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Parent FCPA Violations Based on Subsidiary Misconduct

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The $384 million in penalties, forfeitures and disgorgement in Alcoa, Inc.'s (Alcoa) recent Foreign Corrupt Practices Act (FCPA) settlement ranks as the fifth largest FCPA case to date. The most significant feature of the settlement, however, is not its size, but the theory of parent liability it reflects. In the Alcoa action, the government openly embraces a prosecution theory of (virtually) strict parent liability that has run as an undercurrent in certain other recent enforcement actions. Alcoa's liability stemmed from the improper payments of the company's far-flung foreign subsidiaries. The government did not allege that Alcoa knew of, or participated in, these payments. Rather, the Security and Exchange Commission's (SEC) cease-and-desist order states explicitly: "***This Order contains no findings that an officer, director or employee of Alcoa knowingly engaged in the bribe scheme.***" In the absence of such findings, the SEC based Alcoa's liability on expansive "agency" principles that, if adopted more broadly, could render virtually any subsidiary the "agent" of its parent.

The Alcoa settlement underscores the pressing need for a parent company to extend its anti-corruption compliance policies, practices and procedures, including appropriate due diligence on third parties, to subsidiaries, even distant ones. Such an approach not only helps detect and deter potentially improper conduct at the subsidiary level, it may arm the parent company with a persuasive story of why it should not face liability in the case of subsidiary misconduct. After reviewing the Alcoa settlement, this article concludes with recommendations on a risk-based approach to such an endeavor that seeks to balance both compliance and cost concerns.

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The Alleged Bribery Scheme

The alleged scheme at the heart of the Alcoa action related to a supply arrangement between Alcoa subsidiaries and Aluminum Bahrain B.S.C. (Alba), a majority-government owned aluminum smelter. An Alcoa subsidiary entered into a series of supply agreements with Alba, eventually employing a London-based consultant (Consultant A) to assist with negotiations. Over time, the subsidiary and affiliated companies, including Alcoa World Alumina LLC (AW"), determined that the alumina should be provided to Alba through the consultant's shell companies acting as nominal distributors. Under this arrangement, the consultant was allegedly able to impose inflated markups on the purported sales. The consultant used the markups and the commissions he earned from the Alcoa entities to make "at least $110 million in corrupt payments to Bahraini officials."

The Department of Justice's (DOJ) criminal information and the SEC's order identify a number of potential red flags regarding Consultant A's role. The consultant had close ties to the Bahraini royal family and certain government officials. The Alcoa subsidiary sales team approved of the consultant's role because he was "well versed in the normal ways of Middle East business" and "will keep the various stakeholders in the Alba smelter happy." Further, although Consultant A acted as a purported distributor, his companies performed none of the traditional duties associated with such a role, such as taking possession of the alumina or assisting with shipping arrangements. "Despite the red flags inherent in this arrangement, [the Alcoa subsidiary's] in-house counsel approved the arrangement without conducting any due diligence or otherwise determining whether there was a legitimate business purpose for the use of a third party intermediary."

In February 2008, Alba filed a civil suit against Alcoa in the U.S. District Court for Western Pennsylvania, alleging that Alcoa was bribing Alba officials and overcharging for alumina. The DOJ and SEC then launched investigations, which resulted in the $384 million settlement.

The Government's Theory of Parent Liability

The anti-bribery provisions of the FCPA prohibit companies and individuals from, either directly or indirectly, offering, promising, giving, or authorizing the giving of money or anything else of value to a "foreign" (*i.e.*, non-United States) official for the purpose of improperly influencing that official to use his or her position in order to obtain or retain business. Typically, parent liability under the anti-bribery provisions in cases involving payments made subsidiaries has been premised on the parent company's authorization, direction or control of the alleged improper payments.

Recently, the DOJ and SEC have advanced a more aggressive enforcement approach, seeking to hold a parent responsible for the actions of subsidiary without its knowledge of, or participation, in the alleged misconduct. The government announced this position in the November 2012 Resource Guide to the U.S. Foreign Corrupt Practices Act ("*Resource Guide*"), in which the agencies asserted that a parent company may be liable under the FCPA's anti-bribery provisions not only when the parent "participated sufficiently" in a subsidiary's misconduct, but also "under traditional agency principles." Under those principles, a parent company has typically not been held liable for the acts of its subsidiary except when the companies

disregard corporate formalities (alter ego theory) or when the subsidiary acts as the agent of the parent *for a specific purpose*. The *Resource Guide* and the subsequent handful of enforcement actions that implicate the new theory of parent liability have cast little light on the important question of what level of knowledge and control the parent must have over the allegedly improper conduct, rather than over the subsidiary generally.

The Alcoa settlement addressed the issue directly in a single, succinct paragraph, which begins with the above-quoted sentence: "This Order contains no findings that an officer, director or employee of Alcoa knowingly engaged in the bribe scheme." The order then lays out the factors on which the SEC relied in determining Alcoa's subsidiaries were agents of the parent corporation. First, Alcoa appointed the majority of seats on a Strategic Council that provided "direction and counsel" to the subsidiaries. Second, Alcoa and a subsidiary transferred personnel between them. Third, Alcoa set the business and financial goals for the subsidiaries and coordinated their legal, audit, and compliance functions. Fourth, the subsidiaries' employees managing the Alba alumina business reported functionally to Alcoa officials. Fifth, Alba was a significant Alcoa customer. Sixth, members of Alcoa senior management met with Alba officials and Consultant A to discuss matters related to the Alba relationship. Seventh, Alcoa officials were aware that Consultant A was the subsidiaries' agent and that the terms of related contracts were reviewed and approved by senior Alcoa managers.

With the potential exception of the sixth and seventh points, each of the factors relates to the parent company's influence over the subsidiaries generally, not in connection with any alleged wrongdoing. Suffice it to say, if such factors set forth in the Alcoa order are sufficient to establish parent liability under the FCPA, many subsidiaries are likely to be deemed "agents" moving forward.

As framed in the SEC order, the sixth and seventh factors are described neutrally. There is no assertion that Alcoa's management took any inappropriate action with respect to Consultant A. Although the order is not explicit, when read closely it appears clear that Alcoa's liability stems at least in part from its failure, in the eyes of the SEC, to extend its corporate compliance policies and procedures, including due diligence on third parties, to its subsidiaries in an effective manner. The SEC emphasizes that Alcoa was aware of Consultant A, that the "red flags" regarding the relationship with Consultant A should have been readily apparent and yet no due diligence was undertaken to ensure that the relationship was a proper one.

When viewed in this light, it may be that the Alcoa settlement, while still representing a significant development in the realm of FCPA jurisprudence, is not, practically speaking, quite as radical as it would appear at first sight. The primary lesson from the enforcement action is not an entirely new one: Parent companies need to ensure that they appropriately expand their FCPA compliance measures to the operations of their subsidiaries.

A Risk-Based, Cost Effective Compliance Program

Although, as Alcoa underscores, the consequences of failing to undertake appropriate anti-corruption compliance measures can be dramatic, the cost of adopting such measures – if not handled properly—can be steep. To balance these competing needs, companies should adopt a risk-based approach to identify the

subsidiary (or other) activities that represent most significant potential FCPA exposure. A number of factors are relevant to such a determination, including:

- The level of corruption in the country or region;
- The level of interaction the subsidiary has, or third parties (including agents and joint venture partners) affiliated with subsidiary have, with "foreign officials" (including employees of state-owned entities);
- Volume of business involved in such arrangements;
- Possible ties between the third parties affiliated with the subsidiary and foreign officials.

Using such metrics, the parent company can determine where best to deploy its compliance time and resources, at least initially. The parent company should then adjust and adapt its anti-corruption policies and practices based on the information it gleans from its initial efforts. Such an approach not only helps a parent company detect and deter possible FCPA violations, it arms the company with a credible evidence of an effective and appropriate compliance program if allegations of improper payments arise. Such a compliance program properly extended throughout a corporate family allows the parent to argue it should neither be deemed to have constructive knowledge of any alleged impropriety by its subsidiary or the subsidiary's agents, but also that if any punishment is to be meted out it should not be at the parent level.