP, July 2010.

In Tenaris's case, both the SEC and the DOJ alleged that Tenaris "made use of the means and instrumentalities of interstate commerce" in making a "same day transfer of approximately $32,140.67 through an intermediary bank" in New York to the agent acting on Tenaris's behalf. Although neither the SEC nor the DOJ asserted that the $32,140.67 transfer was the only act in the U.S., it is the sole example provided in each agreement. There is no other jurisdictional connection to the U.S. asserted. Save this transfer, all other actions occurred far from U.S. shores. Tenaris is a Luxembourg company whose business in Uzbekistan was operated from offices in Azerbaijan and Kazakhstan. The contracts at issue were put out to bid by the Uzbekistani government and the pipeline products offered by Tenaris were to be used by a subsidiary of the Uzbekistani state-owned oil and gas company for development efforts in Uzbekistan.

Significantly, neither the SEC nor the DOJ chose to define the term "intermediary" or to provide any other context as to the role of the U.S. bank in the funds transfer. It remains unclear, therefore, whether Tenaris (either directly or through a subsidiary or affiliate) owned or controlled the U.S. bank account or whether the account was merely a correspondent account for a foreign bank. If the latter—which one might suspect from the government's deliberate vagueness as to the term "intermediary"—then the Tenaris matter represents the successful culmination of the theory the U.S. government introduced in *Siemens* and developed in the *Halliburton/KBR, Technip and Snamprogetti* actions: a non-U.S. company's use of a correspondent account in the U.S. is sufficient to provide for territorial jurisdiction over that company under the FCPA.

Regardless of whether Tenaris's only point of contact with the U.S. was its use of a correspondent bank account, however, the government's assertion of jurisdiction is also noteworthy for what is missing. Tenaris's actions here do not appear to implicate any U.S. public policy interests, either foreign or domestic, outside of the condemnation of bribery as an acceptable business practice. In contrast to cases such as *Siemens* and *TSKJ*, where the U.S. government had reached for the outer limits of FCPA jurisdiction to bring enforcement actions against companies who had long competed with U.S. companies through corrupt conduct or which were located in countries viewed as failing to enforce their own transnational bribery laws, the use of an extreme jurisdictional theory against a relatively small Luxembourg company would not seem justified.

The Tenaris matter demonstrates the U.S. government's continued aggressive approach to expanding the reach of the FCPA, no matter how attenuated or *de minimis* a non-U.S. company's contact with the U.S. may be. In Tenaris's case, a single U.S. dollar transfer through an intermediary bank for less than $33,000 gave rise to jurisdiction and led to penalties and disgorgement of $8.5M. Though it remains unclear whether jurisdiction was asserted here solely based on a single instance of correspondent bank account use, the government's increasing reliance on this theory of jurisdiction suggests that if not Tenaris, then some other matter will soon provide such an opportunity. The U.S. government's expansive—and expanding—reach over non U.S. companies with *any* connection to the U.S., coupled with the rise in actions brought by non-U.S. authorities, makes for fewer and fewer corners where corporate corruption can escape liability.

If you wish to receive more information on the topics covered in this publication, you may contact your regular Shearman & Sterling contact person or any of the following:

Philip Urofsky
London
+44.20.7655.5611
Washington, DC
+1.202.508.8060
philip.urofsky@shearman.com

Danforth Newcomb
New York
+1.212.848.4184
dnewcomb@shearman.com

Stephen Fishbein
New York
+1.212.848.4424
sfishbein@shearman.com

Patrick D. Robbins
San Francisco
+1.415.616.1210
probbins@shearman.com

Paula Howell Anderson
New York
+1.212.848.7727
paula.anderson@shearman.com

Richard Kelly
London
+44.20.7655.5788
richard.kelly@shearman.com

Jo Rickard
London
+44.20.7655.5781
jrickard@shearman.com

Markus S. Rieder
Munich
+49.89.23888.2119
markus.rieder@shearman.com

Richard Kreindler
Frankfurt
+49.69.9711.1420
rkreindler@shearman.com