Compliance Risks and Pitfalls in China – Navigating the FCPA and the Use of Third Parties

Greg Wajnowski
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177 COUNTRIES. 177 SCORES. HOW DOES YOUR COUNTRY MEASURE UP?

The perceived levels of public sector corruption in 177 countries/territories around the world.

- 36. Taiwan: 114.
- S. Korea: 46.
- China: 80.
- India, Philippines: 94.
- Indonesia: 114.
US Foreign Corrupt Practices Act

Don’t Bribe Foreign Officials

Keep Accurate Records

The FCPA’s anti-bribery provisions prohibit:
- directly or indirectly...
- with corrupt intent...
- offering, paying, or promising to pay *anything of value*...
- to a “*foreign official*”...
- in order to obtain or retain business
Who Is a “Foreign Official”?

- Employees of government agencies and institutions
  Ex: SAIC, AQSIQ, MOC
- Employees of state-owned commercial enterprises (SOEs)
- Procurement managers at state-owned enterprises
- University researchers and professors
- Members of official advisory committees
- Political parties and political party officials
- CCP officials
- Employees of public international organizations such as the WHO, World Bank, or UN
What Is “Anything of Value”?

- Cash
- Cash equivalents (shopping cards, gift cards, etc.)
- Liquor
- Cigarettes
- Jewelry
- Electronics (mobile phones, watches, laptops, TVs, etc.)
- Antiques
- Meals
- Leisure activities (karaoke, golf, spa)
- Travel

- Bribes or kickbacks masquerading as “fees”
- Loans of money, car, housing, etc.
- Stocks/securities
- Discounts on products or services
- Tuition/scholarship for relatives
- Employment/internships for relatives
- Paying for medical treatment
- Donations to favored organization
China’s Anti-Bribery Laws

No less strict than US laws

PRC Criminal Law prohibits
- Commercial bribery
- Corruption of public officials
- Overseas bribery

“whoever provides property to a foreign official or an official of an international public organization for the purpose of seeking an improper commercial benefit, will be punished [in accordance with the provisions applicable to commercial bribery].”
FCPA cases increasingly involve third parties and focus on third-party due diligence and companies’ responses to red flags
Who is a “Third Party”?

Agents (including sales, marketing and travel agents)
Consultants
Distributors
Dealers
Government service providers (visa processor, customs brokers)
Transportation companies & freight forwarders
Attorneys and accountants
Labor contractors
Design Institutes
Joint venture partners
The Design Institute Game

- End User
- EPC
- Design Institute
- "ABC" Co. (DI Employees)
- Seller

End User → EPC: Bids Products and Services
Design Institute → End User: Services
EPC → Seller: Bids Products and Services
"ABC" Co. (DI Employees) → Design Institute: Services
From 2003 to 2006, certain employees of Rockwell Automation Power Systems (Shanghai) Co., Ltd. (Rockwell) paid approximately $615,000 to Design Institutes, which were typically state-owned enterprises that provided design engineering and technical integration services that can influence contract awards by end-user state-owned customers.

The payments were made through third-party intermediaries at the request of Design Institute employees and at the direction of Rockwell’s Marketing and Sales Director.

Payments made directly to the Design Institute employees, with the expectation that they would influence the ultimate state-owned customers to purchase Rockwell products.

Even though the Design Institutes did provide some bona fide engineering and other services, Rockwell could not substantiate the specific services rendered or the value of those services.
A Chinese subsidiary of Watts Water Technologies ("Watts") allegedly paid employees of Chinese state-owned design institutes to recommend Watts’ products and to create design specifications that favored Watts’ products.

Watts’ sales policy provided that all sales-related expenses—including travel, meals, entertainment and “consulting fees” paid to design institutes—would be paid by sales employees out of their sales commission, which was approximately 7% of the contract price, and provided that sales personnel could use their commission to make payments to employees of design institutes of up to 3% of the total contract amount.

Watts agreed to pay penalties of $3.7 million.
Travel and Entertainment – IBM

The SEC alleged that employees of IBM’s two wholly-owned subsidiaries in China engaged in a widespread practice of providing overseas trips, entertainment, and improper gifts to Chinese government officials of an unspecified total value.

More than 100 IBM-China employees were allegedly involved in an improper travel and entertainment scheme planned by two key IBM-China managers. There were also allegedly more than 114 instances of fabricated invoices, improperly documented and/or funded trips, and unapproved sightseeing activities.

In addition, IBM-China personnel allegedly falsely designated travel agents as training providers and submitted fraudulent purchase requests to funnel payments for unapproved trips for Chinese officials.
Maxwell Technologies Inc. (“Maxwell”), a California-based manufacturer of energy storage and power-delivery products, settled criminal and civil FCPA charges stemming from improper payments related to sales of Maxwell’s products to state-owned enterprises in China.

DOJ and the SEC alleged that Maxwell used a Chinese agent to bribe officials at SOEs to secure contracts worth more than $15.4 million. Maxwell allegedly made these payments at the agent’s instruction by adding 20% to invoice prices and passed the surplus to the agent, who then used the amount to bribe officials at the customers.

Maxwell mischaracterized the bribes as sales commissions and reclassified the kickbacks as a reduction in revenue.

Maxwell agreed to pay more than $14 million to settle the charges.
GSK

Chronology

• **Jan 2013:** whistleblower says sales staff in China were involved in widespread bribery of HCPs between 2004 and 2010, but internal investigations found “no evidence” of bribery

• **Jun & Jul 2013:** 4 executives (BD Director, HR Director, GC, VP of Operations) and 18 employees were detained; GSK China head of finance barred from leaving country

• **Jul 2013:** GSK headquarters called the bribery accusations “shameful” and “deeply disappointing”; acknowledged “some of its Chinese executives appeared to have broken the law” and apologized publicly; also replaced China CEO

• **Sept 2013:** Chinese government investigation shows GSK bribery in China was “organized by GSK China rather than drug salespeople’s individual behavior”

• **Sept 2013:** GSK issued a statement denying wrongdoings had been part of a sanctioned corporate strategy

• **Sept 2013:** GSK China Head of Recruitment commented that GSK turned a blind eye to illegality and “pushed all responsibilities to individual employees when the problems were exposed”
• Funneled up to RMB3B ($489M) to more than 700 travel agencies and consultancies to facilitate bribes to doctors and officials since 2007
• Based on local news reports, bribery may include providing HCPs speakers fees (i.e. to non-speaking HCPs), arranging fake conferences to cover expenses of sightseeing tours, giving cash kickbacks, inappropriate gifts and luxury meals
So… How do you select third parties and manage the relationship?

3 Stages in the Relationship:

1. Due Diligence
2. The Contract
3. Monitoring & Auditing
Due Diligence Resources

Desk-top due diligence – internet searches
Application questionnaire
References and credit checks

US Embassy (Foreign Commercial Service’s International Company Profile – ICP – report)

Investigation firms, but be careful…
  – Many of the best are not licensed in China
  – Use of independent contractors
  – China Whys case…sale of private data
DD & Screening – Spot the Red Flags

Reputation
- Reputation for unethical conduct?
- Terminated by other companies for improper conduct?
- Subject to civil or criminal enforcement actions?

Government ties
- Family or business ties to gov’t officials?
- Employs a current or former government official?
- Owned or controlled by a current or former gov’t official?
- Large or frequent political contributor?
- Recommended by a gov’t official?
DD & Screening – Spot the Red Flags

Capability

- Sufficient staff or facilities to perform required work?
- Industry/technical experience and track record?
- Financial stability?

Other goofy stuff

- Requests for anonymity or that the relationship remain a secret?
- Lack of cooperation with due diligence investigation or refusal to make representations and warranties?
- Suspicious statements such as needing money to “get the business” or “make necessary arrangements”?
- Obtains info to which he should not have access?
Contractual Protections

Once vetted and approved, these third parties should enter into a written contract with the following:

- Anticorruption representations and undertakings relating to compliance with the anticorruption laws
- Rights to review the books and records of the third party that are related to their business with your company
- Rights to terminate the third party as a result of any breach of anticorruption laws and regulations or representations and undertakings related to such anticorruption laws and regulations.
Monitoring & Auditing – Red Flags

Compensation
• Is compensation significantly above market rate?
• Substantial up-front payment requested?
• Request for payment to be made in cash or in checks payable to cash or bearer?
• Request for payment be made through a third party or in a third country?
• Commissions are improperly calculated?

Expenses
• Refusal to properly document expenses?
• Records provided are suspect?

Rebates and Discounts
• Excessive or unusual rebates or discounts?
Monitoring & Auditing – Red Flags

Affiliated Entities
- Failure to report affiliated entities (this should have been on your due diligence questionnaire)?
- Corporate name changes?

Shared Marketing Expenses
- Outside the contractual provisions?

Training Costs
- Outside the contractual provisions?