

BAKER HUGHES SETTLES FCPA CHARGES WITH DOJ AND SEC

May 2007

Introduction

On April 26, 2007, Baker Hughes Inc. settled charges with the Securities and Exchange Commission (“SEC”)¹ and the Department of Justice (“DOJ”)² relating to improper payments to two agents associated with its business in Kazakhstan and for failed due diligence in connection with payments made in Nigeria, Angola, Indonesia, Russia, Uzbekistan, and Kazakhstan; Baker Hughes was also penalized for violating a 2001 SEC cease and desist order requiring Baker Hughes to comply with the books and records and internal controls provisions of the FCPA.³

The combined SEC and DOJ settlement of \$44 million is the largest sanction ever imposed in an FCPA case. The settlement is composed of over \$23 million in disgorgement and a \$10 million penalty to the SEC, along with an \$11 million criminal fine imposed by the DOJ. Under the terms of the SEC and DOJ resolutions, Baker Hughes is required to retain a monitor for three years to review and assess the company’s compliance program and monitor its implementation of and compliance with new internal policies and procedures.

In addition to the sheer size of the monetary settlement, the Baker Hughes resolution is noteworthy: (1) for its unparalleled emphasis on due diligence; (2) as a vehicle through which the SEC and DOJ highlighted conduct believed to raise red flags; and (3) as it continues the trend requiring the appointment of a monitor. As to the first of these, the critical importance of robust internal controls, the SEC found violations not after proof was adduced that Baker Hughes made corrupt payments to foreign government officials, but rather from the company’s inability to know that payments *were not* being passed on to government officials – effectively shifting the burden onto companies to prove that payments were not made to government officials when no or inadequate due diligence is conducted.

¹ In the SEC proceedings, Baker Hughes, without admitting or denying the SEC’s allegations in a filed complaint, consented to the entry of a final judgment enjoining it from future violations of the FCPA and ordering it to pay disgorgement, a civil penalty and prejudgment interest. The SEC complaint also charged a former business development manager of Baker Hughes with violating and aiding and abetting violations of the FCPA; no resolution has been reached with the business development manager.

² In the DOJ proceedings, Baker Hughes entered into a deferred prosecution agreement with the DOJ, while its wholly owned subsidiary, Baker Hughes Services International, Inc., entered a guilty plea to violating the anti-bribery provisions of the FCPA and other related charges.

³ In 2001, the SEC entered a cease and desist order requiring Baker Hughes not to violate the books and records and internal controls provisions of the FCPA. The order stemmed from an attempt to bribe an Indonesian tax official and payments to agents in Indonesia and Brazil.

HIGHLIGHTING RED FLAGS AND QUESTIONABLE CONDUCT

The government's allegations underlying the prosecution and settlement with Baker Hughes underscore the government's current position regarding various types of agent-related conduct it deems improper as well as the kinds of activities and information it appears to deem red flags. While such conduct, if litigated, might not violate the FCPA and such red flags might not give companies sufficient knowledge to be held derivatively liable for acts of their agents, companies seeking to avoid the watchful eye of the United States government are wise to heed the advice conveyed through the Baker Hughes prosecution.

- Need for Due Diligence: No message is clearer than the compelling need for appropriate due diligence on agents and intermediaries. Just the failure to conduct due diligence leaves a company in a position where it cannot form a basis to rationally conclude that *no illegal payment was made* and therefore can subject the company to liability under the relevant recordkeeping and internal control requirements.
- Need to Examine Carefully the Qualifications of Agent: Emphasis is placed on the need to understand the background, competence and track record of the agent or intermediary.
- Careful Examination of Tasks to Be Performed by Agent and Their Relative Value: Companies must examine the competence of the agent to provide the particular tasks for which it is being engaged together with the relative value of those tasks. "Paper tasks" will not suffice: companies must also validate the tasks allegedly being provided by the agent to ensure they are undertaken.
- Source of Agent: Companies are reminded to be especially suspicious of agents suggested to them by government officials with whom such companies are bidding or negotiating.
- Location and Method of Payment: Companies are reminded that a red flag is raised in making payments to agents incorporated in notorious locations (such as Panama) and to locations outside where the service is being provided or work done.
- Check Family and Personal Connections: Appropriate due diligence must not only look to the business affairs of the agent but must look to the agent's family and close personal relationships.
- No De Minimis Exception: The Baker Hughes prosecution included charges associated with a \$9,000 payment, providing a stark reminder that there is no *de minimis* exception to the FCPA.
- Liability for Payments Made on Behalf of Subcontractors: The mere fact that a payment is made on behalf of a subcontractor is not a defense to the potential inappropriateness of the payment.
- Examine Agency Relationships Obtained Through Acquisition: Charges can be levied in connection with agency relationships inherited through an acquisition, especially where red flags present themselves post-acquisition.

- Commonality of Practice Not an Excuse: Amplifying (and correcting a common misperception), it was made clear that a common but illegal practice is still illegal.
- Terminate Agents Without Payment of Accrued Commissions: Once payments to an agent are determined to be inconsistent with the FCPA or company policies, termination of the payments is expected. Creative payment arrangements, such as a severance arrangement, will not necessarily avoid criticism under the FCPA.
- Hiring An Outside Law Firm Not Enough: The mere use of outside counsel without such an exercise being undertaken in an appropriate and careful fashion will not allow a company to avoid FCPA liability.
- Agent Compensation: Compensation needs to be rationally tied to the task to be performed by the agent. Exotic compensation arrangements, such as tying compensation to a percentage of an above-market price, are deemed suspicious.
- Paper Procedures Not Enough: Company procedures that require due diligence, contractual provisions or FCPA certifications, will provide no protection (and may prove harmful) where they are not followed.

CHALLENGED PAYMENTS AND ARRANGEMENTS

The Payments in Kazakhstan Found to Violate the FCPA

The Karachaganak Oil Project

Baker Hughes was found to have violated the FCPA anti-bribery prohibitions in connection with its efforts to secure subcontracting work on the Karachaganak oil field. In 1997, a Production Sharing Agreement was signed to develop the Karachaganak oil field. The project was overseen by Kazakhstan's then national oil company, Kazakhoil, and developed by a consortium of international oil companies including Eni-AGIP, S.p.A., British Gas Exploration and Production, ChevronTexaco, and Lukoil.

In September 2000, Baker Hughes heard unofficially that it had been awarded the contract. Later that month, however, Kazakhoil requested that Baker Hughes pay a commission to an agent, even though that agent did no work on the bid. Baker Hughes's "team leader," allegedly understood that if they did not hire the agent Baker Hughes would lose this contract and future business in Kazakhstan. By the end of September, Baker Hughes hired the agent, a company based in the Isle of Man led by an individual citizen and resident of the U.K., through a side letter agreement that contained no FCPA warranties or representations and without performing any meaningful due diligence or subjecting the side letter to legal review. The agency agreement called for Baker Hughes to pay a commission of 2% on revenues from the Karachaganak project. From May 2001 through November 2003, Baker Hughes made 27 commission payments totaling approximately \$4.1 million to the agent (approximately \$1.8 million was made by Baker Hughes on behalf of subcontractors).

Baker Hughes was also charged with pressuring one of its subcontractors to make a \$20,000 payment to the same agent in connection with an unrelated contract. While the subcontractor was awarded the contract before formally contracting with the agent, Baker Hughes's former business development manager advised the subcontractor that the agent had supported the subcontractor's bid, and that failure to pay a commission could negatively affect the subcontractor's ability to perform on the awarded contract and negatively impact the subcontractor's and Baker Hughes's ability to obtain future work.

The KazTransOil Payments

From 1998 to 1999, a Baker Hughes subsidiary also made payments to another agent, FT Corp., at the direction of a high-ranking executive of KazTransOil (the national oil transportation operator in Kazakhstan), who was in a position to influence the award of a large chemical contract to Baker Hughes. Despite already having an agent for the project in question, the Baker Hughes subsidiary hired FT Corp. after the contract award was delayed for fear that it would not be awarded the chemical contract with KazTransOil. In doing so, it failed to conduct sufficient due diligence and its agency agreement contained no FCPA representations. The payments to the agent were based on a percentage of the price the agent was able to negotiate with KazTransOil over Baker Hughes's bid price. The agent was to carry out certain field work as part of its engagement but there is no evidence the work was ever undertaken. In December 1998, an employee of Baker Hughes's subsidiary learned that the FT Corp. representative was also a high-ranking KazTransOil executive. Nevertheless, payments were made until April 1999, with FT Corp. receiving commissions via a Swiss bank account of approximately \$1.05 million.

Books and Records and Internal Controls Violations

In addition to settling the above charges relating to improper payments, Baker Hughes also settled allegations that it improperly recorded items in its books and records, and failed to implement sufficient internal controls, relating to its business in several countries. In each instance, the SEC explicitly found Baker Hughes to have violated these requirements – even though there is no finding that illegal payments were in fact made – because Baker Hughes failed to conduct sufficient due diligence to determine whether the payments were provided to government officials.

Payments to N Corp. Regarding Kazakhstan, Uzbekistan and Russia

Between 1998 and 2004, a Baker Hughes subsidiary made payments to an agent (“N Corp.”) totaling nearly \$5.3 million in connection with N Corp.'s assistance in selling products to customers in Kazakhstan, Russia, and Uzbekistan. Prior to 2002, there was no written agreement with N Corp., and the agreement eventually entered into in 2002 did not contain the full FCPA provisions required by Baker Hughes's FCPA policies and procedures. In addition, N Corp. made it through Baker Hughes's revised due diligence procedures, including review by outside counsel hired to assist with agent re-certifications.

The commissions to the agent, a Panamanian company, (some of which were paid in cash) were made outside the countries in which the service was being provided. In addition, the payments were calculated as a percentage above price achieved by the agent over Baker Hughes's previously negotiated price.

Angola

Between 1998 and 2003, Baker Hughes paid over \$10.3 million in commissions to an agent without assuring itself that the agent was not passing on payments to Angola's state-owned oil company, Sonangol. Baker Hughes inherited the relationship with the agent through its acquisition of Western Atlas Corporation in 1998. After the acquisition, Baker Hughes learned that a Sonangol employee was aware of the agent's agreement (but dismissed this red flag out of hand) and further learned of connections between the agent and senior-level Sonangol employees. In one instance, Baker Hughes was billed for the travel expenses of a senior Sonangol employee and his family, and deducted those expenses from the agency agreement, suggesting a connection between Sonangol and the agent. Baker Hughes recorded the payments to this agent as "commission" payments.

In April 2000, a Baker Hughes division made payments to another Angolan agent, despite the fact that the agent was the brother of a senior-level Sonangol employee. Baker Hughes paid this agent approximately \$1.2 million without conducting any due diligence. The severance arrangement negotiated with the agent on its termination in 2002 provided for the payment of \$500,000 in accrued commissions.

Nigeria

In May 2001, a Baker Hughes subsidiary disregarded clear warnings of potential FCPA violations and paid Nigerian state tax officials, directly or indirectly, in exchange for receiving a reduced income tax bill, and then inaccurately recorded such payments on its books and records. The local tax authority assessed the subsidiary for underpayment of certain local income taxes. The subsidiary negotiated a possible settlement and the tax officials proposed that the settlement amount contain two parts: a payment to the tax authority and a payment to unnamed tax officials. The Baker Hughes international tax manager concluded that such a payment could violate the FCPA.

The Baker Hughes subsidiary then reached an agreement in which it would pay a reduced fee, in part to the tax authority and in part to an agent described as "persons connected with the local tax authority." The Baker Hughes district manager that authorized the payment determined that it would not violate the FCPA because "all companies are doing the same in Nigeria." The ultimate payment to the tax authority was less than 10% of the original assessment. The agent submitted a false invoice stating that he had performed tax consultancy work when no such work was done, and the payment to the agent was booked as a "miscellaneous expense."

Separately, between 2001 and 2005, another Baker Hughes division authorized customs brokers to intervene with Nigerian customs authorities in connection with alleged claims against Baker Hughes of underpayment of customs duties. The Baker Hughes unit paid over \$2.5 million to the customs brokers to resolve the dispute (a fixed fee of 50% of Baker Hughes's alleged underpayment), but never received any record of the resolution or any record of the payment supposedly made to the customs authorities. Despite a 2003 worldwide review of its customs procedures, Baker Hughes failed to discover this incident.

Kazakhstan

In 2002, Baker Hughes sought land in connection with a Kazakh project – the KCO project – and was advised by its former business development manager to purchase a plot of land owned by a Kazakh company (“SCo”) because the owners of SCo were “influential.” At the time the business development manager was aware that a high-ranking official of Kazakhstan’s current national oil company, KazMunaiGas, had significant connections to SCo. In addition, had Baker Hughes done due diligence (which it did not) it could have discovered that the principle partner of SCo appears to be the agent with which Baker Hughes engaged on the Karachaganak project. In 2003, Baker Hughes made two payments totaling \$60,000 to SCo for an option on the land in connection with its bid for work on the KCO project.

Separately, in March 2000, a Baker Hughes subsidiary made a \$9,000 payment to a Kazakh company – in cash to an individual affiliated with the company – to secure a license needed to import tools into Kazakhstan. The payment was made despite two employees’ knowledge that one of the directors of the company was a Kazakh government official (possibly with a nuclear agency), and without any due diligence being done on the company. The subsidiaries accounting records did not reflect the payment.

Indonesia

Between 2000 and 2003, two Baker Hughes divisions made payments to Indonesian freight forwarders to import its products by a method designed to bypass the Indonesian customs clearance process. The divisions failed to assure themselves adequately that the freight forwarders being used were not passing payments along to Indonesian customs officials. Despite a consultant advising Baker Hughes in 2001 that the import method was illegal under Indonesian law and may involve payments to customs officials, Baker Hughes continued using the freight forwarders until 2003.

For more information, please contact:

Kevin T. Abikoff
(202) 721-4770

abikoff@hugheshubbard.com

Marc A. Weinstein
(212) 837-6460

weinstei@hugheshubbard.com

Bryan Sillaman
(202) 721-4688

sillaman@hugheshubbard.com

F. Amanda DeBusk
(202) 721-4790

debusk@hugheshubbard.com

Beatrice A. Hamza Bassey
(212) 837-6778

hamza@hugheshubbard.com

Edward M. Little
(212) 837-6400

little@hugheshubbard.com

Gregory M. Williams
(202) 721-4643

williamg@hugheshubbard.com

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