Courts Continue to Dismiss Shareholder Suits Based on FCPA Violations

On March 16, 2015, Judge Paul G. Gardephe of the Southern District of New York dismissed a shareholder derivative suit filed by Sylvia Pritika against the CEO and others of Avon Products Inc. ("Avon") alleging breach of fiduciary duty, unjust enrichment, and corporate waste by causing or permitting Avon to violate the Foreign Corrupt Practices Act of 1977 ("FCPA").[1] The shareholder suit was filed in the wake of Avon's disclosures that it had commenced an FCPA-focused internal investigation of several foreign operations; that the DOJ and SEC had begun their own investigation into potential FCPA violations; and that Avon had made a $12 million settlement offer to resolve the government's investigations. As widely reported, Avon ultimately paid $135 million to the DOJ and SEC on December 17, 2014 to settle the government's FCPA probes and entered into a deferred prosecution agreement with the DOJ, while Avon's China affiliate pled guilty to a criminal information alleging conspiracy to violate the FCPA's accounting provisions.

FCPA Shareholder Derivative Suits

The *Pritika* opinion is just the latest in a recent string of decisions rebuffing plaintiffs' attempts to bootstrap FCPA violations into shareholder litigation. Courts have routinely dismissed FCPA-related derivative actions at the motion to dismiss stage on procedural grounds. The most significant hurdle for plaintiffs has been the demand requirement imposed by many states, including Delaware and New York, at the motion to dismiss stage. The demand requirement obliges a plaintiff to ask the board to bring a suit on behalf of the corporation before filing a derivative suit itself or, alternatively, to plead with particularity facts showing a demand would have been futile.

Because such derivative suits typically are filed without first making a demand on the board, plaintiffs have been forced to argue – to little avail – demand futility. In fact, the Fifth Circuit recently upheld a district court's decision to dismiss an FCPA-based derivative suit against energy services company Parker Drilling and its board of directors based on the demand requirement.[2] The lower court found that the complaint, which alleged that the defendants failed to implement or monitor adequate internal anti-bribery controls and benefitted from the potential wrongdoing, was devoid of particularized facts regarding the basis of defendants' knowledge of compliance concerns and inadequate controls, and the specific benefits that accrued to defendants.[3]

The *Strong v. Taylor* case (commonly referred to as "Tidewater"),[4] a derivative action over offshore oil servicer Tidewater's $15 million FCPA settlement, perhaps best illustrates the difficulty in bringing a derivative action predicated on alleged FCPA violations. In the Tidewater action, a disgruntled shareholder sued Tidewater's board of directors, alleging that the board knew or recklessly disregarded the fact that the company's agents paid more than $2 million in bribes to Azerbaijani and Nigerian officials, and failed to maintain adequate internal controls to ensure compliance with the FCPA. In ruling on defendants' motion to dismiss, the court found the allegations sufficient to establish the company's FCPA violations, yet still dismissed the suit, rejecting plaintiff's argument that demand was futile. Focusing on whether the complaint set forth particularized facts that Tidewater's directors were "incapable of making an impartial decision regarding the pursuit of litigation," the court found that the plaintiff had failed to allege facts showing that the majority of Tidewater directors were interested or lacked independence. First, there were no allegations

[1] *Pritika v. Moore*, No. 13-cv-8369 (S.D.N.Y. Mar. 16, 2015).
[2] *Freuler v. Parker*, 517 Fed.Appx. 227 (5th Cir. 2013).
[3] *Freuler v. Parker*, 803 F.Supp.2d 630, 648-51 (S.D. Tex. 2011).
[4] *Strong v. Taylor*, No. 11-392, 2012 WL 2564907 (E.D. La. July 2, 2012).

that any director expected to receive a personal benefit from the transactions at issue. Second, there were no particularized allegations of the directors' participation, acquiescence, or approval of bribes funded and paid for by Tidewater.

The Pritika Decision

In contrast, the basis of the court's dismissal in *Pritika* was jurisdictional. Even though all of the plaintiff's claims were brought pursuant to New York state law, plaintiff Pritika filed suit in federal court. The plaintiff nevertheless alleged that the court had subject matter jurisdiction under 28 U.S.C. § 1331 (federal-question jurisdiction), because the claims were predicated on the assertion that defendants caused or permitted Avon to violate the FCPA. To decide whether it could exercise jurisdiction, the court applied the four-prong test articulated by the Supreme Court in *Grable & Sons Metal Products, Inc. v. Darue Eng'g & Mfg.*, focusing on the "substantiality" prong of the test, which requires that the claims "raise a substantial federal issue." The *Pritika* court found that plaintiff's claims did not meet this prong for two reasons: Because the FCPA issues in the case – whether Avon's employees committed FCPA violations, and whether defendants caused or permitted these violations – were fact-specific and turned on well-settled law, the case did not have the requisite "broad consequences to the federal system or the nation as a whole." In addition, the court reasoned that exercising subject matter jurisdiction here "would be tantamount to recognizing a private right of action under the FCPA." Such an approach, as the court explained, would usher in a wave of private lawsuits, contravening Congress' intent that FCPA enforcement rest solely with the SEC and DOJ and "not via private suit."

FCPA Securities Fraud Suits

Besides derivative suits, shareholders have also attempted to bring corollary class action securities fraud suits based on FCPA violations—again, unsuccessfully to date. These suits typically allege that the company's misrepresentations or omissions concerning its FCPA liability (*e.g.*, underplaying and/or hiding evidence of violations) artificially inflated a company's share price to the detriment of the shareholders. In many of these suits, the underlying claim is based on Section 10(b) of the Exchange Act, which "prohibits the employment of any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investor."[5]

Similar to FCPA derivative suits, the pleading requirements for FCPA-derived securities fraud claims have often proved insurmountable.[6] To maintain a § 10(b)/Rule 10(b)-5 claim, a plaintiff must show: (1) a misstatement or omission of a material fact by defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.[7] A securities fraud complaint based on misstatements must also plead with specificity the fraudulent statements, identity of the speaker, and occasion when the statements were made, as well as explain why the statements were fraudulent.[8]

This past September, Judge Gardephe dismissed another Avon-related FCPA lawsuit, this one a putative class action by Avon shareholders, alleging that Avon made materially false and misleading statements concerning the FCPA compliance of Avon's Chinese operations between July 31, 2006 and October 26,

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[5] Exchange Act § 10(b), 15 U.S.C. § 78j(b) (2006).
[6] *See, e.g., Glazer Capital Mgmt. v. Magistri*, 549 F.3d 736 (9th Cir. 2008); *City of Brockton Ret. Sys. v. Avon Products Inc.*, No. 1:11-cv-4665, 2014 WL 4832321 (S.D.N.Y. Sept. 29, 2014).
[7] *Stoneridge Inv. Partners, LLC v. Sci.-Atl., Inc.*, 552 U.S. 148, 157 (2008).
[8] *Rombach v. Chang*, 355 F.3d 164, 170.

2011.[9] For example, the class action plaintiffs claimed that a number of statements in Avon's ethics codes and corporate responsibility reports regarding its compliance programs were misleading, in that senior management were aware of or recklessly disregarded material weaknesses in Avon's systems of internal controls (to which the plaintiffs argued management should have been aware based on previous whistleblower letters and internal fraud reports). In granting defendants' motion to dismiss, the court held that the statements in Avon's ethics codes were non-actionable "puffery," and that plaintiffs had failed to plead particularized facts supporting scienter.

Several other FCPA-derived securities class action suits have been brought in the past few months against Cobalt International Energy,[10] Petroleo Brasileiro, S.A.,[11] and other multinational corporations. Motions to dismiss have been filed in one action[12] and more are likely to soon follow.

Practical Implications

As the aforementioned cases demonstrate, procedural hurdles make it difficult for FCPA-derived shareholder lawsuits to succeed. However, given increasing global scrutiny of anti-corruption investigations and the United States government's continued focus on FCPA enforcement, it is reasonable to expect the plaintiff's bar to continue pursuing such litigation—and reasonable for multinational corporations to continue to monitor this trend closely.

For more information regarding the *Pritika* decision and its potential impact, or to discuss the FCPA or any other anti-corruption concerns, please feel free to contact Cori Lable, a member of Ropes & Gray's leading anti-corruption team, or your regular Ropes & Gray contact.

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[9] *City of Brockton Ret. Sys. v. Avon Products Inc.*, No. 1:11-cv-4665, 2014 WL 4832321 (S.D.N.Y. Sept. 29, 2014).
[10] *St. Lucie County Fire Dist.Firefighters' Pension Trust Fund, et al. v. Bryant, et al.*, No. 14-3428 (S.D. Tex.).
[11] *In re Petrobas Secs. Litig.*, No. 1:14-cv-09662 (S.D.N.Y.).
[12] *Menaldi v. Och-Ziff Capital Mgmt. Group LLC*, No. 1:14-cv-03251 (S.D.N.Y.).