

China FCPA Risks: Anticipating and Managing Corruption Risks in Transactions Involving the PRC

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Introduction

For a company planning entrance into the Mainland China market, exploring and assessing corruption concerns may be at the bottom of a long priority list, particularly during the accelerated moments around a transaction. It may be tempting to assume that, whatever the problems at a local People's Republic of China ("PRC") entity, they can be fixed once the entity is integrated into the corporate structure as a subsidiary, or once the reins are handed over to managers of a joint venture armed with compliance training materials. But corrupt acts by the target or venture, including violations of the U.S. Foreign Corrupt Practices Act ("FCPA"), can and will become the foreign corporation's problem if it fails to conduct adequate pre-transaction due diligence and follow through on whatever it finds.

In this article, we address how a company entering the Mainland China market can assess and manage corruption risks during the run-up to closing, and early in the post-close period. We first sketch out the basic contours of the FCPA. We then describe recent FCPA enforcement actions involving foreign company's actions in China, directly or through subsidiaries, and describe several relevant trends that can be seen in on-the-ground business practices at entities operating in China. Finally, we explore a number of areas that should be on the

radar screen for foreign companies entering the PRC through an existing entity or the formation of a new venture, and describe a U.S. issuer's obligations with regard to the internal controls and compliance structure at a foreign subsidiary or venture.

Overview of the Foreign Corrupt Practices Act

The FCPA was enacted in 1977,¹ amended several times over the years, and has been the subject of vastly increased enforcement over the last ten years. The U.S. Department of Justice ("DOJ") and Securities and Exchange Commission ("SEC") share enforcement responsibilities. The FCPA has two main components: the anti-bribery provision, prohibiting bribery of foreign public officials; and, the accounting provisions, which require accurate books and records and adequate internal accounting and compliance controls.

Anti-Bribery Provisions

The FCPA prohibits an issuer of securities, or an officer, director, employee, or agent of that issuer, any U.S. citizen or U.S. private company, or anyone else while on U.S. soil, from (1) offering, paying, promising to pay, or authorizing the payment of (2) money or things of value to (3) foreign officials or political parties (4) for the purpose of obtaining or

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retaining business.² No money needs to change hands; the mere offer of money or a thing of value is enough to trigger the anti-bribery provision.³ "Anything of value" includes not only cash, but also gifts, travel, meals, and entertainment. Passing money or offers to pay through agents is the equivalent of directly paying the bribe, and deliberately shielding oneself from knowledge about the conduct of agents or other third parties does not prevent liability.⁴

Criminal fines for violating the anti-bribery provisions can reach to \$2 million per violation for a corporation, \$250,000 per violation for an individual, or twice the benefit obtained.⁵ Individuals can face up to five years imprisonment. Both corporations and individuals can also face civil fines and disgorgement to the SEC. A violation of the anti-bribery provisions carries with it significant collateral effects, including potential debarment from contracting with the U.S. government or the European Union.

Of particular note to companies operating, or considering operating, in the PRC, are the FCPA's definition of "foreign official," and the affirmative defense for bona fide travel expenses. A "foreign official" is defined broadly as "any officer or employee of a foreign government or any department, agency, or instrumentality thereof, or of a public international organization, or any person acting in an official capacity for or on behalf of" such an entity.⁶ The DOJ has interpreted this provision as meaning that *any* employee of a foreign state-owned or controlled company is a foreign official, as demonstrated by a number of FCPA enforcement actions. In the PRC, where a sizeable percentage of companies are either wholly or partly state-owned or controlled, this means that FCPA liability may attach in many situations where the fact that someone qualifies as a "foreign official" may not be immediately apparent. Companies must expressly address this PRC-specific risk in their compliance programs.

The FCPA also contains an affirmative defense that can be invoked where "the payment, gift, offer, or promise of anything of value that was made, was a reasonable and bona fide expenditure, such as travel and lodging expenses, incurred by or on behalf of a foreign official, party, party official, or candidate."⁷ Any such expense must, though, be "directly related" to either "the promotion, demonstration, or explanation of products or services; or . . . the execution or performance of a contract with a foreign government or agency thereof." Business customs and traditional courtesies deeply ingrained into PRC practice make it critical that particular attention is focused on this issue, as demonstrated by a number of FCPA enforcement actions.

Accounting Provisions

The accounting provisions of the FCPA require issuers to "make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer," and to "devise and maintain" an adequate "system of internal accounting controls."⁸ "[K]nowingly circumvent[ing] or knowingly fail[ing] to implement a system of internal accounting controls or knowingly falsify[ing] any book, record, or account" is a violation of the FCPA.⁹ A parent company that consolidates the financials of its subsidiaries can find itself in violation of the accounting provisions if its subsidiary's books were misstated. Criminal penalties for violating the accounting provisions include fines up to \$25 million (for a corporation), \$5 million (for an individual, along with up to twenty years imprisonment), or twice the benefit obtained.¹⁰ Civil penalties and disgorgement to the SEC are also potential penalties.

Enforcement Activity Related to the PRC – FCPA, and Local Anti-Corruption Actions

In both the U.S. and the PRC, enforcement of anti-corruption laws over the last five years has

skyrocketed. We describe below a number of recent notable examples of law enforcement agencies in both jurisdictions taking action against corrupt activity in the PRC.

FCPA Enforcement

By one measure, there have been almost three dozen FCPA enforcement actions related to conduct in the PRC, with many more investigations under way right now.

Gifts, Travel and Entertainment: Improper travel expenses are a recurrent problem in many FCPA enforcements involving China. In December 2009, a telecommunications company, UTStarcom, Inc., settled with the DOJ and the SEC and agreed to pay a \$1.5 million penalty to each agency to address charges that its Chinese subsidiary paid \$7 million for lavish overseas trips by employees of Chinese-owned telecoms, as well as tangible gifts and tuition for attendance at executive training programs.¹¹ The expenses were recorded as training expenses. The subsidiary also created sham employment arrangements for government officials.

In 2007, Lucent Technologies settled charges with the DOJ and SEC regarding paying over \$10 million in travel expenses for more than 300 trips by Chinese government officials, including officials at state-owned telecommunications companies and subsidiaries.¹² The trips to the U.S., Australia, Germany, and Japan, consisted almost entirely of entertainment activities. Lucent also paid educational expenses for officials and their relatives. All of the expenses were recorded as sales and marketing expenses. Lucent paid \$1 million to the DOJ, and \$1.5 million to the SEC. Improper payment of travel expenses also may be the tip of the iceberg for companies with widespread corruption activities. Label-maker Avery Dennison Corp. settled with the SEC in July 2009 and agreed to pay over \$500,000 in civil penalties, disgorgement, and interest, to address charges that its Chinese subsidiary paid kickbacks to Chinese

officials to get their products authorized for use.¹³ Additional attempted payments were caught and stopped by the parent company.¹⁴ The subsidiary also gave gifts such as expensive shoes to the officials, hosted sightseeing trips, and hired relatives of those officials.

Life Sciences Companies: Another recurrent theme in recent enforcement actions involving the PRC has been the involvement of state-owned hospitals. AGA Medical Corp., a U.S. medical device company with a Chinese distributor, paid \$2 million to the DOJ in 2008 over charges that the distributor paid \$460,000 in kickbacks, disguised as commissions, to doctors at Chinese state-owned hospitals so that the doctors would direct the hospitals to buy AGA devices.¹⁵ The distributor also paid \$20,000 in bribes to officials in the PRC State Intellectual Property Office to get several patents approved. A few years earlier, Diagnostic Products Corp., a medical diagnostics company, settled with the SEC regarding the kickbacks paid by its Tianjin, China-based subsidiary to employees of state-owned hospitals.¹⁶ Although DPC had ordered the cessation of the kickbacks as soon as it became aware of them, DPC disgorged to the SEC all China-related profits from 1991-2002, over \$2 million. The Tianjin subsidiary simultaneously pleaded guilty to violating the anti-bribery provisions of the FCPA and paid \$2 million in fines.¹⁷

Third Party Representatives: The use of third party agents to pass bribes to government employees has also emerged as a problem in the PRC, as in many other countries. In 2009, an engineering products and services company, ITT Corp., settled charges with the SEC related to ITT's Chinese subsidiary, formerly a joint venture, which paid \$200,000 to employees in China's state-owned Design Institutes to influence the purchase of ITT water pumps.¹⁸ In addition to wiring payments directly to the state employees, the joint venture also passed money through third-party agents through inflated commissions. The payments and commission were booked as costs of sales. ITT agreed to pay a

\$250,000 civil penalty, and disgorge over a million dollars before interest.

In 2008, Faro Technologies, Inc., a software company, agreed to pay \$1.1 million to the DOJ, and \$1.8 million to the SEC, over charges that its Chinese subsidiary paid over \$200,000 in "referral fees" to an agent, which were passed on as bribes to employees of state-owned entities.¹⁹ The subsidiary also paid bribes directly to officials. A year later, Faro's former Vice President settled with the SEC and agreed to pay \$56,000 over charges that he had authorized the corrupt payments, then altered the subsidiary's accounts to conceal the payments.²⁰

Deliberate concealment of bribes played a role in another 2009 enforcement action, against Control Components, Inc. The company pleaded guilty to bribing, and conspiring to bribe, employees of Chinese-owned power and petroleum companies in order to influence contract awards and secure favorable project specifications, in addition to officials in numerous other countries.²¹ CCI employees also impeded an internal audit conducted by CCI's parent company, including by creating false invoices, providing false information, and destroying documents. CCI paid \$18.2 million in fines and hired a compliance monitor; numerous CCI executives were also indicted by the DOJ or pleaded guilty.

Stepped-Up Anti-Corruption Enforcement by the PRC

Numerous recent high-profile enforcement actions have been taken in the PRC against government officials who were the recipients of bribes from local or foreign companies. By one estimate, over 100,000 officials were punished in some way for corruption in China in 2009.²² In 2010 thus far, examples include a former Vice President of the China Development Bank who was sentenced to death, then given a two-year reprieve on the sentence, for accepting about \$1.8 million in bribes.²³ A former judge on the Supreme People's

Court was sentenced to life in prison for accepting over \$500,000 in bribes, as well as embezzlement.²⁴ This level of activity seems likely to continue, in conjunction with the high levels of FCPA enforcement activity.

Anticipating and Managing Corruption Risks in Transactions Involving the PRC

For any company considering initiating, or expanding, a business relationship in the PRC, anticipating the potential for corruption risk must form a significant part of any pre-transaction planning. Past or continuing FCPA violations within a target company or a joint venture partner can have a significant bearing on the success of a transaction. Even after the initial due diligence is done, however, ongoing compliance efforts on the ground and at the parent level must continue to address potential corruption risks. While no list of areas to target for due diligence or to use when integrating a new business unit can hope to be exhaustive, recent enforcement cases, including those described above, reveal patterns that companies must monitor.

- *There is no substitute for pre-transaction due diligence:* Discovering a specific problem—or a business culture that is accepting and approving of corrupt activities—gives a chance to walk away or amend the transaction agreements, and to plan for post-merger integration. For a company contemplating a minority investment in a venture, discovery of a problem up-front permits the company to implement measures it may not have the power to implement down the line. (See below, regarding Section 13(b)(6)'s requirement of "good faith efforts" to implement internal accounting controls). Failure to do adequate pre-transaction diligence, by contrast, sets up potential successor liability for past

bribery acts, and primary liability for future ones.

- *Insist on on-the-ground interviews:* An on-the-ground interview with local management is highly recommended during pre-transaction diligence, and questions about potentially corrupt activity must be asked. Local management may not be familiar with the prohibitions of the FCPA, but may disclose the existence of those practices if asked about practices that are questionable under the FCPA, but culturally permissible in the PRC.. For example, the giving of gifts to clients at state-owned entities may be seen as a culturally expected fact of life at a purely local PRC organization. Knowing where, if anywhere, those gifts are recorded on the company's books and records is an essential part of an acquiring company's diligence.
- *Assess the existing use of agents and vendors:* As in many places around the world, companies doing business in the PRC often use third parties such as agents, distributors and consultants, to identify business opportunities, obtain market intelligence, and interact with government agencies for such routine matters as tax, customs and lobbying. As noted, though, under the FCPA companies may not do indirectly what is prohibited if done directly, i.e., use agents to pass bribes to government officials. During pre-transaction diligence, areas to be alert for include large commissions paid to agents, over and above what other agents are paid or the customary practice in the region; inability to produce contracts with agents or vendors; and sham contracts.
- *Assess the payroll and employment relationships:* Sham employment relationships and sham employees have

emerged as one of the common methods of accomplishing corrupt activities in the PRC. Questions addressing these risks include: Does the number of employees listed on the payroll, match the number of employees who show up to work every day? Are there relatives of employees of relevant state-owned entities on the payroll? Are they suited for the jobs they are in, at the salary they are receiving?

- *Focus on marketing activities and gifts:* As above in the ITT Corp. and UTStarcom cases, cost of sales and marketing expenses are two of the common accounts used to disguise improper payments, and should be focused on during due diligence. Gifts pose a special problem in the PRC, where such gifts and tokens are an important part of demonstrating basic business courtesies and relationship-building. While the prevalence of gift-giving in business relationships may be waning due to the potential association with bribery, understanding the current practice at a local PRC company is essential, as well as where they book the expense of those gifts.
- *Follow the Fa piao:* Fa piao—official receipts or invoices used for calculating business taxes—form the paper trail for payments and reimbursements. They are also often fake or generic, and may be used to disguise payments to agents or government officials, by providing purported official backup to money spent from certain accounts or reimbursed to employees.
- *Ensure adequate local language skills:* Existing PRC operations which have not previously done business with international corporations may have no management personnel who speak

English. Adequate regional language skills are needed for personnel conducting due diligence; for personnel integrating operations; and for audit and compliance personnel monitoring the situation after a transaction is completed. Compliance training and training materials should be provided in the local language if at all possible, even for on-the-ground personnel who have some proficiency in English.

Evaluate the Risks of the Proposed Organizational Structure, and Implement Ongoing Monitoring

We conclude with the trickiest and potentially the most dangerous aspects of transactions involving the PRC—a company's potential liability for acts done by a minority-owned PRC-based entity, and implementing an on-going compliance structure to head off future liability. In general, parents who consolidate subsidiaries' books into their own will be liable for FCPA books and records violations in the subsidiaries' accounts. For joint ventures, a member's liability for violations committed by the joint venture is a little murkier. If a member of a joint venture is an *issuer* under the U.S. securities laws, Section 13(b)(6) of the Securities Exchange Act of 1934, 15 U.S.C. § 78m(b)(6), sets the rules for the member's liability in the books and records area:

Where an issuer . . . holds **50 per centum or less of the voting power** with respect to a domestic or foreign firm, the provisions of paragraph (2) [the FCPA's books and records provisions] require only that the **issuer proceed in good faith to use its influence**, to the extent reasonable under the issuer's circumstances, **to cause such domestic or foreign firm to devise and maintain a system of internal accounting controls** consistent with paragraph (2). Such circumstances include the relative degree of the issuer's ownership of the domestic or foreign firm and the laws and practices

governing the business operations of the country in which such firm is located. **An issuer which demonstrates good faith efforts** to use such influence **shall be conclusively presumed to have complied with the requirements of paragraph (2)**. (emphases added)

Even a minority member of a PRC joint venture, then, must attempt to impose a compliance system on the venture that complies with the U.S. securities laws and the FCPA. If possible, that compliance system should include a right to audit the company, annual certifications of compliance, rights to terminate the venture if there is an FCPA violation, and the placement of well-trained compliance personnel in the venture to impose an appropriate level of compliance control, including adoption of an FCPA compliance policy.

While a company establishing a wholly-owned subsidiary, or taking a majority stake in a venture, may have no difficulty establishing such an on-going compliance monitoring system that involves compliance personnel from outside China, that may be much more difficult for a minority partner, or even impossible. But the effort described by Section 13(b)(6) is worthwhile, even for non-issuers. Avery Dennison's Chinese subsidiary, in the case noted above, ultimately only paid about \$24,000 in kickbacks to Chinese officials. Several hundred thousand dollars in additional planned kickbacks were detected and stopped by employees at Avery Asia, higher up in the corporate structure. And while the FCPA prohibits offers to pay as well as the payments themselves, Avery's settlement with the SEC would likely have been far more punishing if the kickbacks had not been detected and halted.

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not be representative of those of the firm or its clients.

¹ Pub. L. No. 95-213, 91 Stat. 1494 (codified at 15 U.S.C. §§ 78m, 78dd-1, 78dd-2, 78dd-3, 78ff, as amended).

² 15 U.S.C. § 78dd-1(a) (issuers); *id.* § 78dd-2(a) (domestic concerns); *id.* § 78dd-3 (anyone else "while in the territory of the United States").

³ *Id.* § 78dd-1(a).

⁴ *Id.* § 78dd-1(a)(3) (prohibiting such pass-throughs "knowing that all or a portion of such money or thing of value will be offered, given, or promised, directly or indirectly, to any foreign official").

⁵ *Id.* §§ 78ff(c)(1), (2); Alternative Fines Act, 18 U.S.C. §§ 3571(b)-(d).

⁶ 15 U.S.C. § 78dd-1(f)(1).

⁷ *Id.* §§ 78dd-1(c)(2), dd-2(c)(2), dd-3(c)(2).

⁸ *Id.* §§ 78m(b)(2)(A), (B). The internal controls provisions specify a number of aspects by which the adequacy of the internal control system will be measured. *See id.* § 78m(b)(2)(B)(i) – (iv).

⁹ *Id.* § 78m(b)(5).

¹⁰ *Id.* § 78ff(a); Alternative Fines Act, 18 U.S.C. §§ 3571(c), (d).

¹¹ Complaint, *SEC v. UTStarcom, Inc.*, No. 09-cv-6094 (N.D. Cal. Dec. 31, 2009); SEC Litigation Release No. 21357 (Dec. 31, 2009), *available at* <http://www.sec.gov/litigation/litreleases/2009/lr21357.htm>; Press Release, DOJ, Dec. 31, 2009, *available at* <http://www.justice.gov/opa/pr/2009/December/09-crm-1390.html>.

¹² Complaint, *SEC v. Lucent Techs., Inc.*, No. 07-cv-2301 (D.D.C. Dec. 21, 2007); Press Release, DOJ, Dec. 21, 2007, *available at* http://www.justice.gov/opa/pr/2007/December/07_crm_1028.html.

¹³ Complaint, *SEC v. Avery Dennison Corp.*, No. 09-cv-5493 (C.D. Cal. July 28, 2009); SEC Litigation Release No. 21156 (July 28, 2009), *available at* <http://www.sec.gov/litigation/litreleases/2009/lr21156.htm>.

¹⁴ While most of the attempted kickbacks were caught by parent corporate officials before they were paid, at least \$24,000 in kickbacks were alleged to have been actually paid.

¹⁵ Press Release, DOJ, June 3, 2008, *available at* <http://www.justice.gov/opa/pr/2008/June/08-crm-491.html>.

¹⁶ Order, *In the Matter of Diagnostic Products Corp.*, Administrative Proceeding No. 3-11933 (May 20, 2005), *available at* <http://www.sec.gov/litigation/admin/34-51724.pdf>.

¹⁷ Press Release, DOJ, May 20, 2005, *available at* http://www.justice.gov/opa/pr/2005/May/05_crm_282.htm.

¹⁸ Complaint, *SEC v. ITT Corp.*, No. 09-cv-00272 (D.D.C. Feb. 11, 2009); SEC Litigation Release No. 20896 (Feb. 11, 2009), *available at* <http://www.sec.gov/litigation/litreleases/2009/lr20896.htm>.

¹⁹ Order, *In the matter of Faro Techs., Inc.*, Administrative Proceeding No. 3-13059, *available at* <http://www.sec.gov/litigation/admin/2008/34-57933.pdf>; Press Release, DOJ, June 5, 2008, *available at* <http://www.justice.gov/opa/pr/2008/June/08-crm-505.html>.

²⁰ Complaint, *SEC v. Oscar H. Meza*, No. 09-cv-1648 (D.D.C. Aug. 28, 2009); SEC Litigation Release No. 21190 (Aug. 28, 2009), *available at* <http://www.sec.gov/litigation/litreleases/2009/lr21190.htm>.

²¹ Press Release, DOJ, July 31, 2009, *available at* <http://www.justice.gov/opa/pr/2009/July/09-crm-754.html>.

²² <http://www.fcpablog.com/blog/2010/1/12/china-the-year-in-graft.html> (citing the Chinese Ministry of Supervision and Central Commission for Discipline Inspection).

²³ *See* Agence France Presse, *Suspended Death Sentence for Ex-China Bank VP*, Apr. 15, 2010.

²⁴ *See* Agence France Presse, *Top Chinese Judge Jailed for Life for Graft*, Jan. 19, 2010.