

Outside Counsel

Terminating Contracts Based On Known or Suspected FCPA Violations

Companies are understandably eager to terminate their contractual relationships with counterparties that are known or suspected to be violating the Foreign Corrupt Practices Act (FCPA) because of the severe repercussions, legal and reputational, associated with violating the FCPA—or even being subject to internal or external investigations relating to the same. This is particularly the case because a significant number of FCPA enforcement actions against companies are based on misconduct by their contractual agents and other third-party representatives. However, companies may also be concerned about the legal risks associated with breaching a valid contract, especially if the damages could be significant.

A recent decision in the Eastern District of New York, *Cicel (Beijing) Science & Technology Co., Ltd. v. Misonix*, 17-cv-1642-GRB, 2022 WL 188994 (E.D.N.Y. Jan. 20,

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2022), provides helpful guidance in this regard, addressing the circumstances under which a company may lawfully terminate a contract when its counterparty is violating (or is suspected of violating) the FCPA. In *Cicel*, a Chinese distributor sued a U.S. medical device company for, among other things, breach of contract based on the medical device company terminating its distribution agreement because the distributor violated the FCPA. Judge Gary Brown granted summary judgment to the medical device company, holding that “[u]nder New York law, the well-documented illegal conduct here [violations of the FCPA] renders the contract unenforceable.” *Id.* at *3.

In addition to discussing the court’s decision in *Cicel* and other relevant case law, this article provides guidance to companies that

may be confronted by similar circumstances, including steps that companies can take when negotiating contracts to address these issues.

‘Illegal Contracts’ Under New York Law

As a general matter, contracts to commit illegal acts are not enforceable under New York law. Courts are particularly unlikely to enforce contracts to commit acts that are *malum in se*, or inherently wrongful (like fraud), but may also decline to enforce contracts for acts that are *malum prohibitum*, or not inherently wrongful but nonetheless prohibited (like performing a service without a license). Likewise, New York courts are unlikely to enforce contracts where one of the parties violates the law in connection with its performance under the contract, even when the contract is lawful on its face.

This latter category is particularly relevant in the context of the FCPA—for example, where an agent pays a bribe to generate sales pursuant to a distribution agreement for which it receives a commission. The New

York Court of Appeals set forth the standard for analyzing the enforceability of such contracts in *McConnell v. Commonwealth Pictures*, 7 N.Y.2d 465 (1960). There, Commonwealth Pictures Corporation (Commonwealth) agreed to pay Fred McConnell \$10,000, plus a percentage of gross receipts, if McConnell procured a distribution agreement for Commonwealth's films. *Id.* at 468. Although McConnell procured the distribution agreement and Commonwealth paid him \$10,000, Commonwealth refused to pay him any gross receipts under the contract. *Id.* McConnell subsequently sued Commonwealth, but Commonwealth claimed as an affirmative defense that McConnell procured the distribution agreement by bribing a producer's representative. *Id.* at 468-69. The Court of Appeals held that this bribery, if proven, could render the contract unenforceable. *Id.* at 471.

The Court of Appeals explained that a party that engages in "gravely immoral and illegal conduct" in performing its contractual duties cannot enforce the contract. *Id.* However, the Court of Appeals cautioned that "not every minor wrongdoing" excuses performance; there must be a direct connection between the misconduct and the contract. *Id.* ("There must at least be a direct connection between the illegal transaction and the obligation sued upon. Connection is a matter of degree. Some illegalities are merely incidental to the contract sued on.") The Court of Appeals also limited its holding to "cases in which the illegal performance of a contract

originally valid takes the form of commercial bribery or similar conduct and in which the illegality is central to or a dominant part of the plaintiff's whole course of conduct in performance of the contract." *Id.*

In *Cicel*, a judge in the Eastern District of New York applied *McConnell* to a breach of contract case arising from alleged violations of the FCPA.

'Cicel'

Facts. An employee at Misonix, a medical device manufacturer,

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informed the company's Chief Financial Officer that its main distributor in China, Cicel, was marking up Misonix's products by more than a commercially unreasonable "thirty times" when selling them to customers. *Cicel*, 2022 WL 188994, at *1-2. Misonix promptly conducted an internal investigation that concluded that Cicel was paying kickbacks. *Id.* at *2-3 (describing how Cicel used third parties to facilitate illegal payments to doctors to secure contracts). Misonix then terminated its distribution agreement with Cicel, and Cicel responded by suing for, among other things, breach of contract. *Id.* at *1.

Arguments. At summary judgment, Cicel argued that Misonix terminated

its contract with Cicel "to benefit financially from getting rid of Cicel by entering into more commercially lucrative contracts with its new distributors," not because of Cicel's illegal conduct. See Cicel's Mem. in Opp. to Misonix's Mot. for Summ. J., *Cicel (Beijing) Sci. & Tech. Co., Ltd. v. Misonix*, ECF No. 219-2, at 18 (E.D.N.Y. Dec. 20, 2021). Cicel also pointed to the fact that Misonix failed to negotiate for the specific right to terminate the distribution agreement based on Cicel's alleged misconduct. See *id.* at 6.

In response, Misonix argued that the evidence demonstrated that it terminated the distribution agreement solely because of Cicel's illegal conduct. See Misonix's Reply Mem. in Supp. of Misonix's Mot. for Summ. J., *Cicel (Beijing) Sci. & Tech. Co., Ltd. v. Misonix*, ECF No. 219-3, at 10 (E.D.N.Y. Dec. 20, 2021). Relying on *McConnell*, Misonix also argued that it was entitled to terminate the distribution agreement under New York law based on Cicel's illegal conduct, regardless of whether the agreement specifically addressed this situation. See, e.g., *id.* at 5-8.

Holding. In relevant part, Judge Brown found that the "undisputed facts conclusively evidence Cicel's involvement in illegal conduct." *Cicel*, 2022 WL 188994, at *1. Judge Brown concluded that Cicel's "well-documented illegal conduct ... render[ed] the contract unenforceable" under New York law. *Id.* at *3 (citing *McConnell*, 7 N.Y.2d at 471). Therefore, Judge Brown agreed that Misonix had the right to terminate the distribution agreement in order

“to protect [itself] from FCPA liability.” *Id.*

Beyond ‘Cicel’

As Judge Brown recognized, *Cicel* was a relatively “easy” case because the bribery went to the heart of the contract. *Id.* at *1. But neither *McConnell* nor *Cicel* squarely address the more difficult situation where an agent’s bribery is unrelated (or only tangentially related) to a particular contract. Notwithstanding the potential legal and reputational risks that a counterparty may be exposed to in that situation, *McConnell* and *Cicel* suggest that New York courts may only excuse performance of a contract based on evidence of bribery where there is a strong connection between the bribery and the contract at issue.

Given this lack of clear guidance and the potentially significant costs associated with improperly terminating (i.e., breaching) a valid contract, many companies negotiate for the contractual right to terminate contracts where there is evidence or allegations of bribery. For example, in *Hijazi Medical Supplies v. AGA Medical*, No. 07-cv-3419-DAD/JJG, 2008 WL 4861517, at *2 (D. Minn. Nov. 10, 2008), a medical device company (AGA Medical Corporation, or “AGA”) suspected that its business partner (Hijazi Medical Supplies, or HMS) was engaged in bribery and terminated its contract with HMS as a result. *Id.* at *1-2. The underlying contract required HMS to comply with the FCPA in “the conduct of all activities under” the contract, and

it also allowed AGA to terminate the contract for FCPA violations without notice or an opportunity to cure. *Id.* at *1. HMS sued for breach of contract and moved for partial summary judgment. *Id.* at *2. The court denied HMS’s motion based on the contractual language that allowed AGA to terminate the contract based on HMS’s alleged FCPA violations. *Id.* at *3.

While the relevant provision in *Hijazi* is similar to the standard set forth in *McConnell* and *Cicel*—i.e., HMS was required to comply with the FCPA when performing under the contract and AGA could terminate the contract in the event of any related breach—there are benefits to addressing the circumstances under which the parties to a contract can terminate on FCPA-related grounds in the contract itself. For example, parties to a contract can ensure greater certainty about how a court will adjudicate an FCPA-related termination by specifically addressing that situation in the contract. Absent clear contractual language, the parties to a contract will be subject to the fact intensive common law inquiry described in *McConnell* and *Cicel*, which will vary by jurisdiction and can also be unpredictable.

Moreover, the parties to a contract can negotiate for greater protections than would likely be available under the common law, such as allowing a party to terminate based on allegations of corruption (whether verified or not) or to terminate without regard to whether the corruption relates directly to the underlying contract. Such protections can be

particularly helpful where even allegations of corruption by agents and other third parties can have a severe impact on a company, such as where a contracting party operates in a regulated industry.

Conclusion

While *McConnell* and *Cicel* may provide a basis for companies to terminate a contract based on FCPA violations by a counterparty, there is uncertainty about how a New York court will analyze any related breach claim, including the degree of connection that a court will require between the FCPA violation and the counterparty’s performance under the contract. As such, there are significant benefits associated with setting forth facts and circumstances justifying contract termination to the extent practicable, including a good faith unilateral right under which the parties to a contract may terminate on FCPA-related grounds.