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## Is BAE Systems Too Big To Fail?

*Law360, New York (December 16, 2009)* -- It has often been said that truth is stranger than fiction. It is also true that the drama accompanying most international bribery investigations would provide a plot more interesting than some of the recycled storylines cobbled together by Hollywood screenwriters.

International bribery matters have all the elements of a blockbuster drama: powerful corporate interests working through shadowy emissaries to secure a lucrative contract.

The ongoing investigation into improper payments allegedly made by BAE Systems, Britain's largest defense contractor, has more than its share of interesting plots and subplots.

But this international drama of the BAE investigation also highlights a number of policy questions concerning antibribery enforcement.

What happens when an antibribery investigation conceivably jeopardizes national security by crippling a defense contractor who supplies military equipment that is essential to some interest?

With the excessive fines levied on already struggling companies, should regulators consider the extent to which their actions may ultimately punish innocent stakeholders such as shareholders and even those employees that will be laid off as a result of losses sustained at the conclusion of an investigation?

These and other questions have no easy answers but they should be considered as governments seek to regulate and deter this conduct.

### **Background to BAE**

The allegations against BAE Systems by the U.S. Department of Justice and the U.K.'s Serious Fraud Office (SFO) centered originally around payments allegedly made to

Saudi Arabian officials and the Saudi royal family. BAE Systems was alleged to have run a US\$100 million slush fund to entertain Saudi officials.

In 2006, the U.K. dropped its investigation into the allegedly illegal payments citing national security concerns. The DOJ's investigation is ongoing.

In addition to the alleged violations in Saudi Arabia, for the past six years, the SFO has investigated possible improper payments relating to weapons sales in Romania, the Czech Republic, Tanzania and South Africa. BAE Systems currently faces prosecution by the DOJ and SFO for allegedly improper payments.

BAE System's size and its importance to the British economy make it an ideal case for analyzing whether an effective alternative enforcement mechanism exists, aside from potentially crippling fines.

### **Statutes Aimed at Combating Corruption**

The Foreign Corrupt Practices Act prohibits U.S. companies, and companies whose securities are traded in the U.S., their subsidiaries, officers, directors, employees and agents from providing anything of value (including money, entertainment, goods and gifts) to a "foreign official" to assist the company for an improper advantage.

The FCPA was passed by Congress in 1977 in the wake of the Watergate scandal as a reaction to perceptions of governmental corruption in the United States and abroad.

The law was prompted by an SEC study revealing that over 400 U.S. companies admitted to making questionable or illegal payments in excess of US\$300 million to foreign government officials, politicians and political parties.

In addition to the strict prohibition against improper payments, the act also includes strict record-keeping and accounting regulations designed to prevent cash transactions or "under the table" payments from being made to foreign officials.

In the U.K., payments or bribes made to induce an official to act are illegal under the Public Bodies Corrupt Practices Act 1889, Prevention of Corruption Act 1906 and Prevention of Corruption Act 1916, extended to overseas corruption by the Anti-Terrorism, Crime Security Act 2001.

In March 2009, the Ministry of Justice presented draft bribery legislation to Parliament for its consideration, which has been included in the government's legislative program for the months leading to the next general election.

The proposed bill would create a framework of two general offenses: one dealing with the giving, promising and offering of a bribe and the other with agreeing to receive or accept a bribe.

Though the proposed legislation has similarities with the United States' FCPA, it covers both the giving of an improper payment and the receipt of such a payment and prohibits facilitation payments.

Regardless of whether a prosecution takes place under U.K. legislation, or under the FCPA, because of the size and importance of BAE Systems to the British economy and because of the size of other recent sanctions, any prosecution of BAE Systems could have a substantial effect on the British economy and perhaps even national security.

### **The Siemens Precedent**

The bleak outlook for a company such as BAE Systems is made even more sobering by the fines and indirect penalties assessed against Siemens AG just one year ago.

In April, 2006, Baker Hughes Inc. set the record for highest FCPA settlement/plea when it settled with the U.S. Securities and Exchange Commission and DOJ for a combined US\$44 million.

In December 2008, the German engineering company Siemens shattered this record when it entered into a plea agreement with the DOJ and contemporaneous settlement agreement with the SEC, by which it was required to pay a combined US\$800 million (a US\$450 criminal fine and US\$350 million in disgorgement of profits), the largest sanction ever issued for violations of the FCPA.

But that US\$800 million only resolved the prosecution by the U.S. government; Siemens also agreed to pay approximately US\$800 million to resolve charges by the German government.

The total direct cost of US\$1.6 billion does not take into consideration indirect costs such as the fees to be paid to a monitor who will conduct an internal auditor for a four-year term.

It should come as no surprise that a bribery investigation of this magnitude results in the stock taking a pounding. The decline in Siemens' stock price tells the story. The stock fell precipitously from US\$119.76 on August 8, 2008, to US\$52.94 as of Jan. 23, 2009.

It is no wonder that, after the investigation was launched, a shareholder derivative action was filed in an attempt to recover these losses.

In February 2009, KBR Inc. and Halliburton Co. further advanced the precedent set by Siemens when they settled allegations of FCPA violations by agreeing to pay US\$579 million to the SEC and DOJ in combined disgorgement and penalties.

The combined penalty represents the largest fine ever by a U.S. company since the FCPA's inception. It is reported that discussions between the U.K.'s SFO and BAE Systems failed with the SFO seeking payment of £0.5 — 1.0 billion.

## **Potential Fallout and Consequences**

The question must be asked: What would happen if BAE Systems suffers a loss as devastating as Siemens, particularly in this struggling economy? Who will suffer the most?

Consider the following facts.

BAE Systems employs approximately 106,400 people worldwide, 32,800 of which are based in Britain (2008 Annual Report, March 30, 2009). Fines of the magnitude assessed in the Siemens case could result in layoffs of substantial numbers just to rescue the balance sheet.

The shareholders will undoubtedly take a hit at a time in which their personal fortunes have already suffered a blow from the worldwide recession. These are not merely large institutional shareholders. According to an Oct. 2, 2009, article in The Times (“Britain Regrets its Hands are Somewhat Dirty”), many of BAE’s shareholders are “pension savers and retail investors.”

The potential fallout does not end with the employees and shareholders. This is where the BAE Systems investigation is different than the Siemens investigation and most others.

The very governments that are seeking to prosecute BAE Systems rely on the company as a key defense contractor. These concerns led the British government to drop a similar investigation in 2006 but the U.S. government, which continues to lead the charge against BAE Systems risks losing an important supplier.

BAE Systems’ biggest client is the United States, receiving approximately 43 percent of its business from the United States. The United States has spent or will spend somewhere around US\$1 trillion on defense in 2009.

In its 2008 Annual Report, BAE Systems announced that, although it “expects growth in U.S. defense spending to slow, it believes it is well placed to support the U.S. Department of Defense’s likely emphasis on force sustainment, readiness and affordable transformation.”

If found guilty of these charges, BAE Systems would not only face enormous fines, it could be barred from bidding on or winning new U.S. defense contracts. As BAE Systems noted in the Annual Report “failure to comply with [antibribery] laws and regulations could result in ... the suspension or disbarment of the group for government contracts for some period of time ...”

## **A More Focused and Fair Approach**

The BAE Systems investigation presents a compelling case for a more targeted approach to antibribery enforcement. But should these concerns limit prosecutions? An argument could be made that U.S. and U.K. prosecutors must ignore these secondary consequences.

Indeed, both countries are signatories to the “Convention on Combating Bribery of Foreign Public Officials in International Business Transactions,” which provides that in making enforcement decisions including commencing an investigation or prosecution, the government “[s]hall not be influenced by considerations of national economic interest, the potential effect upon relations with another state or identity of the natural or legal persons involved.”

While member nations must not consider any of those factors in determining whether to investigate or prosecute antibribery legislation, an argument can be made that these factors can be considered in arriving at an appropriate penalty.

Prosecutors and enforcers typically have greater latitude at the sentencing stage. The following principles should guide prosecutors in determining an appropriate penalty for FCPA violations.

To that end, the first priority of any FCPA case must be to punish the wrongdoer — those most directly responsible for the improper payments — and only the second priority should be to penalize the company.

In this regard, it is curious that few individuals have actually served time in prison for violations of the FCPA. There are signs that this trend may be changing with a dramatic increase in the number of individual prosecutions.

Even when prosecutions result in convictions of individuals, the sentences vary. While Fredric Bourke was sentenced earlier this year to just 366 days in prison for FCPA violations, far less than required under sentencing guidelines, Louisiana Congressman William Jefferson was sentenced to 13 years in early November.

After punishing those directly responsible for the wrongdoing, appropriate financial sanctions should be imposed on the company. Disgorgement of profits obtained from the bribery is certainly an appropriate remedy.

The disgorgement of profits, ideally, would put the violator (and its shareholders) in the position it would have been in but for the violation. No shareholder should be heard to complain about disgorgement resulting from a direct violation of antibribery legislation.

Finally, penalties against the company should be severe enough to incentivize vigilant self-governance and provide a deterrent to future wrongful conduct. Penalties such as those we have seen in the past three years are so severe that the company is crippled and innocent shareholders and employees alike are penalized.

The objective of antibribery legislation should be to eradicate corruption, not fund future prosecutions through excessive fines. As Britain seeks to revise its antibribery legislation and enforcement strategy, it has an opportunity to analyze the purpose of antibribery legislation and evaluate how to effectively accomplish that goal.

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