

**How Multinational Investors Evade
Developed Country Laws**
By Theodore H. Moran

Abstract

How effective are G-8 and OECD efforts to combat bribery and corrupt payments when multinational companies bid on concessions in the developing world? Have the rich countries – and the United States, in particular – done what is necessary to restrain multinational investors from paying off daughters of Presidents and cronies of Ministers to secure favors for their activities?

This paper argues that the answer is no. Multinational corporations from the US, Europe, and Japan have devised sophisticated payment mechanisms, as documented and described here, to evade home country anti-corruption laws, including the US Foreign Corrupt Practices Act, with impunity. According to this paper, some US companies have laid these payment arrangements out before the US Department of Justice, the Securities and Exchange Commission, and other US agencies, without arousing any objection whatsoever.

Without reforms of the kind spelled out here, the OECD and G-8 campaign to prevent corrupt payments will turn out to be a sham.

This working paper provides a preview of research included in a much broader forthcoming CGD monograph entitled *Harnessing Foreign Direct Investment for Development: Policies for Developed and Developing Countries*.

The Center for Global Development is an independent think tank that works to reduce global poverty and inequality through rigorous research and active engagement with the policy community.

Use and dissemination of this Working Paper is encouraged, however reproduced copies may not be used for commercial purposes. Further usage is permitted under the terms of the Creative Commons License. The views expressed in this paper are those of the author and should not be attributed to the directors or funders of the Center for Global Development.

How Multinational Investors Evade Developed Country Laws to Prevent Bribery and Corruption in the Developing World – Including the US Foreign Corrupt Practices Act – and What Can Be Done About It

by
Theodore H. Moran
Marcus Wallenberg Professor of International Business and Finance
School of Foreign Service
Georgetown University
Non-Resident Fellow, Center for Global Development

February 2006

I. Current Developed Country Efforts to Prevent Firms from Making Bribes and Corrupt Payments in Developing Countries

Through 1995, many developed countries considered “facilitation payments” made abroad a normal cost of doing business, and routinely allowed multinational corporations to deduct such payments to host government officials, or their friends and family members -- in order to secure contracts and investment concessions -- as a legitimate business expense. Then, in 1996, the OECD approved Tax Recommendations on the Non-Deductibility of Bribe Payments, and in 1999 the OECD-wide Convention on Combating Bribery of Foreign Public Officials in International Business Transactions entered into force. Led by the United States -- which has long considered itself the exemplar of good conduct, having passed the Foreign Corrupt Practices Act in 1976 – the G-8 at Evian in 2003 placed anti-corruption among the top goals for common action on the part of developed states.

The OECD Anti-Bribery Convention of 1999 has become the central international mechanism to ensure developed country prosecution of corrupt payments from multinational investors to public officials in developing countries. As of 2005, all 30 OECD members and six non-members have enacted national anti-bribery laws based on the OECD Convention, making a bribe by one of their multinationals to an official in a host country a punishable offense.¹

¹ *The OECD Anti-Bribery Convention: Does it Work?* 2005. Paris: OECD.

Signatories to the OECD Anti-Bribery Convention then go through a two phase peer-review examination process. Phase 1 involves an assessment of the conformity of the country's anti-bribery laws with the OECD convention. Phase 2 consists of one week of intensive meetings in the examined country between experts from other OECD states and key actors from government, business, trade unions and civil society to assess how effectively that country's anti-foreign bribery laws function in practice.

As of 2005, Phase I has been completed for the 35 of the 36 signatories, with one country remaining to be examined. Eighteen countries, including the G-8, have completed Phase 2. The remainder are scheduled to be completed by 2007.

But the scope of the OECD Convention is quite narrow – requiring member states to pass domestic legislation that criminalizes a direct payment to a public official by an international company to secure a contract.

New evidence that has emerged from the awarding of power projects to international companies in Indonesia, between 1995 and 2003, shows that multinational corporations have devised clever current-payoff-and-deferred-gift structures to relatives and friends of host country officials that do not technically put them at risk of OECD-consistent home country anti-bribery laws, or the US Foreign Corrupt Practices Act.

The basic structure has been for the multinational to approach a prominent family member or close friend of the host country leadership about forming a partnership to own the target investment project (or respond favorably when approached by a family member or close friend about forming a partnership), loan that family member or close friend the funds needed to take an equity stake in the project, and pay a dividend to the family member or close friend more than what was needed to service the original loan. This arrangement functions as a deferred gift – the loan to fund the equity stake of the family member or close friend was paid off via the dividend over time. The excess return above what was needed to service the loan was a current payoff.

Unlike a genuine equity investor, the family-member-or-close-friend partner had no capital of his/her own at risk, nor any responsibility to repay the loan out of his/her own assets. The equity stake came to the family member or close friend for free – the only “service” that was required was to ensure the foreign company was chosen to receive the infrastructure concession (in the Indonesian case discussed later, all but one of twenty-seven internationally-funded power projects were awarded without competitive bids). In some cases, the family-member-or-close-friend partner began to receive “dividends” as soon as the concession was awarded, before the project was even in operation. Then, since the return to cover the loan payments and the current payoff depended upon the project remaining profitable, the family member or close friend had an on-going interest in ensuring that the project enjoy beneficial treatment.

]

Particularly startling has been the discovery that some of these sophisticated payment mechanisms – as deployed by US investors to obtain infrastructure concessions – had been vetted by well-respected US law and accounting firms as part of the investors' due diligence prior to committing funds, and reported to the US Securities and Exchange Commission, without objection.

The following is a schematic illustration of how these arrangements were constructed:

How to Provide Corrupt Payments Without Running Afoul of the US Foreign Corrupt Practices Act

As a hypothetical example that illustrates what has been uncovered in Indonesia, “MNC Enterprises” is considering investing \$200 million in the Bahia power plant (“Bahia Power & Light”) to expand electricity production for the capital city of a developing country.

How can MNC Enterprises ensure that it secures the concession to supply the electricity, and receives favorable treatment on rates and other regulatory issues over the life of the project?

One way might be to deliver an envelope containing \$1 million to the daughter of the President of the country each year for twenty years. A second way might be to give the daughter of the President a one-time gift of \$20 million. A third way might be to provide a stream of payment’s to the daughter’s Swiss bank account that allows her to accrue at least \$20 million before the concession is ended.

If these methods seem too blatant in violating the spirit of the 1999 OECD Convention against bribery, and perhaps even the letter of developed country law against corrupt payments, an alternative approach to securing the concession, and ensuring favorable treatment, might be to take on the President’s daughter (or another family members or cronies) as a local partner.

In this hypothetical example, the daughter of the President of the country is CEO of “Presidential Initiatives, Inc.,” a small but highly successful private company providing consulting services in the capital city.

The foreign investment code of the country where Bahia Power & Light is located requires that all power projects have a local partner. MNC Enterprises offers to sell Presidential Initiatives a 25 percent share in the Bahia power plant.

Where does Presidential Initiatives get \$50 million to pay for its quarter share of Bahia Power & Light? From its own capital reserves? Most assuredly not.

MNC Enterprises loans Presidential Initiatives the \$50 million needed for the joint venture. Presidential Initiatives is certified by Moody’s as a good credit risk, having earned high profits while never having defaulted on any commercial payment, over the preceding decade. MNC Enterprises loans Presidential Initiatives \$50 million at the Moody’s-recommended Triple AAA rate of 6%.

The new Bahia Power & Light project has been rated as an untried and potentially risky enterprise by Moody’s. It receives Moody’s BBB rating, requiring repayment terms 3 percentage points (300 basis points) higher than Triple AAA, according to international standards. MNC Enterprises creates stock shares in Bahia Power & Light that pay a dividend of at least 9% to the joint venture partner as long as the project is profitable.

From the 9% stock payment stream (\$4.5 million each year), Presidential Initiatives, Inc., repays the 6% loan (\$3 million), plus a small portion of the principal (perhaps \$0.5 million), each year, and pockets the difference of \$ 1 million.

The loan principal will essentially never be paid off (full repayment would take one hundred years). The dividend is paid only in years that Bahia Power & Light earns a profit, ensuring that the indigenous partner will use her influence to ensure good treatment for the MNC Enterprise affiliate. The larger the profits, the larger the dividend.

A hypothetical example by Theodore H. Moran, drawing upon materials presented to the Working Group on Reforming OPIC for the 21st Century and other new evidence from Indonesia, to be published by Louis T. Wells, Jr., Harvard Business School.

MNC ENTERPRISES

\$200

EQUITY

**BAHIA POWER & LIGHT
(MOODY'S RATING BBB)**

50 MILLION LOAN

6% RATE = \$3 MILLION PER YEAR

\$50 MILLION

EQUITY

DIVIDEND

10% RATE = \$4.5 MILLION PER

**PRESIDENTIAL INITIATIVES, INC.
(MOODY'S RATING AAA)**

Actual partnership arrangements were actually much more blatant – with outsized dividends and miniscule equity costs – than the schema presented above.

The consortium established for the Paiton I power project in Indonesia, for example, consisted of four foreign corporations: Edison Mission Energy, Mitsui, and General Electric Capital Corporation. Their local partner was Batu Hitam Perkasa (BHP) that featured a prominent Indonesian named Hashim Djojohadikusumo, who was the brother-in-law of President Suharto's second daughter, Titiek.

According to Louis T. Wells, Jr., of the Harvard Business School, Mission, Mitsui, and GE loaned \$49.6 million to Batu Hitam Perkasa (BHP) to acquire a 5% interest in Paiton I.² It is not clear whether BHP paid “a market rate of interest” or a mere 1.5% per year. In any case, the foreign consortium then paid a dividend to the BHP “partner” high enough that 65% could be “withheld” to service the debt. This was called a “carried interest arrangement”. The Indonesia partner put up no money of its own, had none of its assets at risk, and did not have to service the loan at all if the partner did not receive the dividend from the consortium.

With regard to CalEnergy's Dieng geothermal project, ten percent of the equity was held by PT Himpurna Enersino Abado (PT HEA), a subsidiary of an association of retired Indonesia military officers.³ Not only were these friends of President Suharto (a former general), they were also potential competitors or coup-makers, and had to be kept satisfied. There is no evidence that PT HEA possessed any business or consulting skills whatsoever. As in the Paiton I case, PT HEA used a loan provided by CalEnergy to “purchase” the equity stake. What is different is that the foreign investor began to pay its Indonesian “partner” a dividend even before the project had been built.

Why were structures such as these not found to be in violation of the US Foreign Corrupt Practices Act (FCPA)?

When Lou Wells posed this question to the Justice Department, the answer was that whether a series of payments, or a loan, or a deferred gift would be a violation of the FCPA would depend upon whether it occurred at the direction of the President, or other public official, and whether some benefit accrued directly to the President, or other public official.⁴ In actual cases involving his daughters or friends, there is no record that President Suharto issued such a directive on their behalf, or required them to share their gains with him.

² Louis T. Wells, Jr., and Rafiq Ahmed, *High Tension: Foreign Investment, Property Rights, and National Sovereignty*. New York: Oxford University Press, forthcoming, 2006, ch. 8

³ *Ibid.*, ch. 13.

⁴ As reported in Wells, forthcoming, 2006.

II. US Government Monitoring of Partnerships and Payments to Close Friends and Relatives of Developing Country Leaders

The detailed evidence about how the arrangements between foreign investors and relatives or close friends of the leadership in the host country were constructed comes from infrastructure projects in Indonesia. This method of securing concessions and negotiating favorable investment agreements could equally well apply to other sectors – petroleum and mineral ventures, for example – in other countries.

A detailed look at the behavior of the Overseas Private Investment Corporation with regard to one of these power projects in Indonesia -- in which President Suharto's daughter was revealed by the *Wall Street Journal* to be the local partner -- shows that the United States does not yet deserve the reputation it has claimed to have earned in the battle against bribery and corrupt payments.

“Most of the billions of dollars of US electric-power investments in Indonesia went through cronies and relatives of Mr. Suharto,” reported the *Wall Street Journal*.⁵ “Nearly all the Suharto relatives involved in the power projects got shares in joint ventures from their American partners without investing money of their own.”

On January 22, 1999, David Wofford, Senior Counselor to the President of OPIC, wrote to El Paso Energy International, citing the *Wall Street Journal* article, to request information about the ownership arrangements of the \$40 million PT Energi Sengkang power plant (PTES).

El Paso replied that the PTES was 47 ½ percent owned by El Paso Energy, 47 ½ percent owned by an Australian public company, and 5 percent owned by PT Trihasra Sarana Jaya Purnama (Trihasra). The latter company, Trihasra -- El Paso affirmed -- was wholly-owned by Indonesian nationals, including Ms. Siti Hardijanti Rukmana, President Suharto's daughter. The Indonesian Foreign Investment Law, El Paso noted, requires that all private power generation entities must have a minimum of 5 percent Indonesian shareholding. “Trihasra meets this requirement,” El Paso pointed out.

Trihasra's 5 percent stake in PTES (\$2 million), El Paso argued, had been “obtained in return for the fair value of services provided” during the development period for the project.

In performing due diligence on PTES prior to investment, El Paso sought independent reviews by a major US law firm and a major US accounting firm to ensure that the

⁵ Peter Waldman and Jay Solomon, “Wasted Energy; How U. S. Companies and Suharto's Circle Electrified Indonesia – Power Deals That Cut In First Family and Friends Are Now Under Attack – Mission-GE Sets the Tone”, *The Wall Street Journal*, December 23, 1998, p. A-1. According to the *Journal*, only one of Indonesia's 26 private-power contracts was competitively bid.

company was in compliance with the US Foreign Corrupt Practices Act. “Their reviews concluded that Trihasra’s ownership interest in the project did not present any compliance issues under the Act,” concluded El Paso.

This response appears to have satisfied OPIC. OPIC did not pursue the matter further, or refer El Paso to the Justice Department. In Jakarta, OPIC President George Munoz insisted that “the contracts” – including the PTES contract – “have to be honored.”⁶

III. What Needs To Be Done?

To be effective, an authentic effort to combat bribery and corrupt payments in the awarding of investment concessions and the negotiation of investment agreements requires a new three-pronged attack.

First, the current scope of the 1999 OECD Convention Against Bribery is far too limited to be effective – requiring member states to pass domestic legislation that does no more than criminalize a straight payment to a public official by an international company to secure a contract. The partnerships with family members and cronies sketched out here--backed by sophisticated loans-to-purchase-equity-shares, overlapping payment arrangements, and deferred-gift mechanisms – would almost certainly not be caught or punished using legislation that merely met the OECD Convention standard.

In contrast to the 1999 Convention, the OECD’s informal “Guidelines for Multinational Enterprises” have what the OECD admits is much broader scope.⁷ In defining bribery, the Guidelines state “Enterprises should not, directly or indirectly, offer, promise, give, or demand a bribe or other undue advantage to obtain or retain business or other improper advantage.”

“In particular, enterprises should ...not use sub-contracts, purchase orders or consulting agreements as means of channeling payments to public officials, to employees of business partners or to their relatives or business associates.” To this last sentence should be added, “partnership arrangements.”

The payment structures described above make it clear that until the OECD Convention – and implementing laws in ratifying states – are tightened at least to the degree recognized in the “Guidelines for Multinational Enterprises”, the Convention *simply does not have the capability to curb any but the most unsophisticated corrupt payments.*

Second, parallel with strengthening the OECD Convention, there is a need to introduce anti-corruption provisions explicitly into multilateral investor-state dispute settlement mechanisms. Oddly enough, the 2,300-plus bilateral investment treaties (BITs) make no

⁶ *Ibid.*, p. A-2.

⁷ Anti-Corruption Instruments and the OECD Guidelines for Multinational Enterprises. Paris: OECD, September 2003, p. 11.

mention of bribery or corruption, and recent tribunals that have heard states defend actions taken against foreign investors as justified because the latter engaged in corrupt practices have rejected this line of argument.

To put teeth into anti-corruption efforts, a new balance must be struck. Not only must international investors be protected against misbehavior on the part of host states, but host states must be better protected against misbehavior on the part of international investors.

Precedents already exist in international law – just as they do in domestic law -- to reject the validity of any contract or permit obtained by corrupt means, thus vitiating rights pertaining to such an investment.⁸

In the final decision of arbitration in the Methanex case-- an investor-state dispute brought under NAFTA's Chapter 11-- the tribunal recognized that it had the capacity for a finding of fact of corruption even though such allegations had not been proven in associated criminal trials.⁹ While the tribunal ruled that the evidence available to the members did not support a finding of corruption in this particular case, it made clear that the presumption that an investor can rely upon arbitrators to enforce a contract obtained via corrupt actions is not justified.¹⁰ International adoption of a corruption definition along the lines of the OECD Guidelines for Multinational Enterprises would give arbitral panels a standard to decide whether an investor is entitled to protection in a dispute with host authorities.

The discoveries recorded here leave no doubt that the OECD effort to thwart the use of corrupt practices will require considerably more determination – and more sophistication – than member countries, including the United States, have shown thus far. If the national legislative practices being examined under the auspices of the Convention on Combating Bribery of Foreign Public Officials in International Business Transactions cannot, at the end of the day, show that schemes like these discovered in Indonesia will be detected, found to be illegal, and punished, *then the OECD review exercise will have to be considered a charade.*

Finally, arrangements of the kind uncovered in Indonesia have to be regularly brought into the light of day. To move in this direction, the Extractive Industry Transparency

⁸ Richard H. Kreindler. 2003. Aspects of Illegality in the Formation and Performance of Contracts. *International Council for Commercial Arbitration Congress Series*, 11. The Hague: Kluwer, pp. 209 - 260

⁹ Methanex Corporation v. United States of America. In the Matter of An Arbitration under Chapter 11 of the North American Free Trade Agreement and the UNCITRAL, Arbitration Rules, Final Award of the Tribunal, August 7, 2005.

¹⁰ Howard Mann. 2005. *The Final Decision in Methanex v United States: Some New Wine in Some New Bottles*. Institute for Sustainable Development, Canada. I am indebted to Howard Mann and Aaron Cosby at the Institute for assistance with this analysis.

Initiative (EITI) must be steadily expanded in geographical scope, and broadened to cover infrastructure projects as well as mining and petroleum investments.

In laying the foundation for the EITI, various NGOs – led by George Soros – proposed a “Publish What You Pay” requirement to help prevent natural resource investments from turning political elites in host developing countries into rent-seeking kleptocrats, by requiring that investors in extractive industries be required to make public all taxes and fees paid to host governments before being allowed to list their shares on the US or other major stock exchanges.¹¹

It soon became clear that in this form the “Publish What You Pay” approach suffered from serious faults. Foreign investors had often signed contracts requiring them to keep the terms confidential, as insisted upon by host authorities. Publicly-traded extractive companies feared that they would be placed at a competitive disadvantage to state-owned companies, or to private companies without such disclosure requirements – from Russia, China, India, or Turkey, for example.¹²

To address these shortcomings, the UK government launched the Extractive Industries Transparency Initiative (EITI) at the World Summit on Sustainable Development in Johannesburg in 2002, an effort to put pressure on host countries to require all investors (equally) within a given host country to publish what they pay while host authorities simultaneously reveal how they dispose of the revenues. In 2003, the World Bank Group endorsed the EITI, created a multi-donor Trust Fund to promote transparency, and began to work with developed and developing country governments to gain support for the initiative and to provide training for government officials and civil society organization that might serve as monitors and auditors.

The first wave of countries that endorsed the EITI, and began working on implementation, included Azerbaijan, Ghana, the Kyrgyz Republic, and Nigeria. A second wave included Angola, Chad, the Republic of Congo, Ghana, the Kyrgyz Republic, Peru, Gabon, Sao Tome and Principe, and Timor Leste, with other countries expressing an interest in participating.

The EITI cannot be effective, however, unless the countries that sign on require that all companies – including state-owned companies and privately-held companies from all countries – submit their payment records for independent audit, which can then be matched with expenditure records of host authorities that are also independently audited. This match-up must be conducted by a credible, independent monitor whose findings are made public, highlighting discrepancies that need to be reconciled. The countries that sign on must agree to a common time-bound action plan to implement the EITI. Such

¹¹ See the Publish What You Pay Campaign at www.globalwitness.org.

¹² Jeff Gerth, “US and Oil Companies Back Revised Effort on Disclosure”, *The New York Times*, Friday, September 19, 2003, p. w1. Emil Salim, *Striking a Better Balance* (Washington, DC: The World Bank Group, January 12, 2004).

action plans can then be backed with resources from the World Bank Trust Fund and other donors, to build the capacity for conducting audits and disclosing the results in a manner that can be widely comprehended and tracked by their citizens.¹³

To the “extractive industry” effort to provide transparency about payments involving natural resource investment must be added transparency about partnerships and payments involving infrastructure projects.

These three steps -- tightening the OECD definition of what constitutes corrupt payments, denying investors that engage in bribery protection in international arbitration, and steadily enlarging the exposure of payment and partnership arrangements to domestic and international scrutiny – can eliminate the current hypocrisy and lay the basis for a genuine effort to combat bribery and corruption.

The objective is to allow relevant authorities – and ultimately the public – to address six questions:

- 1) Was a payment made?
- 2) If so, to whom (and what is their relationship to host country leadership)?
- 3) For what services?
- 4) Does the payment constitute a “gift”?
- 5) Did the payment or the “gift” affect the awarding of the investment concession, or the structure of the terms?
- 6) Can the entire transaction withstand technical legal – and public – scrutiny?

Developed country authorities and multilateral agencies can only achieve limited progress on their own. Vital to this endeavor is the endorsement and wholehearted participation of developing country authorities – requiring all potential investors to take meet the same standards, including public and private companies from home countries that do not require transparency or adherence to the OECD Convention. Developed countries have a role in encouraging developing countries with whom they have special relationships to take part. They can also contribute to the World Bank’s Trust Fund, and provide bilateral support to build independent monitoring capacity within individual developing countries and sponsor widespread timely disclosure. Ultimately developed countries may decide that it is counterproductive to continue to provide assistance – including multilateral financial assistance – to developing countries that do not take part in a broadened Extractive Industries Transparency Initiative, the Kimberly Process (for diamonds), and other such programs.

¹³“Statement of Outcomes: EITI London Conference, March 17, 2005.