SEC v. INTERNATIONAL SYSTEMS & CONTROLS CORP.

United States District Court, District of Columbia. No. 79-1760
December 17, 1979. Litigation Release in full text.

The Securities and Exchange Commission ("Commission") announced today that the United States District Court for the District of Columbia has entered a Final Order enjoining International Systems & Controls Corporation ("ISC") – a Houston, Texas based, Delaware Corporation; and two of the individual Defendants, J. Thomas Kenneally ("Kenneally"), currently a director and formerly Chief Executive Officer and Chairman of the Board of Directors of ISC; and Herman M. Frietsch ("Frietsch"), Senior Vice President of ISC, from future violations of the antifraud, reporting and proxy provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 and the accounting and bookkeeping provisions of the Foreign Corrupt Practices Act. ISC, Kenneally and Frietsch consented to the entry of the Final Order without admitting or denying the allegations of the Complaint.

In addition to the imposition of the injunction against ISC, Kenneally and Frietsch, the Final Order directs ISC to: 1) file with the Commission a report amending ISC's prior filings relating to foreign payments; 2) appoint three nonaffiliated directors, satisfactory to the Commission, who shall comprise an Audit Committee with specified oversight and audit duties and functions; and 3) appoint a Special Agent, satisfactory to the Commission, who shall investigate and report on certain specific transactions and on certain related party transactions and on the history and accounting for ISC's unbilled receivables account.

Furthermore, Kenneally and Frietsch (for periods of four years and two years respectively) agreed to be employed as an officer or director of a publicly held company only if that company has a committee with duties and functions similar to those required of the ISC Audit Committee; and to dispose of any publicly held company's assets or enter into any substantial contracts or make any disclosures on behalf of a public company only if such disclosure or transactions are first approved by another person not subordinate to Kenneally or Frietsch. In addition, Kenneally agreed to disgorge to ISC the amount, if any, which the ISC Audit Committee subsequently determines is appropriate.

For further information, see Litigation Release No. 8815, July 9, 1979.

United States District Court, District of Columbia. July 9, 1979 – Summary of SEC Complaint

Exchange Act – Foreign Corrupt Practices Act – Antifraud Violations Alleged – SEC Complaint

The Securities and Exchange Commission has charged an issuer and several of its officers and directors, present and former, with violations of the antifraud, proxy and reporting provisions of the Exchange Act. The complaint also alleges false and misleading disclosures concerning the issuer's questionable and improper payments of approximately $23 million in a number of foreign countries and the issuance of false and misleading financial statements which overstated assets, earnings and shareholders' equity.

The complaint specifically alleges that the issuer and its subsidiaries paid more than $23 million in material, questionable, and illicit payments to foreign persons and entities in connection with the procurement of contracts. These payments were disguised on the book and records of the issuer, it is alleged, and concealed from customers including foreign governments and government-owned entities. The issuer allegedly failed to disclose that it was dependent upon its foreign payments for the securing of business and the obtaining of payments in addition to the originally contracted amounts, and that material risks to its earnings and revenues were allegedly occasioned by such practices. The issuer also is alleged to have filed false and misleading statements with the United States Export-Import Bank concerning foreign payments.

The issuer is also alleged to have falsely and misleadingly recorded and publicly reported as "unbilled receivables" cost overruns on fixed price contracts, claims for escalation and kickback arrangements with suppliers. Additionally, uncollectable contract costs which indicated losses in fixed price contracts were alleged to have been

improperly rolled into other unrelated contracts, liabilities and other obligations that were not reported in, or were misleadingly reported in the financial statements.

Allegedly, the issuer failed to make and keep adequate books, records and accounts, which, in reasonable detail, accurately and fairly reflect transactions involving the assets of the issuer. There was an alleged failure to devise and maintain a system of internal accounting controls sufficient to maintain assurances that transactions were recorded properly and as necessary to permit the accurate preparation of reports.

The issuer is also charged with failing to disclose that more than $1,000,000 was expended for the purchase, decoration, and maintenance of an Irish estate primarily used as a summer residence of one of the Board of Directors. Additionally, the issuer is alleged to have made false and misleading disclosures concerning a subsidiary.

The March, 1978 Form 8-K and the 1978 annual report did not disclose these material facts, the SEC alleges. In addition, the reports are alleged to falsely present the opinions of the Special Counsel that was investigating the matter. In addition, the reports did not state that the issuer's continuing viability depends upon its ability to recover escalation claims made against several foreign governments.

It is alleged that in its filings with the Commission, the issuer failed to disclose the nature and effect of amendments to a revolving credit agreement, which granted the lenders procedures and rights as to the control over and use of net proceeds from the sale of collateralized assets.

The issuer has been additionally charged with overstating assets in its financial reports of this decade. In particular, it is alleged that:

(a) cost overruns on ISC's contract were improperly reflected as "unbilled receivables" without any reasonable assurance that ISC customers would reimburse such costs; (b) improper and questionable payments were included in "unbilled receivables" as legitimate reimbursable contract costs; (c) liabilities and obligations were not properly recorded and accounted for; (d) additional cost reimbursement sought on a fixed-price contract was misrepresented as an "escalation payment"; (e) profits were prematurely recognized; (f) funds received through kickback arrangements were improperly accounted for; (g) costs which were not collectible under the contract to which they were attributable were improperly rolled into other contracts and carried as assets; and (h) sham "escalation" claims were and are still being carried as receivables.

It is alleged that the foregoing activity constituted a violation of Section 17 of the Securities Act, and Sections 10(b), 13(a), 13(b) (2) and 14(a) of the Exchange Act; and Rules 10b-5, 12b-20, 13a-1, 13a-11, 13a-13, 13b-2, 14a-3 and 14a-9 promulgated thereunder.

The Commission is seeking a preliminary injunction and the appointment of a special agent to, among other things, take custody and control of the assets, books and records of the issuer and oversee its business activities and to assure that these activities are being carried out for legitimate business purposes.

SEC v. Crown Cork & Seal Co., Inc., Civil Action No. 81-2065 (DDC Sept. 2, 1981)

The Commission filed a Complaint seeking injunctive and other relief against Crown Cork & Seal Co. ("Crown Cork") alleging violations of the anti-fraud, periodic reporting and books and records provisions of the Exchange Act. The Complaint alleged that Crown Cork made 42 payments to Pasha Services Corporation from October 1970 through October 1978, which amounted to about $5.9 million. It was further alleged that Pasha Services Corp. was controlled by a senior officer of one of Crown Cork's major customers; that the payments were recorded by Crown Cork as competitive allowances, discounts or rebates; and that approximately $5.1 million was diverted to the benefit of the senior officer that controlled Pasha Services Corp. The Complaint alleged that Crown Cork violated the record-keeping requirement because it was reckless in not knowing that the payments were for the personal benefit of the individual involved rather than for the purposes stated.

Simultaneously with the filing of the Complaint, Crown Cork consented to the entry of a Final Order of Permanent Injunction from future violations of Sections 10(b), 13(a), 13(b)(2)(A) of the Exchange Act, and Rules 10b-5, 12b-20, and 13a-1 thereunder. [This action is related to SEC v. Herbert G. Paige et al., Civil Action No. 81-2666 (DDC Sept. 2, 1981).]

SEC v. International Systems & Controls Corp., et al., Civil Action No. 79-1760 (DDC July 9, 1979)

The Commission filed a Complaint alleging, among other things, that International Systems & Controls Corp. ("ISC") paid more than $23 million through one or more subsidiaries to certain foreign persons and entities in order to assist the company in securing certain contracts. The Complaint alleges that in furtherance of this scheme ISC disguised such payments on its books and records as consulting fees, consulting services, agent's fees or commissions. The Complaint also alleged that ISC violated the internal accounting controls provisions by failing to devise an adequate

system of internal controls because it failed to require vouchers, expense statements, or similar documentation for the activities or services for which certain expenditures were made.

SEC v. Page Airways, Inc., et al., Civil Action No. 78-0656 (DDC April 12, 1978)

The Commission alleged in its Complaint that Page Airways, Inc. ("Page") and six individual defendants violated, among other things, Section 13(b)(2) of the Exchange Act. The Complaint alleged that Page and the individual defendants paid in excess of $2.5 million of the corporation's funds to officials of foreign governments, their agents, or entities controlled by them as part of their efforts to sell Gulfstream II aircraft and spare parts. The Complaint alleged that Page violated the recordkeeping requirements because it disguised the payments to government officials and other payments through false, incomplete and misleading entries in its books and records. The Complaint also alleged that Page violated the internal accounting controls provision because many expenditures were effected without adequate documentation to ensure that expenditures were made for the purposes indicated.

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CORRUPTION

ISC: Corporate Bribe Factory

The SEC case against International Systems & Controls Corporation undercuts the arguments of U.S. businessmen demanding an end to legal curbs on overseas bribery. Businessmen have claimed they are forced to bribe to remain competitive with foreign firms, but the ISC record of illicit payments suggests other reasons for overseas bribery.

by George Riley

In the midst of a broadside attack by U.S. multinationals on the 1977 Foreign Corrupt Practices Act, the Securities and Exchange Commission (SEC) has won a settlement of its massive bribery suit against International Systems & Controls Corporation (ISC). According to the complaint, filed in July 1979, ISC engaged in over $23 million of "questionable and illicit payments" between 1970 and 1977. The case against ISC, settled on December 17 by consent decree, undercuts the protests of U.S. businessmen now seeking to weaken the act, who claim that bribery is an unavoidable part of doing business overseas.

According to the SEC charges, ISC made illicit payments to government officials and members of ruling families in Iran, Saudi Arabia, Nicaragua, Ivory Coast, Algeria, Chile and Iraq. The Houston-based company made the payments in connection with contracts for engineering and construction projects. Although the payments were made before the passage of the 1977 act, the commission claimed that ISC violated U.S. securities laws by making false and misleading financial statements concerning the payments. The settlement follows a three-year commission investigation and repeated SEC administrative attempts to force ISC to disclose the questionable transactions.

The unique look inside this global corporation, contained in a 56-page complaint and 763 pages of exhibits, provides a sharp contrast with the arguments of business opponents of the 1977 act. Multinational executives have maintained they must bribe to remain competitive with foreign companies and that host country governments condone and even encourage illicit payments. Confidential company documents obtained by the SEC, however, show how agents of ISC used bribes to win contracts after offering higher bids than those of competitors. In some cases, ISC apparently made bribes in an attempt to win payments to recoup the financial losses due to former bribes. In two countries, illicit payments were carried out despite host government investigations and warnings, and despite assurances by ISC officials that the company had paid no bribes.

An inter-agency task force impanelled by President Carter recently adopted this leading business position on foreign bribery. It recommended a watering down of the act, arguing that "many people in many countries accept as given that extra payments often grease commercial transactions." The task force estimated-with no evidence to support the claim-that the Foreign Corrupt Practices Act has caused an annual loss of $1 billion in U.S. exports.

Behind the recent efforts to undermine the anti-bribery statute are a number of corporations who publicly advocate changes in the law. Such open corporate pressure is new to the issue; fearing adverse publicity, no business representative testified against the bill during the original hearings. Today, _ however, multinational executives hardly cower at being portrayed as defenders of overseas crime. They have been emboldened by government officials who lend a receptive ear to their pleadings, as well as by a growing safety in numbers: more than 570 corporations have now admitted questionable payments since the start of the SEC's voluntary disclosure program in 1974. Now it is possible for a Lockheed executive to unabashedly declaim on the problems of moral imperialism posed by the anti-bribery measure: "The U.S. brand 16f [anti-bribery] morality hasn't been successfully sold to a lot of areas yet," he commented this summer on the act. Perhaps Lockheed was more successful in selling another brand of morality to Japanese Prime Minister Kakuei Tanaka, whose 1976 acceptance of a$1.6 million Lockheed bribe led to his arrest and the downfall of his government.

Much of ISC's "grease" was applied to projects in Iran, a country that in recent years accounted for 20 percent of ISC's sales. On two forest projects, the SEC estimates that ISC paid $11.3 million of $22.3 million promised to "agents and consultants." More than $250,060 went to the head of a government corporation for a project that ISC's subsidiary, Lang Engineering, eventually dropped. The official, originally promised $650,000 if Lang received the contract, threatened to make trouble for the company if he was not reimbursed for the "loss of oppor tunity" to take bribes from some other company. After some hesitation, Herman M. Frietsch, later senior vice president of ISC, settled the matter in a curt note to his representative in Iran: "Let's stop soul searching and just tell him we are going to pay the money."

In January of 1972, another ISC subsidiary, Stadler Hurter, sought to rescue an Iranian contract that company officials feared was almost lost to a low-bidding Japanese firm. The president of Stadler Hurter, A.M. Hurter, flew to Iran to discuss the proposed forest-industry project with a member of the royal family, Prince Abdul Reza. About a month after the meeting, Stadler Hurter agreed to pay an associate of the Prince 3 percent of the total contract price. Another 4 percent was to go to a Liechtenstein corporation; some of this money was later designated for officials in the ministry of economics. On April 21, 1973, Stadler Hurter was awarded two contracts for the project. The SEC estimates that ISC paid $5.8 million in

commissions for the project, $2.4 million to the Prince's associate, $3.2 million to the Liechtenstein corporation, and an additional $100,000 to Dr. Max Mossadeghi, the head of a company owned by the Ministry of Agriculture and Natural Resources.

But Stadler Hurter began almost immediately to experience major problems with the Iranian project. First, the Prince began to complain about delays in his payments. Commenting on requests for advance payments, an ISC executive asserted in an internal company memorandum that the Prince's payoffs must come out of the "cash flow" of the job. "Anything else is a stick-up," he noted. "Even in Iran. We can go to the local cops there too." Additionally, the company sought to secretly commission agents to obtain $9 million in "escalation costs" from the Iranian government. According to a memorandum by ISC executive Harlan M. Stein, Stadler Hurter sought to recoup $3 million, the amount by which the company had to reduce its original bid to compete with the Japanese offer. In addition, the company saw the escalation costs payment as "a potential means of increasing the gross profits on the project." The memo adds that at least $2.5 million of the payment was needed to cover earlier payoffs and the new bribes,, necessary to win the $9 million award.

Algeria provided another source of ISC contracts between 1971 and 1975. 'ISC's subsidiaries were awarded $320 million in engineering contracts by the Algerian government. Despite warnings from the government that ISC should not employ agents or influence peddlers-and despite contract provisions expressly forbidding the use of intermediaries in any way-the corporation commissioned Munib R. Masri as its "sales representative." According to company memoranda, by August 28, 1972 Masri was paid $820,000 for two of ISC's contracts. -

The Algerian government, acting on rumors that Masri was attempting to influence contract negotiations, sought assurances that ISC had not engaged an agent. Investigators finally requested an affidavit declaring that ISC had not employed an intermediary. Although the local manager refused to sign such a declaration, ISC's vice president and general counsel, Raymond G. Hofker, completed the document. At this time, ISC had commissioned not only Masri but had paid what the company called "secret commissions" to a Belgian national, Hubert Renault, for contracts awarded to ISC's subsidiaries in Algeria.

Another example of ISC's mode of operation in the Third World was its attempts to win a $375 million project in Chile. ISC executive Alfred Lerner traveled to Chile in December 1975. Shortly after his visit, Lerner filed a detailed report describing his contacts with government officials and recommending a course of action.

The Lerner memo begins with a brief history of Chile in which he describes General Pinochet's military regime as a "stern father with a benevolent attitude toward the majority of the population." He then assesses ISC's opportunities to influence the junta. Early efforts to influence certain young army officers, failed; according to Lerner these officers "act like men with a mission, and are not susceptible to gift givers." ISC's "gift giving," Lerner concluded, would have to begin at higher levels of the military-government bureaucracy.

Lerner found a more grateful recipient in David Fuenzalida, the chief economic advisor to a junta member, Air Force General Gustavo Leigh. Lerner urged Fuenzalida to form a company, CHILC0, to represent ISC's interests before the Chilean government. Because Fuenzalida was a member of the government, another Chilean would serve as President. Lerner pledged that "everyone will be justly compensated if the project is approved and signed."

Although the exhibits submitted by the SEC give a thorough look into some of ISC's operations, the full story remains hidden. For example, the SEC alleged that ISC paid two agents $288,000 in connection with a contract for a grain storage facility in Nicaragua. Apparently this money went to two companies controlled by the now deposed president. Anastasio Somoza. But the SEC filed no public exhibits to substantiate these claims.

The SEC's failure to reveal the extent of ISC's activities in Nicaragua may have resulted from quiet pressure by the executive branch. Several days before the SEC filed the charges, news reports suggested that the State Department had urged the agency not to reveal material dangerous or embarrassing to U.S. allies. When the charges became public, the U.S. government was involved in an eleventh-hour struggle to save the embattled Somoza dictatorship.

In the consent decree, ISC agreed to appoint a special agent to investigate the o undercover payments and other questionable transactions. With the prior approval of the SEC, the company will name three new directors not presently affiliated with ISC. Two of the defendants in the suit, Director and former chairman .1. Thomas Kenneally and Herman Frietsch, are prohibited under the terms of the court decree, from making certain agreements and transactions, without the agreement of the independent directors.

The final arrangement with ISC represents a significant step back from the remedies originally requested by the SEC. The SEC had sought the appointment of a court receiver to take custody of ISC's assets and operations, as well as to investigate the bribes. The agency had also sought the removal of Kenneally and Frietsch, not merely a restriction on their activities.

Attack Renewed on Anti-Bribery Law

Antagonists are gearing up for a new battle over the Foreign Corrupt Practices Act of 1977. Senator John Chafee of Rhode Island, working closely with multinational businessmen, is planning to introduce legislation that may significantly dilute the anti-bribery statute. An aide involved in the preparation of the bill remarked that Chafee is "trying to get business to tell us what they think ought to be done."

Chafee's proposals come in the wake of a bitter inter-agency dispute over enforcement of the Foreign `Corrupt Practices Act. The Justice Department recently announced that it will advise multinationals on the legality of overseas bribes. The new enforcement policy enables corporate executives to enquire about the likelihood of prosecution under the 1977 law before paying off foreign officials.

The Carter administration claims this "business review procedure" eliminates a serious obstacle to the export of US. products. Ambiguities in the law, some businessmen argue, force overcautious executives to forego permissible

payments, thereby losing potential contracts for export sales.

Chafee's modifications may do much more than "clarify" the act. According to an aide, the bill may call for the decriminalization of overseas bribery; executives contemplating foreign payoffs would no longer need to worry about possible imprisonment. Even more dramatically, Chafee may propose that the U.S. permit multinationals to operate under host country laws. This step would effectively gut the anti-bribery statute.

Officials from the Securities and Exchange Commission (SEC) object to revisions in the law or enforcement procedures. Stanley Sporkin, SEC director of enforcement and an ongoing opponent of the administration proposals, considers the "business review procedure" one step in a corporate-sponsored campaign to scuttle the act. He has announced that his office will not recognize Justice Department rulings as binding on SEC investigations. And Robert Ryan, SEC special counsel, predicts that business will soon launch another "organized lobbying effort to modify the bill."

Chafee's proposals are not the first time government officials have suggested changes in the anti-bribery law. Early this summer, preliminary recommendations from the President's Export Disincentive Task Force ignited a furor over possible amendments to the act. Suggesting that multinationals face a form of "double jeopardy" since both the SEC and Justice Department currently enforce the statute, the task force recommended that Congress strip the SEC of enforcement responsibility. The group also urged Justice to prepare written guidelines to clarify what it deemed "ambiguities" in the law.

Congressional leaders reacted swiftly to oppose the recommendations. Representative Bob Eckhardt called task force coordinator John Renner before his Subcommittee on Oversight and Investigation. Decrying what he considered backroom maneuvering by corporate lobbyists, Eckhardt cautioned against "subterraneous attacks" on the law.

Senator William Proxmire, a key legislative proponent of the anti-bribery act, joined Eckhardt in condemning the proposals. Proxmire disputed the task force's undocumented claim, that the law reduced U.S. exports by $1 billion annually. Indeed, the group's self-described "hit or miss' estimate directly contradicted past testimony by administration officials, 1 and ignored studies minimizing the impact of the statute.

Not surprisingly, Sporkin quickly added his voice to those opposing the task force recommendations. He rejected out of hand proposals to strip the SEC of enforcement powers. Labeling written guidelines " a roadmap to bribery," the SEC enforcement chief voiced skepticism about difficulties in interpreting the law. "We don't have guidelines for rapists, muggers and embezzlers," Sporkin exclaimed. "I don't think we need guidelines for corporations who want to bribe foreign officials."

Rebukes from Eckhardt, Proxmire and the SEC diffused talk of formal written

guidelines for the act. But adoption of the "business review procedure" reflects the partial success of corporate efforts to weaken the law.

Businessmen are now focusing their criticism on the SEC's refusal to abide by the Justice Department's new advisory policy. Executives claim that the SEC will launch bribery investigations based on information supplied to Justice.

Ryan is quick to reject such claims. "That's a smokescreen," he said recently. "This notion of the SEC as a bunch of wildmen roaming the streets is unjustified."

Chafee has not announced when he will introduce his bill. According to an aide, "our timetable is dependent on the business community." Meanwhile, reports of overseas corporate lawlessness continue. Kenny International Inc. recently pleaded guilty in U.S. District ' Court to a ,charge of interfering with elections in the Cook Islands. And executives of McDonnell Douglas are now facing criminal charges of making payments to Pakistani and Venezuelan officials. Criminal statutes have not brought illicit corporate activity overseas to a halt, and with the Foreign Corrupt Practices Act under attack, othe stage seems set for a possible return to the days of government-sanctioned international corporate intrigue.

- *William Taylor*

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