Welcome to the FCPA: Chinese Companies and Reverse Mergers

In a Wall Street Journal article on January 27, 2011 entitled "What's Behind China's Reverse IPOs?", reporter Joseph Sternberg wrote that several Chinese companies were under investigation by the Securities and Exchange Commission (SEC) for "accounting irregularities". The basis for this SEC jurisdiction over these Chinese companies is their reverse merger into a publicly traded US company. The article notes that while the goal in a traditional IPO is to extract cash, a reverse merger requires the expending of cash to purchase a shell company. From their new position in the US market, a Chinese company may then turn to the US securities market for cash through secondary offerings. The article notes that the key element of these reverse mergers is the desire by Chinese companies to obtain capital.

However when entering into such a financing arrangement if a Chinese company purchases a US listed company to utilize as a shell, it will fall under the jurisdiction of the SEC. The Chinese company will now also be subject to the Foreign Corrupt Practices Act (FCPA). In addition to investigating "accounting irregularities" the SEC also has jurisdiction of the books and records component of the FCPA. This article stirred out thinking about some of the ways a Chinese company might find itself under a FCPA investigation.

A. A Chinese Company with US Presence

Chinese companies are increasingly listing shares on US stock exchanges. However, with the upside of access to US capital comes risk and one of the consequences of a Chinese company listing shares on a US exchange (and thus becoming an "issuer") is that it becomes subject to a variety of US laws, including the FCPA. It is clear that the SEC, the primary enforcer of US securities laws, will hold Chinese issuers accountable under US securities laws. For instance, Rino International Corp., a Dalian China-based issuer (here), disclosed in an SEC filing as follows:

"*The Company has been notified by the Staff of the Securities and Exchange Commission (the "SEC") that it is conducting a formal investigation relating to the Company's financial reporting and compliance with the Foreign Corrupt Practices Act for the period January 1, 2008 through the present. The Company is cooperating with the SEC's investigation. It is not possible to predict the outcome of the investigation, including whether or when any proceedings might be initiated, when these matters may be resolved or what if any penalties or other remedies may be imposed."*

While Rino International is an "issuer" it is only a matter of time before a Chinese non-issuer becomes entangled by the broad reach of the FCPA given the following FCPA enforcement trends: (i) an increase in overall FCPA enforcement activity; (ii) an increase in FCPA enforcement activity against foreign companies and foreign nationals subject to the FCPA; and (iii) an increase in FCPA enforcement activity concerning business activity in China. The nexus will be that some or part of the business transaction went through the US. This could include

money flowing through the US banking system, work on a contract by the US subsidiary of a Chinese company or even the use of US citizens, always subject to the FCPA, in all or part of a transaction which takes place through the body of Chinese corporation.

The fact that US enforcement agencies will not draw a distinction between US FCPA violators and foreign FCPA violators was made clear by the 2006 prosecution of Statoil ASA (Statoil), an international oil company headquartered in Norway with shares listed on the New York Stock Exchange. In announcing the resolution of a FCPA enforcement action against Statoil (in which the company agreed to pay approximately $21 million in combined penalties and fines for making improper payments to Iranian government officials in connection with oil and gas field projects in Iran), a high-ranking Department of Justice (DOJ) official stated: "Although Statoil is a foreign issuer, the Foreign Corrupt Practices Act applies to foreign and domestic public companies alike, where the company's stock trades on American exchanges. This prosecution demonstrates the Justice Department's commitment vigorously to enforce the FCPA against all international businesses whose conduct falls within its scope."

US government enforcement agencies were able to prosecute Statoil for payments made to Iranian officials because the improper payments were made to a consultant through a US bank. The Statoil enforcement action was the first criminal FCPA enforcement action against a foreign issuer for FCPA anti-bribery violations, but will surely not be the last. In fact, the largest FCPA enforcement action to date involved the German issuer Siemens, which has already disclosed numerous payments in various countries that may have violated the FCPA. Siemens paid over $1.6 billion in fines and penalties.

Statoil was not only prosecuted for violations of the anti-bribery provisions, but also charged with violations of the books and records and internal control provisions. Unlike anti-bribery violations, there is no US nexus required for a foreign issuer to be charged with violating the books and records and internal control provisions, other than the fact that, as an issuer, the company must file reports with the SEC in the US. In the Statoil matter, the books and records and internal control violations were charged because the payments were improperly characterized on the company's books and records as "consulting fees" and because the company's internal controls did not detect and stop the payments.

The Statoil enforcement action should alert Chinese issuers that if a bribery scheme has any nexus to the US, such as use of a US bank; use of US computer servers, etc., the company could be subject to US prosecution. Such prosecutions could be based not only on a situation in which a Chinese issuer makes an improper payment to a high-ranking government official in order to secure a government contract, but also, because of the broad scope of the anti-bribery provisions, a situation in which a Chinese issuer provides things of value to SOE (what is SOE?) employees in order to obtain or retain business. The Statoil enforcement action should also alert Chinese issuers that books and records and internal control violations will also likely be charged any time the company makes an improper payment.

Chinese issuers are not the only China-based companies that can directly be subject to US prosecution for violating the FCPA. Under certain circumstances, a Chinese subsidiary of a US company can also be prosecuted for FCPA violations.

B. A Chinese Subsidiary Company Acting as an Agent of a US Company

A Chinese subsidiary may be directly subject to FCPA prosecution if the DOJ and/or SEC conclude that the subsidiary acted as an agent of the US Company and took action, or failed to take action, in the US in furtherance of an improper payment. This theory of FCPA prosecution is best demonstrated by the DOJ's prosecution of DPC (Tianjin) Co. Ltd. (DPC (Tianjin)), the Chinese wholly-owned subsidiary of US issuer Diagnostic Products Corporation (DPC). In 2005, DPC (Tianjin) pled guilty to violating the FCPA for making improper payments to physicians and laboratory personnel employed by Chinese government-owned hospitals, individuals deemed "foreign officials" under the anti-bribery provisions. The prosecution was based on the theory that DPC (Tianjin) acted as an "agent" of DPC in making the improper payments and because DPC (Tianjin's) General Manager and Deputy General Manager regularly sent proposed budgets and financial statements which contained the improper payments to DPC's offices in the US.

More recently was the enforcement action against RAE Systems, Inc., a California based global provider of rapidly deployable connected intelligent gas detection systems that enable real-time safety and security threat detection. RAE agreed to a fine, penalty and profit disgorgement of $2.9 million, for actions by its Chinese subsidiaries which were deemed violative of the FCPA regarding certain conduct in China. RAE has two subsidiaries in China, KHL and Fushun which were found to have made improper payment to Chinese governmental officials for the purposes of furtherance of business. RAE was found to have known about the bribery schemes engaged in by KHL prior to the time RAE became the majority interest holder in the KHL and did not take steps to end the illegal acts. RAE was found not to have performed any due diligence prior to its takeover of Fushun but thereafter was made aware of illegal bribery schemes.

The RAE prosecution demonstrates that the theory of prosecution used by the DOJ in the DPC matter will subject any Chinese subsidiary of a US company to direct US prosecution any time it is found to have participated in a payment prohibited by the anti-bribery provisions.

C. A Chinese Business Executive Acts in the US in Furtherance of a Bribe Payment

The anti-bribery provisions can reach not only Chinese issuers and Chinese subsidiaries of US companies, but also Chinese business executives, individually, if the executive acts in the US in furtherance of an improper payment.

That US government enforcement agencies will aggressively pursue individual FCPA violators, regardless of the individual's nationality, is demonstrated by the 2007 prosecution of Christian Sapsizian, a French citizen and former executive of French issuer Alcatel CIT, who pled guilty to violating the FCPA in connection with improper payments to Costa Rican government officials.

US enforcement agencies were able to prosecute the French citizen for making improper payments to Costa Rican foreign officials because Sapsizian processed various payment requests from a consultant, which were used to fund the improper payments, through his employer's account at a US bank.

By engaging in payment schemes prohibited by the FCPA, Chinese business executives employed by Chinese issuers also risk SEC charges for violating and/or aiding and abetting violations of the books and records and internal control provisions. For instance, in September 2007, the SEC filed a settled civil action against Chandramowli Srinivasan, an Indian resident who was the president of a unit of a subsidiary of US issuer Electronic Data Systems Corporation (EDS). According to the SEC's complaint, Srinivasan made improper payments, either directly or indirectly, to Indian officials in order to obtain business. The payments were funded through fabricated invoices that were ultimately incorrectly recorded on EDS's books and records. Based on this conduct, the SEC charged Srinivasan with knowingly falsifying EDS's books and records and knowingly circumventing or knowingly failing to implement a system of internal controls – all in violation of the books and records and internal control provisions.

The WSJ article concludes by noting that it is the inefficiency of the Chinese capital markets which is the major driver behind these reverse mergers. In time it may also become clear that this inefficiency may lead to a new wave of FCPA enforcement actions against Chinese companies.