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Behind Petrobras $1.8 Billion FCPA Settlement, An Interesting Accounting

On September 27, 2018, the U.S. Department of Justice ("DOJ") and the U.S. Securities and Exchange Commission ("SEC") announced coordinated enforcement resolutions with Petróleo Brasileiro S.A. – Petrobras, the Brazilian state-owned energy company ("Petrobras"), in connection with numerous schemes to bribe Brazilian public officials.[1] Specifically, the DOJ and the SEC allege that, between 2003 and 2012, senior Petrobras executives, many of whom served as company board members, worked with the company's largest contractors to inflate the cost of its infrastructure projects by billions of dollars in exchange for more than a billion dollars in kickbacks, much of which was in turn paid to Brazilian politicians and political parties responsible for appointing the Petrobras executives to their positions.[2]

The DOJ has entered into a non-prosecution agreement ("NPA") with Petrobras, and the company has agreed to pay a criminal penalty of $853.2 million to resolve the matter. Separately, to resolve the SEC investigation, Petrobras agreed to the entry of a cease and desist order, and to pay an additional $933 million in disgorgement and prejudgment interest, for a total of nearly $1.8 billion between the two resolutions. Although this may at first appear to be one of the largest settlements in FCPA history, on closer inspection, U.S. authorities will recover only a relatively small portion of the total. And while there are other instances in which U.S. authorities have brought coordinated enforcement actions with foreign authorities and taken the minority share of the penalties assessed, it appears that these Petrobras resolutions reflect more complex issues than simply a recognition that the company is a foreign company, principally subject to foreign regulation. Petrobras will pay only 20 percent, or $170.6 million, of the penalty assessed in the NPA to the DOJ and the SEC, and the remaining 80 percent ($682.6 million) to Brazilian authorities to be placed in a special fund for social and educational programs to promote transparency and compliance in Brazil's public sector.[3] Notably, the settlement does not contemplate that Petrobras will be prosecuted or penalized by the Brazilian authorities. As for the $933 million settlement

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1 *See* Press Release, Dep't of Justice, Petróleo Brasileiro S.A. – Petrobras Agrees to Pay More Than $850 Million for FCPA Violations (Sept. 27, 2018), *available at* https://www.justice.gov/opa/pr/petr-leo-brasileiro-sa-petrobras-agrees-pay-more-850-million-fcpa-violations; In the Matter of Petróleo Brasileiro S.A. – Petrobras, Exchange Act Release No. 84295 (Sept. 27, 2018), *available at* https://www.sec.gov/litigation/admin/2018/33-10561.pdf.

2 Release No. 84295, ¶ 2.

3 *See* Petrobras Press Release (Sept. 27, 2018), *available at* http://www.petrobras.com.br/en/news/petrobras-reaches-coordinated-resolutions-with-authorities-in-the-united-states-and-agreement-to-remit-bulk-of-associated-payments-to-brazil.htm.

with the SEC, this amount may be offset completely by payments Petrobras makes in a related securities class action, which settled in September 2018 for nearly $3 billion.[4]

Factual Allegations

From 2004 to 2012, Petrobras executives and managers allegedly facilitated "massive bid-rigging and bribery schemes" by failing to implement adequate internal controls, thereby enabling contractors to generate funds by obtaining noncompetitive, inflated contracts.[5] In return for the inflated contracts with Petrobras, the contractors paid between one percent and three percent of the contract costs to certain Petrobras executives, Brazilian politicians and political parties.[6] The money to pay the bribes was also funneled through fictitious expenses, such as consultancy agreements, incurred by the contractors in association with Petrobras projects. The DOJ estimated that contractors used more than $2 billion to make corrupt payments, of which more than $1 billion was directed to politicians and political parties.[7]

While the various bribery and bid-rigging schemes were underway, Petrobras's American Depository Receipts ("ADRs") traded on the New York Stock Exchange ("NYSE"), which made the company subject to jurisdiction under the FCPA as a U.S. issuer. In connection with its ADRs, Petrobras filed annual reports with the SEC.[8] Petrobras executives allegedly capitalized the inflated amounts paid to corrupt contractors as legitimate costs, recording the costs in the company's books and falsely inflating the value of certain Petrobras assets.[9] As a result, according to the allegations, Petrobras failed to make and keep books, records and accounts that accurately and fairly reflected the company's capitalization of assets, which was overstated in the SEC filings as a result of the bribes generated by the company's contractors. Petrobras admitted that certain executives signed Sarbanes-Oxley certifications and similar management representation letters to certify that the SEC filings did not contain materially false or misleading statements, although they were aware that they had facilitated the payment of many millions of dollars in kickbacks to themselves, and in bribes to Brazilian politicians and political parties.[10]

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4 *In re Petrobras Securities Litigation*, No. 14-cv-9662 (S.D.N.Y.). *See* Release No. 84295, at 9. The SEC's order also established a "Fair Fund" to distribute any penalty received by the SEC to harmed investors. *Id.* at 10–11.

5 Petrobras NPA, at A-4 to A-5.

6 *Id.*

7 *Id.* at A-5.

8 *Id.* at A-10.

9 *Id.* at A-5.

10 *Id.* at A-10 to A-11.

Petrobras also admitted that, to facilitate bribe payments to Brazilian politicians and political parties, certain executives failed to implement internal financial and accounting controls.[11] According to the DOJ, Petrobras executives facilitated the corruption schemes by failing to implement, among other mechanisms, "appropriate due diligence procedures for the retention of third-party vendors," "sufficient oversight to prevent the revision of estimates at the conclusion of the bid phase to favor certain bidders," and "sufficient safeguards to prevent the manipulation of bid participant lists or criteria for selecting bid invitees to permit the invitation of companies that were not qualified."[12]

As a result of these executives' failure to implement adequate internal controls and their submission of false certifications related to the company's internal process for preparing its SEC filings, Petrobras allegedly made material misstatements and omissions in documents relating to a $69.9 billion global public offering of equity securities in 2010—including approximately $10 billion raised in the United States—the purpose of which was to raise funds for Petrobras's business expansion.[13]

Although Petrobras did not voluntarily self-disclose its misconduct, the DOJ acknowledged that, once the misconduct was discovered, Petrobras fully cooperated in the investigation.[14] As a result, the DOJ reduced the criminal penalty by 25 percent. According to the NPA, Petrobras subsequently conducted an independent investigation of its business and implemented extensive remedial measures. In particular, the DOJ credited Petrobras for replacing its Board of Directors and Executive Board, as well as disciplining employees and ensuring that the company no longer employed or was affiliated with any of the individuals implicated in the alleged conduct involved in this case.[15] The DOJ also acknowledged that Petrobras implemented extensive governance reforms, including revamping its compliance function by creating a Division of Governance and Compliance and limiting individual decision-making authority by implementing a "four eyes" approval policy "that requires a second review by supervisors from different reporting lines for substantive decisions."[16] Under the agreements, the DOJ recognized that, in addition to committing various crimes, Petrobras was also a victim of its executives' embezzlement scheme, and the SEC recognized the company's status as an Assistant to the Prosecution in 51 criminal proceedings in Brazil.[17]

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11 *Id*. at A-11 to A-12.

12 *Id*. at A-12.

13 *Id*. at A-11; Release No. 84295, ¶ 5.

14 Petrobras NPA, at 1–3.

15 *Id*. at 2.

16 *Id*.

17 *Id*. at 3; Release No. 84295, ¶ 44.

Analysis

The resolutions with Petrobras mark a significant milestone in the fallout from Operation Lava Jato ("Carwash"), the Brazilian authorities' sweeping investigation of money laundering and corruption which began in 2014 and which led, among many other consequences, to a $3.5 billion FCPA settlement with Odebrecht, S.A., a Brazilian conglomerate and the largest construction company in Latin America, and its affiliate Braskem S.A., a Brazilian petrochemical company, as well as to the arrest of former Brazilian president Luiz Inácio Lula da Silva.[18]

It is particularly notable that the DOJ entered into an NPA with Petrobras, as opposed to deferring prosecution or entering a plea agreement as it has done in a number of other Brazil-related enforcement actions, including those against SBM Offshore N.V., Keppel Offshore & Marine Ltd., Rolls-Royce plc, Odebrecht S.A., and Braskem S.A.[19] This outcome is remarkable in light of the involvement of senior executives and board members in bribery, embezzlement and related misconduct; the numerous, high-level officials involved in the bribery; the duration of the crimes – more than a decade long; the pervasiveness of the misconduct throughout Petrobras; the sheer scale of the corruption – billions of dollars in corrupt payments; and the paucity of internal controls at the company. Notably, even though the DOJ estimated that more than $2 billion "have been generated and used to make corrupt payments," and it has ongoing investigations with which Petrobras has agreed to cooperate, the illicit schemes detailed in the NPA only account for a fraction of the $2 billion figure reported, leaving the details of additional illicit activity unspecified.[20]

Similarly, neither the DOJ nor the SEC imposed an independent compliance monitor, citing the understanding that Petrobras will enter into a separate resolution with Brazilian authorities and will be subject to unspecified oversight. The DOJ acknowledged that Petrobras is undertaking numerous compliance enhancements, yet a monitor would typically be appointed to assess their implementation and effectiveness. Yet the company has not finalized a settlement agreement with Brazilian authorities and,

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18 *See* Client Memorandum, Paul, Weiss, Rifkind, Wharton & Garrison LLP, FCPA Enforcement and Anti-Corruption Developments: 2016 Year in Review (Jan. 20, 2017), https://www.paulweiss.com/practices/litigation/anti-corruption-fcpa/publications/fcpa-enforcement-and-anti-corruption-developments-2016-year-in-review?id=23567.

19 *See* Client Memorandum, Paul, Weiss, Rifkind, Wharton & Garrison LLP, FCPA Enforcement and Anti-Corruption Developments: 2017 Year in Review (Jan. 19, 2018), https://www.paulweiss.com/practices/litigation/anti-corruption-fcpa/publications/fcpa-enforcement-and-anti-corruption-developments-2017-year-in-review?id=25839.

20 Petrobras NPA, at A-3, A-5.

consistent with its view that it is more victim than perpetrator, it has informed investors that the expected agreement will not attribute liability to Petrobras under Brazilian law.[21]

The exceptional leniency demonstrated may be attributable in part to the DOJ's recent policy discouraging the "piling on" of penalties and encouraging coordination with other enforcement agencies to avoid multiple penalties for the same conduct.[22] As the DOJ noted, it reached this resolution based on a number of factors, "including that Petrobras is a Brazilian-owned company that entered into a resolution with Brazilian authorities and is subject to oversight by Brazilian authorities."[23] What the DOJ did not fully elucidate is how those circumstances distinguish Petrobras from so many other foreign companies that have resolved FCPA investigations.

Relatedly, it is significant that both the DOJ and SEC resolutions refer to Petrobras's $2.93 billion settlement in a related class action. In that action, brought by holders of Petrobras's ADRs between 2010 and 2015, plaintiffs claimed that, because of the bribery, the company had overstated its assets and earnings in its filings with the SEC. Of note, the amount of disgorgement payable under the SEC's order may be offset entirely by the amount Petrobras pays into the settlement fund for the class action. According to the SEC's order, Petrobras will be required to disgorge its ill-gotten gains to the SEC only if the amount Petrobras pays into the settlement fund is less than $933 million.[24] This term is unusual in FCPA enforcement actions. It may be a product of the particular facts of this case, or it may indicate a willingness by the SEC to consider related securities lawsuits when calculating fine amounts or disgorgement.

The settlement with Petrobras is also unusual for being one of only two with a company directly owned and controlled by a foreign government, the other example being the 2006 DOJ prosecution of Norway's Statoil. Indeed, under established FCPA jurisprudence, state-owned companies may be "instrumentalities" of foreign governments and their employees may qualify as foreign officials, such that paying bribes to employees of such companies constitutes a violation of the FCPA, as does payment of bribes by such individuals to public officials.[25] Here, executives at Petrobras, who arguably were public officials acting for an instrumentality of the Brazilian government, are said to have violated the FCPA by paying bribes to other

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21 *Id.* at 3. *See* Petrobras Press Release (Sept. 27, 2018), *available at* http://www.petrobras.com.br/en/news/petrobras-reaches-coordinated-resolutions-with-authorities-in-the-united-states-and-agreement-to-remit-bulk-of-associated-payments-to-brazil.htm.

22 *See* Client Memorandum, Paul, Weiss, Rifkind, Wharton & Garrison LLP, DOJ Issues New Policy on Coordination of Corporate Penalties to Address "Piling On" (May 10, 2018), https://www.paulweiss.com/practices/litigation/anti-corruption-fcpa/publications/doj-issues-new-policy-on-coordination-of-corporate-penalties-to-address-piling-on?id=26402.

23 Press Release, Dep't of Justice, Petróleo Brasileiro S.A.

24 Release No. 84295, at 9.

25 *See U.S.* v. *Esquenazi*, 752 F.3d 912, 925 (11th Cir. 2014) (holding telephone company controlled by the Haitian government to be an "instrumentality" within the meaning of the FCPA).

Brazilian public officials and political parties. Of note, the NPA nevertheless expressly preserves Petrobras's right to argue that "as an instrumentality of the Republic of Brazil, it is protected by sovereign immunity" in any future prosecution or civil action brought by the United States.[26]

As illustrated by the implicated entities, officials and politicians, this matter involves crimes at the heart of Brazil's democratic system of government. This factor, combined with the upcoming general election scheduled for October 7, 2018, and the fact that Petrobras is a state-owned enterprise, may have allowed defense counsel to avail themselves of arguments not typically available in FCPA cases. Given this unique set of circumstances, the level of leniency accorded Petrobras may not be replicable in cases involving private corporations.

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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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[26] Petrobras NPA, at 8.