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# Oil-For-Food, Iraq: Grist For The Anti-Corruption Mill

*Friday, Mar 21, 2008* --- In recent months the Department of Justice (DOJ) and the Securities and Exchange Commission (SEC) have continued to bring enforcement actions and seek substantial fines against companies accused of making improper payments in the course of their involvement with the United Nations' Oil-for-Food Program ("OFFP") and the Government of Iraq.

Among other things, these actions illustrate the utility of the accounting provisions of the FCPA in reaching payments that fall outside the scope of the Act's anti-bribery provisions, but violate other laws, such as OFAC-administered sanctions and general fraud statutes.

They reflect continued inter-agency and, indeed, inter-governmental, cooperation in prosecuting cases. Several of the cases also illustrate the tendency of investigations that begin with one type of payment focus to turn up other issues – in this case, FCPA anti-bribery issues.

The theory of prosecution in these cases is consistent with the government's past position in FCPA cases regarding "qualitative accuracy" of the books and records and internal control requirements.

*Background To The Oil-for-Food Program*

The United Nations Security Council established the OFFP pursuant to Resolution 986, entering into an implementing memorandum of understanding with Iraq in 1996 as part of a larger sanctions program imposed against it in the wake of the 1991 Gulf War.

This regime generally prohibited UN member states from transacting in Iraqi goods and commodities, but instituted the OFFP to allow certain civilian goods to enter the country on humanitarian grounds, funded by Iraqi oil sales.[1]

Under the Program, the Iraqi government had to devote proceeds from the oil sales to purchase certain enumerated civilian products.

The terms allowed the Iraqi government, through its State Oil Marketing Organization (SOMO) to award "allocations" of oil to purchasers, which would pay into an UN-administered escrow account to be used solely for humanitarian purposes in Iraq; payments to any other accounts were explicitly prohibited.

The Iraqi government used its allocations authority to extract payments from would-be purchasers, variously called "surcharges," "commissions,"

"consultancy payments," and "sales fees."

The sanctions, and the OFFP, ceased in 2003. The next year, Secretary General Kofi Annan established the Independent Inquiry Committee (IIC) to investigate reports of wide-scale corruption involving the OFFP. The UN Security Council endorsed the IIC in Resolution 1538 (2004), and called for the full cooperation of all member states.

In tandem with and pursuant to the IIC's investigation, which ended in December 2006, numerous countries, including the United States, Australia and the United Kingdom, began their own investigations into corruption surrounding the OFFP and involving their nationals.

The United States now has brought roughly a dozen cases under the FCPA for making improper kickback payments under OFFP contracts.[2]

In keeping with its practice since its first OFFP case against a major public corporation, brought against El Paso Corporation in February 2007, the U.S.Government has not cited the antibribery provisions of the FCPA, as the payments went not to a "foreign official," but rather the Government of Iraq. (In fact, as discussed further below, the payments initially were directed to several Iraqi government officials' private accounts, but were then transferred to the Iraqi treasury.)

Settlement in these cases reflects a range of penalties, from a high of $30 million in the Chevron case to a low of $4.65 million in Textron.

*Chevron*

In November 2007, the SEC agreed with Chevron Corporation to settle charges that Chevron inaccurately entered payments into its books and records in violation of the FCPA's antibribery provisions.

The settlement resolved the SEC's allegations that Chevron engaged in 36 transactions from April 2001-May 2002 involving payment of $20 million to third parties for their shares of Iraqi oil allocations, despite knowing or having reason to know that the accompanying "surcharges" — additional payments above the market price — were destined for the Government of Iraq, outside of the OFFP account.[3]

Although Chevron had instituted a compliance policy specifically addressing the OFFP surcharge issue, the SEC found that Chevron failed adequately to implement it or police it with a system of internal controls.

The company's policy prohibited such charges, requiring management to scrutinize and approve all transactions company traders proposed involving Iraqi petroleum.

The SEC found that Management failed to thoroughly review these transactions, however, in one case green-lighting a purchase from a

 

company with no known assets, operations or experience.

Chevron further failed to implement sufficiently the financial controls in its compliance policy — even with information that higher per-barrel prices of oil purchased from its sellers followed reports of Iraq's surcharge demands in the fall of 2000. Despite the jump in prices, Chevron management regularly allowed its traders to proceed with Iraqi oil purchases.

The SEC's civil action charged that Chevron failed to accurately characterize the surcharges it paid on OFFP purchases as payments to the Iraqi government, instead describing these simply as "premiums," in violation of the FCPA's requirement that U.S. issuers keep accurate books, accounts and records.

Because the surcharges ended up in Iraq government coffers, the antibribery provisions presumably did not apply.

Chevron ultimately consented to a permanent injunction from future violations of the accounting provisions and agreed to disgorge $25,000,000 in profits.

This amount was to be divided between the U.S. Attorney for the Southern District of New York and the New York District Attorney.

In addition, it also agreed to a civil penalty of $3,000,000 for the accounting violations and a penalty of $2,000,000 to be paid to the Office of Foreign Assets Control for its violation of OFAC regulations.

As part of this package settlement, Chevron also entered into a non-prosecution agreement with the DOJ, which had alleged wire fraud as the basis of its criminal theory.[4]

The level of these fines should make companies aware that the FCPA's books and records provisions can result in fines that far exceed the amount of penalties U.S. companies would pay solely for an underlying violation of U.S. sanctions laws.

*Ingersoll-Rand*

A similar deployment of the FCPA's accounting provisions occurred when the SEC in October 2007 brought charges against Ingersoll-Rand ("Ingersoll") accusing it of failing to take action upon notice that several of its foreign subsidiaries had been paying kickbacks to the Iraqi government.

The SEC found that Ingersoll, either itself, through its subsidiaries or third parties, authorized kickbacks in the form of hidden "after sales service fees" ("ASSFs") in contracts it with the Iraqi government and submitted to the "661 Committee" charged with managing the OFFP.

Frequently these ASSFs involved no actual after-sale services. Further,

 

these payments were made knowingly in violation of the OFFP and U.S. law. By not classifying these payments accurately in "reasonable detail," or as "unlawful kickbacks" to the Iraqi regime, the SEC found that Ingersoll did not accurately detail its accounts.

The DOJ as well as the SEC also brought charges against Ingersoll-Rand for the conduct of an Italian subsidiary, Ingersoll-Rand Italiana SpA ("IR Italiana"). DOJ alleged that IR Italiana conspired to violate the FCPA's books and records provisions by paying some $20,000 in travel and entertainment expenses for eight Iraqi officials for a training visit to the company's facilities.

Six of the officials, however, were strictly on vacation, and attended to no business during their stay. IR Italiana conspired to conceal these payments on its books and records, resulting in Ingersoll Rand making false statements in its own financial accounts.

Like Chevron, Ingersoll faced no FCPA bribery charges for these payments. With respect to the OFFP payments, the anti-bribery provisions presumably did not apply due to the fact that the payments went to the Iraqi government.[5]

For the travel and entertainment expenses, however, the absence of antibribery charges requires another explanation, perhaps of a jurisdictional nature due to the lack of a nexus of the sponsorship activity carried out on behalf of the foreign subsidiary to the United States.

Ingersoll consented to a three-year non-prosecution agreement and a $2.5 million criminal penalty with the DOJ; the company settled with the SEC for over $4 million, split between profit disgorgement and civil penalties.

The OFFP side of this case closely models that of Textron, settled last August with SEC for $3.5 million and the DOJ for $1.15 million, for similar use of ASSF-labeled kickbacks by a fifth-tier French subsidiary.

*Flowserve*

More recently, the government settled FCPA accounting and internal controls violation charges with Flowserve Corporation, a maker of large-scale water pumps, for entering into contracts containing ASSFs in a manner similar to those described above with respect to Ingersoll.

The SEC's complaint alleged that two of Flowserve's foreign subsidiaries, one in France and one in the Netherlands, entered into a total of twenty contracts providing for kickbacks amounting to some $820,246.

Ultimately, $604,651 of this amount actually was paid, while $173,758 was outstanding at the time of the 2003 U.S. invasion of Iraq. The DOJ focused only on French subsidiary's contracts (comprising 19 of the 20) charging that Flowserve had conspired to violate the US wire fraud statutes and the FCPA's books and records provisions.

The SEC found that Flowserve's French subsidiary, Flowserve Pompes, created two different covers to conceal these payments. One involved the creation of records showing payments to a Jordanian agent for installation services and commissions when no such services were ever in fact rendered, and the other, in its contract reimbursement requests to the UN, marking up the unit price of its equipment to cover the ASSF payments.

Flowserve Pompes also signed a letter with the Iraq government committing to pay the 10% ASSFs. Flowserve's Dutch subsidiary, Flowserve B.V. entered into only one contract involving a kickback, termed a "special project discount," that was passed through an agent to the Iraqi-government-owned South Gas Company with which the contract was made.

Flowserve consented to the entry of final judgment enjoining it from violating the internal controls or books and records provisions of the FCPA, as well as ordering it to pay a civil penalty of $3,000,000.

In addition, it agreed to disgorge approximately $3,500,000 million in profits and pre-judgment interest. Further, under a deferred prosecution agreement with the DOJ, Flowserve agreed to pay a $4,000,000 criminal penalty in respect of an asserted conspiracy to commit wire fraud and criminal books and records violations involving the French subsidiary's alleged violations, as to which the DOJ filed a criminal information against that subsidiary, Flowserve Pompes.[6]

Flowserve B.V., the Dutch subsidiary, will also enter into a criminal disposition with the Dutch Public Prosecution.[7]

*FCPA Accounting Provisions Reach Non-Official/Non-Governmental Payments*

Enforcement actions employing the accounting provisions as an independent ground to reach improper payments, especially those not constituting bribery under the FCPA, are not limited to the OFFP context.

In Schnitzer Steel, for instance, the government brought criminal charges under the books and records provisions for payments made to managers of privately owned steel mills in China and South Korea, accusing Schnitzer and its subsidiaries as falsely describing the payments as "refunds," "rebates," "sales commissions," or "commission to the customer."[8]

These charges accompanied allegations that Schnitzer had also violated the antibribery provisions by paying managers at state-owned scrap metal customers.

These accounting provisions of the FCPA have also been applied to payments that were not commercial bribes or direct or indirect payments to a government, but which fell afoul of U.S. sanctions law.

In the Chiquita settlement, for example, the DOJ and SEC brought charges under the books and records provisions charging that a Chiquita subsidiary, with knowledge of senior management, misleadingly termed extortion payments it made to the United Self-Defense Forces of Columbia ("AUC") — a Foreign Terrorist Organization and a Specially-Designated Global Terrorist with which business transactions are prohibited — as charges for "security payments," "security services," or "security."[9]

Where the government believes there is fraud or deliberate violations of law, these cases show it will not hesitate to bring criminal accounting charges.

From the bribery side, what is most interesting is the fact that in two of the OFFP cases — Chevron and El Paso — the payments were initially paid to individual Iraqi officials, though subsequently paid over to the government.

The lack of FCPA antibribery charges presumably reflects the fact that the companies, in making the payments, intended to pay a fee to the government and not to improperly influence any individual actors.

The fact that the government is systematically extracting payments in return for allocating benefits to all users of a system did not prevent the accounting charges.

*Disclose Or Defend: The Need For Accuracy In Accounting Entries*

These prosecutions reinforce the need for issuers to make qualitatively accurate descriptions of their payments.

Indeed, the SEC's characterization of these companies' alleged accounting mistakes suggests that had they described these payments differently, they might not have faced charges on these grounds, though they might well have exposed themselves to others.

The cases also reinforce the position that payments into government accounts do not trigger the antibribery provisions. And this, moreover, is the case even if they first do pass through officials' individual accounts (as in Chevron and El Paso), and so are arguably made to a government official, at least in the first instance.

The converse, however — where a payment is made initially into a government coffer which is leaky — may not be outside the scope of the antibribery provisions, especially where that leakiness is known to the payor.

As to the former, such payments would, presumably, merely need to be described accurately (if otherwise incriminatingly) to fall outside the purview of the FCPA. The need for such accurate accounting also extends, of course, to grease payments made to facilitate transactions.

Even if such payments are otherwise FCPA-compliant, their mischaracterization as something more innocuous could yet trigger the

 

FCPA through the books and records requirements.

These cases also illustrate the imperative of instituting and maintaining strict internal financial controls and compliance procedures, at every level of the corporate chain, from overseas subsidiaries all the way up to headquarters.

*Developments In Foreign OFFP Enforcement*

Other nations have also stepped up OFFP enforcement actions, some in conjunction with the United States. The Dutch specialty chemical company Akzo Nobel, for instance, recently avoided criminal charges in the U.S. for kickbacks of $280,000 allegedly paid to the Iraqi Government by its Dutch-based subsidiaries through various middlemen it described as agents or consultants to facilitate its OFFP contracts.

The DOJ reached a non-prosecution agreement with the company with the condition that it would pay a criminal fine of 381,000 Euros to the Dutch Public Prosecutor, or forfeit $800,000 to the US Treasury if it failed to do so.

The SEC, meanwhile, settled with Akzo Nobel for a civil penalty of $750,000, in addition to $2.2 million in disgorgement of profits, charging that Akzo Nobel had been reckless in failing to know that their subsidiaries engaged in this conduct, and for having a defective system of internal controls.

Beyond issuing securities in the U.S. market, Akzo Nobel had no ties to the United States. Akzo Nobel ceased its registration with the SEC during the course of the investigation.[10]

In the U.K., the Serious Fraud Office in December 2007 requested the pharmaceutical manufacturers AstraZeneca, Eli Lilly and GlaxoSmithKline, as well as other drug companies, to provide documents pertaining to their participation in the program.

The investigation is said to be one of the SFO's largest, estimated to cost some £22 million.[11] It is unclear what the SFO will find, but the reported scale of the request and the size of the requested companies suggests that much could be swept up in its wake.

In Australia, the Securities and Investments Commission recently initiated charges against six former managers of the Australian Wheat Board that had steered the Board's OFFP business. They are charged with failing to act with "due diligence" and with failing to act in "good faith and for a proper purpose."[12]

Due to a shorter statute of limitations, the Commission is proceeding with these cases prior to possible criminal charges. The civil charges carry potential fines of $150,000 each, with each defendant facing from seven to seventeen counts.[13]

Though less recently, India too has been embroiled in the OFFP scandal. A

 

government investigation ending in August 2006 found that India's former foreign minister, Natwar Singh, had requested oil allocations from Iraqi president Saddam Hussein, setting up transactions similar to those in which El Paso and Chevron had engaged — paying per barrel surcharges to an intermediary that later went to the Iraqi government — and that eventually inured to the benefit of close associates, though not necessarily Mr. Singh himself.[14]

Some of these cases may result in challenges to the prosecution on the ground of the asserted legality of the surcharges under Iraqi law. This was not a defense to the U.S. cases, given U.S. sanctions prohibitions on dealings with the Iraqi government.

*Iraq Continues To Provide Grist For The Anti-Corruption Mill*

In addition to OFFP actions in the U.S. and overseas, Iraq itself continues to provide fodder for a number of enforcement actions, arising out of Iraqi reconstruction efforts.

By the end of 2007, U.S. authorities had brought some 50 prosecutions relating to business activity in Iraq, most arising out of Special Inspector General for Iraqi Reconstruction (SIGIR) investigations, and many for bribery and associated conspiracy, fraud, money laundering and corruption charges.

Only one completed Iraqi reconstruction case so far, United States v. Salam,[15] has involved the FCPA. Nevertheless, the momentum of assertive prosecution of the statute shows no sign of abating, and has proved adaptable to a wide variety of improper payments that the anti-bribery provisions do not cover.

Just as the Oil-for-Food Program investigations began with investigations into individuals and then moved on to encompass large corporations, so may the efforts of SIGIR and other U.S. authorities investigating activities in Iraq.

Perhaps now more than ever, companies, whether with ties to Iraq or not, must be sure that their accounting descriptions encompass all relevant and material aspects of a payment, and that they have stringent internal control systems in place for not only FCPA but sanctions compliance as well.

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[1] United States v. Chiquita Brands International, Inc. (D.D.C. 2007) (Information filed March 14, 2007).

[2] Independent Inquiry Committee Web site.

[3] In addition to the cases discussed herein, see United States v. Sevan and Nadler (S.D.N.Y.) (Indictment of Jan. 10, 2007); United States v. York Int'l Corp. (D.D.C.) (Deferred Prosecution Agreement announced on Oct. 1, 2007); SEC v. York Int'l Corp. (D.D.C.) (Complaint of Oct. 1, 2007) (Relating to Oil-for-Food Program in Iraq).

[4]SEC Lit. Rel. No. 20363 (Nov. 14, 2007); SEC v. Chevron Corporation (S.D.N.Y.) (Complaint of Nov. 14, 2007).

[5]Letter from U.S. Attorney, S.D.N.Y., to Mr. Charles M. Carberry (Nov. 8, 2007).

[6] SEC Lit. Rel. No. 2035 (Oct. 31, 2007); SEC v. Ingersoll-Rand Company Ltd., Civ. Action No. 107- CV- 01955 (D.D.C.) (JDB).

[7] United States v. Flowserve Corporation (D.D.C.) (Criminal Information of Feb. 21, 2008).

[8] SEC v. Flowserve Corporation (D.D.C.) (Complaint of Feb. 21, 2008); SEC Lit. Rel. No. 20461(Feb. 21, 2008); DoJ Press Rel. (Feb. 21, 2008).

[9] In the Matter of Schnitzer Steel Industries, Exchg. Act Rel. No. 54606 (Cease-and-Desist Order of Oct. 16, 2006).

[10] SEC Lit. Rel. No. 20410 (Dec. 20, 2007); SEC v. Akzo Nobel, N.V. (D.D.C.) (Complaint of Dec. 20 2007).

[11] BBC, Firms Probed Over Iraq Cash (Dec. 30, 2007).

[12] Tim Johnston, Oil-for-Food Case Opens in Australia, N.Y. Times (Dec. 21, 2007).

[13] Id.

[14] Amelia Gentleman, India Finds Ex-Official Guilty in Oil Scandal, N.Y. Times, Aug. 5, 2006; John Lancaster, India's Foreign Minister Fired in Oil-for-Food Scandal, Wash. Post, Nov. 7, 2005.

[15] United States v. Salam (D.D.C.) (Complaint of March 8, 2006.