

February 25, 2016

## SEC Settlement Highlights Importance of Third-Party Agent Guidelines

On February 4, 2016, the Securities and Exchange Commission announced a settled enforcement action against Ignacio Cueto Plaza, the current CEO of Chile-based airline company LAN Airlines S.A. The SEC alleged that Cueto caused LAN, a foreign issuer, to violate the internal accounting controls and books and records provisions (but not the anti-bribery provisions) of the Foreign Corrupt Practices Act.<sup>1</sup> According to the SEC, Cueto authorized \$1.15 million in improper payments to a third party consultant with the understanding that the consultant might pass some portion of those payments to union officials or unspecified third parties with influence over the unions who may have included government officials.

Under the SEC's cease-and-desist order, Cueto agreed to pay a civil monetary penalty of \$75,000, and to certify compliance with company policies and procedures by attending anti-corruption training, among other undertakings. Cueto neither admitted nor denied the SEC's findings.

In its press release, the SEC noted that its investigation is continuing.<sup>2</sup> LATAM Airlines Group S.A. ("LATAM"), LAN's current parent company, issued a press release acknowledging the settlement involving Cueto, who remains CEO of LAN, but was silent on the issue of whether the SEC, the Justice Department, or any foreign authorities were continuing to investigate the matter with regard to the company and/or other executives.<sup>3</sup> In light of these somewhat unusual circumstances, it may be that additional enforcement actions may follow involving additional individuals and/or the company.

Although the penalties imposed in this enforcement action were not particularly severe—indeed, Cueto remains the CEO of LAN—this case is noteworthy because it demonstrates the importance of using appropriate procedures when evaluating, contracting with, and working with third-party consultants. In the analysis below, we discuss best practices for avoiding the corruption risk inherent in such contracting relationships through risk-based due diligence, use of contractual anti-corruption provisions, and monitoring activities.

<sup>1</sup> In the Matter of Cueto (the "Order"), Exchange Act Release No. 77057, at 2 (Feb. 4, 2016), available at <https://www.sec.gov/litigation/admin/2016/34-77057.pdf>.

<sup>2</sup> Press Release, Sec. & Exch. Comm'n, Airline Executive Settles FCPA Charges (Feb. 4, 2016), available at <https://www.sec.gov/litigation/admin/2016/34-77057-s.pdf>.

<sup>3</sup> Press Release, LATAM Airlines Grp., S.A., LATAM Airlines Group Has Issued the Following Information (Feb. 4, 2016), available at <http://www.latamairlinesgroup.net/phoenix.zhtml?c=81136&p=irol-newsArticle&ID=2135997>.

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### **Factual Allegations<sup>4</sup>**

For several years prior to 2004, LAN explored expansion into Argentina. The Vice President of Business Development for a LAN subsidiary based in Miami, Florida, who reported directly to Cueto, was in charge of these efforts. In late 2004, a lawyer and purported business consultant in Argentina contacted the Vice President, offering to help LAN with its expansion efforts.

In 2005, LAN entered the Argentine airline market after acquiring a non-operating airline company that owned an airline operation certificate and various flight routes. From the outset, LAN faced demands from labor unions representing employees LAN had acquired to staff its new venture, which began losing money.

The labor unions representing LAN's new employees were allegedly powerful and unafraid to make demands. Several unions had a single-function rule in their respective collective bargaining agreements that prohibited their employees from performing more than one work function at a time. The rule was loosely interpreted and, for the most part, the unions did not enforce it. The unions threatened to enforce the rule, which would have required LAN to double its work force, if LAN failed to agree to a substantial wage increase. LAN's management, including Cueto, attempted to negotiate with the unions but made no progress, and the unions eventually engaged in work stoppages and slowdowns.

In early 2006, the Consultant again contacted the Vice President and offered to assist LAN in Argentina. By this time, the Consultant was an official in Argentina's Ministry of Federal Planning, Public Investment and Services, Department of Transportation. Beginning in the summer of 2006, the Consultant supplied LAN executives with information on how to deal with the unions. Eventually, the Consultant offered to negotiate directly with the unions on LAN's behalf. The Consultant purportedly made clear that he expected compensation for his services and would make payments to unspecified third parties with influence over the unions on LAN's behalf. The SEC's order does not clarify whether these third parties consisted only of union officials, or whether they also included officials with the Department of Transportation, whom the order describes as having "close ties" to the unions.<sup>5</sup> After learning that the Consultant was well connected with the unions and could effectively negotiate an agreement with union officials, Cueto allegedly approved his retention.

After negotiations on the wage dispute concluded successfully in LAN's favor, the Consultant emailed the Vice President a draft consulting contract between LAN and his company, copying a chief advisor to the Transportation Secretary who oversaw airline and union issues. The Vice President forwarded the contract to Cueto for his review. The contract requested \$1.15 million to be paid to the Consultant's company in three installments, and falsely stated that the Consultant would undertake a study of air

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<sup>4</sup> The factual summary is drawn from the SEC's order.

<sup>5</sup> Order 4.

routes in the regional market as the basis for payment. The parties never signed the draft contract, and Cueto allegedly knew the Consultant would not perform such a study.

Following transmission of the draft consulting contract, the Consultant's company sent a backdated invoice for \$300,000 to a Delaware-based LAN subsidiary that was designated to make payments to the Consultant's company but was otherwise uninvolved in LAN's business in Argentina. The invoice indicated that the amount due was for "consulting services provided by and payable . . . under contract signed by both parties."<sup>6</sup> It also contained wire transfer instructions to a brokerage account in Virginia owned by the Consultant and his wife. LAN wired \$300,000 to the brokerage account shortly thereafter. Additional invoices for \$300,000 and \$550,000 were sent to the Delaware subsidiary and paid to the same brokerage account. All these payments were intentionally misrecorded as payments to "other debtors" on the books and records of the Delaware subsidiary.<sup>7</sup> Cueto did not inform LAN's CFO or legal department that these payments were being made to the Consultant's company pursuant to a false contract.

Later, the Vice President received an additional invoice from the Consultant for \$58,000 payable to a Spanish account in the name of a Costa Rican company owned by the Consultant's wife and son. The invoice for this payment again indicated that it was for consulting services that the Consultant had never rendered. Though he was copied on an email attaching the invoice for this payment, which he knew contained false references to services never rendered, Cueto allegedly made no effort to stop the payment, which was again made through LAN's Delaware subsidiary.

### **The SEC's Internal Accounting Controls and Books and Records Charges**

The SEC alleged that Cueto caused LAN to violate the FCPA's internal accounting controls provisions, Section 13(b)(2)(B) of the Securities Exchange Act, 15 U.S.C. § 78m(b)(2)(B), because he did not follow the Company's existing internal accounting controls when he authorized the payments to the Consultant's company in exchange for services he knew would never be provided, and failed to prevent the payment to the company owned by Consultant's wife and son based on an invoice that he knew contained a false description of services. Based on the same conduct, the SEC also alleged that Cueto violated Section 13(b)(5) of the Exchange Act—which prohibits persons from circumventing or failing to implement a system of internal accounting controls, or falsifying corporate books and records—and SEC Rule 13b2-1—which also prohibits persons from falsifying corporate books and records. The SEC further alleged that Cueto caused LAN to violate the FCPA's books and records provisions, Section 13(b)(2)(A) of the Exchange Act, by authorizing payments that were improperly described as "other debtors" costs in the books and records of LAN's Delaware subsidiary, which had no role in LAN's Argentine business.

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<sup>6</sup> *Id.* at 6.

<sup>7</sup> *Id.*

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### **Cueto's Cooperation and Remedial Efforts**

In determining whether to accept Cueto's offer of settlement, the SEC considered a number of factors in addition to the alleged misconduct:

- As CEO of LAN, which is now a division of LATAM, also a foreign issuer, Cueto is subject to LATAM's enhanced compliance policies and internal accounting controls.
- Cueto attended the Corporate Governance Training provided by LATAM's Chief Compliance Officer, and certified his acknowledgement of the Code of Conduct, the relevant applicable regulations, as well as LATAM's policies. He furthermore agreed to attend comparable anti-corruption training on an annual basis so long as he remains a senior executive of LAN and appropriately document his attendance and the session's contents.

### **Key Takeaways and Analysis**

The SEC's enforcement action against Cueto reinforces the need for having appropriate due diligence procedures, protective contractual provisions, and oversight and payment controls when engaging in relationships with third-party consultants. Third party relationships are a traditional corruption risk area, and an overwhelming percentage of FCPA prosecutions involve third parties. While most such third parties have functioned at least in part as conduits for improper payments to foreign officials, third parties can and do of course play a central role in other schemes, ranging from embezzlement to commercial bribery. Because the FCPA's accounting provisions operate independently from its anti-bribery provisions, issuers (and their officers, directors, employees and others causing issuers to act) can be subject to criminal and civil liability for using third parties to make improper payments to individuals who are not government officials—in the case of LAN, to Argentine union officials. From the SEC's order, it appears that LAN failed to engage in many practices that the SEC and DOJ have explicitly and publicly reminded companies to adopt in this area.

First, in 2006 LAN had no third-party due diligence requirements and conducted no diligence at all on the Consultant. Yet the DOJ and SEC have made clear that companies should establish clear and accessible policies and procedures for appropriate, risk-based due diligence of third-party intermediaries. What those policies and procedures should look like will be measured against the particular circumstances of each individual company. That said, the DOJ and SEC suggest at least the following steps when companies plan to use agents, consultants, distributors, and other third parties:

- Understand the qualifications and associations of the third-party, including business reputation and relationships, if any, with foreign officials. The degree of scrutiny should increase as red flags surface;
- Understand the business rationale for including the third-party in the transaction, and ensure that the terms of the contract specifically describe the services to be performed;

- Ensure that payment terms and amounts compare to typical contracts in the industry and country, are commensurate with the third-party's introduction to the business, and are based on work actually provided; and
- Monitor third-party relationships, including updating due diligence, exercising auditing rights, providing training, and requesting compliance certifications.<sup>8</sup>

Had LAN conducted appropriate due diligence on the Consultant, the company likely would have identified a number of “red flags” attending his retention that the DOJ and SEC have warned against. The draft contract between LAN and the Consultant was never executed and appears to have included only a perfunctory description of the services to be performed, and the Consultant maintained shell companies incorporated in offshore jurisdictions and requested payment be made to those companies—all facts that the DOJ and SEC have identified as requiring heightened scrutiny of a third-party relationship. These are, of course, not the only “red flags” that the DOJ and SEC have suggested companies might want to consider when engaging with third parties. Additional “red flags” include:

- Excessive commissions to third-party agents or consultants;
- Unreasonably large discounts to third-party distributors;
- The third-party consultant is in a different line of business than that for which it has been engaged;
- The third party is related to or closely associated with a foreign official; and
- The third party became part of the transaction at the request or insistence of a foreign official.<sup>9</sup>

And apart from those identified by the DOJ and SEC, best practices suggest that companies might also want to consider certain other factors that potentially increase the risks of third-party relationships before deciding whether to enter into such relationships. These include, but are not limited to, the following, several of which were also present in the Cueto enforcement action but went unheeded by LAN's management:

- A third party paid by “success fee” or contingency fee;
- A third party who requests payment to an account in a different jurisdiction from that in which it is domiciled or established;
- Any third party retained or hired to obtain or retain business from government or state-owned clients or to interact with a government official or agency with respect to a regulatory, licensing, approval, tax liability, or other discretionary matter;
- Any third party whose role is to engage with, or introduce the company to, government officials or potential clients;

<sup>8</sup> Enforcement Division, Sec. & Exch. Comm'n & Criminal Division, U.S. Dep't Just., FCPA: A Resource Guide to the U.S. Foreign Corrupt Practices Act 60 (2012).

<sup>9</sup> *Id.* at 56.

- A third party who is a politically exposed person, a foreign government official, or a relative of a foreign government official;
- A third party who has a criminal record or a public reputation for acting corruptly, unlawfully, or unethically;
- A third party who lacks experience (or whose experience cannot be verified) in the type of work he is being asked to undertake; and
- A history of corruption in the country in question or the third party is connected to a high risk jurisdiction.

Finally, the Cueto enforcement action also underlines the need for contracts and payment arrangements with third-party consultants that clearly and accurately account for the work to be performed and the remuneration to be received. Contracts should accurately and with particularity describe the services to be provided. Invoices should accurately reflect their purpose and the intended recipient of the requested funds, and the company's books and records should accurately describe any payments made on such invoices. In the normal course, absent a legitimate business justification, payments should not be made by a company subsidiary that has no involvement in the business at issue.

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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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