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The SEC's FCPA Settlement with Hitachi Underscores the Importance of Robust Anti-Corruption Procedures

Executive Summary

On September 28, 2015, the U.S Securities and Exchange Commission ("SEC") announced a settlement with Japanese conglomerate Hitachi, Ltd. ("Hitachi") regarding alleged violations of the internal accounting controls and books and records provisions of the Foreign Corrupt Practices Act ("FCPA"). The complaint alleges that Hitachi paid over $10.5 million to a local South African business partner it knew to be the "alter ego" and "funding vehicle" for the African National Congress, a political party, in connection with $5.6 billion in power station boiler contracts that were "among the largest government contracts ever awarded in South African history." Notably, the SEC did not charge any violation of the FCPA's anti-bribery provisions, presumably for jurisdictional or evidentiary reasons, and Hitachi neither admitted nor denied the SEC's findings.[1] The proposed settlement was filed, alongside a complaint, in the United States District Court for the District of Columbia as a consent judgment, subject to court approval.

Under the terms of the settlement, Hitachi agreed to pay a civil monetary penalty of $19 million, the second largest civil penalty in an SEC FCPA settlement.[2] Hitachi also agreed to an injunction against future violations of the internal accounting controls and books and records provisions of the FCPA. Although the complaint seeks both disgorgement and pre-judgment interest, the settlement does not provide for either form of relief.

Hitachi's facts serve as a reminder of the importance of robust due diligence before entering into commercial arrangements with any third party that might present a corruption risk, especially enterprises owned or controlled by—or otherwise connected to—a foreign government or political party. *Hitachi* also demonstrates the importance of continuing to monitor business partners throughout the relationship in order to ensure compliance with anti-corruption policies.

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[1] *See* Compl., *SEC v. Hitachi, Ltd.*, 1:15-cv-01573 (D. D.C. September 28, 2015).

[2] The largest civil penalty in an SEC settlement involving alleged violations of the FCPA was announced less than five months ago, on May 20, 2015, when the SEC announced a settlement with BHP Billiton. *See* BHP Billiton Ltd. and BHP Billiton Plc, Exchange Act Release No. 74998, 2015 WL 2393657 (May 20, 2015).

Factual Allegations

According to the SEC's complaint, Hitachi's violations occurred in the context of bids for contracts in connection with projects organized by Eskom, South Africa's largest state-owned public utility. In 2006 and 2007—before Hitachi de-listed from U.S. stock exchanges—Hitachi bid for contracts on two power stations through a consortium consisting of two subsidiaries: Hitachi Power Europe GmbH ("HPE") and Hitachi Power Africa (Pty.) Ltd. ("HPA"). HPE was wholly owned by Hitachi, and HPA was 70% owned by HPE. HPE sold the remaining 30% of HPA to local South African entities in order to benefit from South Africa's Black Economic Empowerment Act of 2003 ("BEE"), which promoted participation in the economy by companies that were "at least 25% owned by black South Africans or black-owned South African entities." In order to qualify for BEE status, HPE sold 5% of HPA to an unnamed "small five-person women's group" in South Africa for an unspecified amount of money, and sold the remaining 25% to Chancellor House Holdings (Pty.) Ltd. ("Chancellor") for approximately $190,819. According to the complaint, Chancellor was a South African investment firm that functioned as a funding vehicle for, and an alter ego of, the African National Congress ("ANC"), South Africa's ruling political party.

Although the complaint does not allege that Hitachi knew of the precise nature of Chancellor's relationship with the ANC from the outset, it does allege that Hitachi chose to partner with Chancellor because it was politically connected with the ANC. It also alleges that Hitachi learned that Chancellor was an alter ego and a fundraising arm of the ANC as a result of a series of news articles in the South African press and also as a result of subsequent conversations with Chancellor's chairman. Even after this revelation, according to the SEC, Hitachi took no steps to alter its arrangement with Chancellor and—although the complaint does not allege what specific actions were taken by Chancellor in support of Hitachi—Hitachi continued to encourage Chancellor to exert political influence on its behalf to help Hitachi obtain the Eskom contracts.

Hitachi ultimately won two Eskom contracts worth approximately $5.6 billion dollars. Hitachi then paid Chancellor approximately $6.1 million, which were recorded in Hitachi's books and records as "success fees" and "dividends." According to the SEC, those records failed to note that the payments to Chancellor effectively constituted payments to a foreign political party to improperly influence Eskom to award Hitachi the two contracts. Hitachi subsequently bought back Chancellor's 25% stake in HPA for approximately $4.4 million, resulting in payments totaling approximately $10.5 million to Chancellor in connection with its initial investment in HPA of $190,819, a more than 5,000% return on Chancellor's initial investment.

A. Hitachi Partners with Chancellor, an Alter Ego of the ANC

The SEC alleged that, in seeking local entities with which to partner in order to benefit from the BEE, Hitachi "prioritized a prospective partner's ability to exert political influence over engineering or operational partners." According to the SEC, Chancellor possessed extensive political connections but

lacked any engineering or operational capabilities—a fact which is reflected in contemporaneous Hitachi reports, which focus on Chancellor's connections with Eskom. Although Hitachi apparently conducted some due diligence of Chancellor, it did not conduct that diligence in accordance with any existing procedures, and, in the course of the SEC investigation, Hitachi was unable to locate any report reflecting the diligence performed.

Chancellor obtained a 25% interest in HPA in exchange for approximately $190,819. The shareholder agreements by which Chancellor obtained its ownership interest indicated that Chancellor's "contribution" to HPA would include, among other things, "lobbying the public and private sector" for business in South Africa. An earlier draft of the agreement also provided for a "success fee" to be paid to Chancellor in the event that its efforts substantially resulted in Hitachi obtaining a government contract. This provision was removed before execution, but Hitachi memorialized a commitment to pay Chancellor a success fee in a separate, unsigned agreement.

B. Hitachi Learns of Chancellor's ANC Connections During Bidding

While Hitachi was preparing to submit its first bid to Eskom, the South African media reported that Chancellor was an alter ego of the ANC, and a subsequent article indicated that the ANC used Chancellor to acquire "empowerment" stakes—that is, stakes sufficient to qualify for BEE benefits—in businesses seeking state procurements. Another article published while Hitachi's first bid was pending, but before it submitted its second bid, quoted an ANC official admitting that Chancellor was an "ANC vehicle" that existed for the sole purpose of funding the ANC.

According to the SEC, both HPA and HPE were aware of the media reports about Chancellor. For example, it was alleged that an HPA director received a phone call from a newspaper reporter regarding the alleged connection between Chancellor and the ANC, to which the director declined to comment. An HPA director also allegedly forwarded copies of one of the articles about Chancellor to HPE executives, and that same director spoke to Chancellor's chairman about the allegations. Chancellor's chairman denied the allegations at first, but admitted that they were true following the public admission by the ANC official.

C. Hitachi Continues to Work with Chancellor

The SEC also alleged that, although Hitachi knew that Chancellor was an ANC alter ego, it made no attempt to alter its relationship with Chancellor. Indeed, in the period of time when one of Hitachi's bids was still pending—and well after the public revelation of the connections between ANC and Chancellor—a South African newspaper quoted an HPE executive as saying that there was "no proof" of the allegations regarding Chancellor and that, if Chancellor *was* a front for the ANC, this would "contradict [Hitachi's] own governance rules."

D. The SEC's Books and Records Allegations

As memorialized in the unexecuted side agreement, Hitachi had agreed to pay Chancellor success fees in connection with any Eskom contracts and HPA ultimately transmitted payments totaling $1,123,381 in the spring and summer of 2008, which were recorded as "consulting fees" under the "Administrative and other expenses" profit-and-loss line item. HPA's records then were consolidated into Hitachi's financial statements and filed with the SEC on Hitachi's 2009 Form 20-F.

By virtue of its ownership interest in HPA, Chancellor was entitled to 25% of the profits derived from the Eskom contracts in the form of HPA dividends. Hitachi ultimately paid Chancellor approximately $5,027,170, which was declared and recorded as dividends rather than as payments to a foreign political party. These dividends were consolidated into Hitachi's 2011 and 2012 financial statements and filed with the SEC.

The SEC alleged that, in failing to describe the payments to Chancellor as payments to a political party in exchange for assistance in obtaining government contracts, Hitachi failed to keep books, records, and accounts which accurately and fairly reflected the transactions and dispositions of its assets.

E. The SEC Alleges That Hitachi Failed to Devise and Maintain an Adequate System of Internal Accounting Controls in Violation of the FCPA

The SEC also alleged that Hitachi failed to maintain adequate internal accounting controls. For example, the SEC pointed to the fact that HPE and HPA were able to enter into both a shareholder's agreement and an undisclosed "success fee" arrangement with Chancellor to pay for political influence. The SEC also relied upon Hitachi's failure to conduct adequate due diligence of Chancellor and failure to keep records of the diligence performed, as well as the fact that neither HPE nor HPA conducted any FCPA-specific compliance training during the relevant time period, in support of its internal controls charge. Finally, the SEC alleged that, despite the existence of a code of ethics and a system of internal controls, Hitachi was not able to provide reasonable assurance that Hitachi would not violate its own codes of conduct and compliance policies, the FCPA, or South African law.

Key Takeaways and Analysis

The SEC's settlement with Hitachi is significant for at least three reasons.

First, this is the second time in the last five months that the SEC has settled stand-alone charges of violations of the FCPA's books and records and internal controls provisions. Although it is unclear whether the SEC declined to charge Hitachi with bribery as a result of (1) an inability to prove that bribery had occurred, (2) jurisdictional complications, or (3) the nuances of settlement negotiations between the

SEC and Hitachi, the substantial monetary penalty levied against Hitachi is a strong reminder that the SEC is committed to broad FCPA enforcement against issuers, even where it cannot allege any conduct that takes place in the territory of the United States in furtherance of any alleged bribery scheme.

Second, Hitachi ceased to be an issuer in 2012 and, therefore, has not been subject to the accounting provisions of the FCPA since that date. The substantial penalty imposed in 2015 on Hitachi, a *former* issuer, can be seen as a sign of the SEC's enthusiasm for broad FCPA enforcement, even against entities that are no longer subject to the books and records and internal accounting controls requirements.

Third, *Hitachi* is a useful reminder of the importance of a robust anti-corruption compliance program. In particular, Hitachi's involvement with Chancellor highlights the importance of taking a robust, but risk-based, approach to due diligence of potential business partners and investors, especially when doing business in countries with high corruption risks.[3] In designing such an approach, third parties that should be considered include not only consultants retained to assist in generating business, but also local lawyers, lobbyists, distributors, sub-contractors, accounting firms, logistics firms, public relations firms, and—as in the case of *Hitachi*—shareholders. In designing an appropriate due diligence program that may satisfy the SEC, a risk-based approach is appropriate, but best practices suggest that the program should (a) cover all relevant types of third-party transactions, (b) be well-documented, and (c) be monitored and continue throughout the lifespan of the relationship.

A. Focuses of Risk-Based Due Diligence

Any issuer engaging a foreign third party would be well-advised to conduct due diligence to try to identify and minimize any potential corruption risks. Adequate due diligence should touch on a wide range of factors, and any "red flags" raised during the initial diligence should prompt additional, deeper scrutiny. As made clear in the *Hitachi* case, due diligence should inquire into, at least, the following factors:

- The qualifications of the third party, including its business reputation;
- The third party's ownership structure, and information concerning all owners;
- The third party's corporate governance structure, and information concerning all key managers, officers, and directors;
- Rumors in the marketplace concerning the third party's activities and relationships;
- The third party's relationship with any foreign officials, foreign government, foreign political party, or foreign state-owned enterprise; and
- If payment of a "success fee" is contemplated, the specific justifications for that arrangement.

[3] The U.S. government's FCPA Resource Guide also stresses the importance of risk-based due diligence of third parties. *See FCPA Resource Guide*, at 60-61.

Additional factors that should also be considered include:

- The existence of any prior allegations or findings of corrupt activities involving the third party, its owners, or its key managers, officers, or directors;
- The business rationale for including the third party in the transaction;
- The third party's internal anti-corruption policies; and
- The specific services to be performed.

B. Memorializing the Due Diligence and Other Appropriate Documentation

Perhaps almost as important as the adequacy of the due diligence is the keeping of meticulous records regarding that diligence. In *Hitachi*, the SEC noted that Hitachi was unable to locate *any* due diligence reports regarding Chancellor, leading, in part, to a finding that Hitachi lacked adequate internal accounting controls. After ensuring that a third party presents no significant corruption risks, a formal, written record of the diligence performed and the conclusions reached should be created.

Best practices also suggest that, in addition to due diligence, the agreements governing the engagement of a third party should be structured so as to minimize corruption risk and take into account the findings of the anti-corruption due diligence. At a minimum, it would be wise to try to include strong anti-corruption and bribery representations and warranties, including, for example, covenants regarding the third party's internal controls and books and records policies and a commitment to periodic anti-corruption training by employees of the third party. The representations should also address whether the third party, its shareholders, directors, officers, or key personnel are foreign government or party officials. Agreements should also document all key terms of transactions involving third parties, including the work to be done, the amounts to be paid, the justifications for all payments, and the use for—and final destination of—any funds paid to the third party. And, if possible, agreements should include audit rights, indemnification provisions, and a mechanism for unraveling the commercial relationship in the event of a significant compliance failure. Of course, however, even the most robust contractual anti-corruption provisions may not provide protection where there is evidence of corrupt intent; issuers must therefore be vigilant to ensure that the carefully crafted anti-compliance provisions appropriately guide the real-world actions of employees, agents, and third parties.

C. Continuing Compliance Oversight

Finally, any anti-corruption compliance program should involve ongoing monitoring and oversight of third-party activities through the duration of the engagement in order to ensure that the third party is actually performing the work it is contracted to perform, that it is complying with the requirements of the relevant anti-corruption policies, and that any invoices properly account for the expenditure of funds.

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The SEC's action against Hitachi is, in many ways, simply further evidence of the SEC's ability and willingness to use its expansive reach under the FCPA's accounting provisions to police and sanction bribery and bribery-related conduct that it may not be able to reach, or may choose not to sanction, under the anti-bribery provisions. Moreover, Hitachi's relationship with Chancellor, an alter ego for the ruling political party in South Africa, should serve as a cautionary tale underscoring the importance of a risk-based approach to due diligence and anti-corruption compliance from the very outset of any interaction with a third party. Any issuer operating in a region with a high corruption risk should take note and ensure that it has a robust set of policies in place to prevent possible exposure to FCPA liability. And finally, the *Hitachi* case serves as a reminder that in many countries, political parties wield significant power and influence over government decision-making and business. Any company's assessment of corruption risk, and any effective corporate anti-corruption program, must take account of exposure to political parties and party officials.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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