

Application of the Foreign Corrupt Practices Act in China

Introduction

U.S. companies and their subsidiaries in China must have an adequate Foreign Corrupt Practices Act ("FCPA") compliance program. Doing business in China may present special risks under the FCPA:

- Business in China historically involves entertaining and gift giving.
- Chinese accounting practices are often not sufficiently transparent to satisfy FCPA requirements.
- Tax avoidance by Chinese companies often results in unreceipted or improperly receipted payments.
- The sheer size of the China market and the nature of business relations may lead companies to engage agents to penetrate markets.
- Disgruntled employees, unhappy agents and distributors, and competitors in China often turn into whistleblowers.
- Employees of US companies, eager to access China market returns, turn a blind eye and allow improper payments through third party intermediaries under the misguided assumption that such payments will not violate US law.
- Chinese companies do not view corporate nepotism or the use of connections to obtain business in the same way that US companies might.
- In certain industry sectors, kickbacks or "huikou" are an accepted means of conducting business.
- Foreign companies feel that "everyone is doing it" and that they must engage in the behavior to remain competitive. They conclude that commercial pressures outweigh the risk of getting caught.
- The US Government seems increasingly focused on China operations of US companies in enforcing the FCPA.

Offenses

There are two types of offenses under the FCPA: (1) bribery and (2) deceptive record-keeping. Bribery is enforced by the DOJ and carries potential criminal penalties. The deceptive record-keeping provisions are enforced by the Securities and Exchange Commission ("SEC") and carry potential civil liability.

Bribery

Under the FCPA, it is illegal (1) to corruptly offer, pay or promise to pay; (2) anything of value; (3) to any foreign official; (4) for the purpose of obtaining or retaining business, including getting or keeping contracts, or gaining "any improper advantage."

With respect to the first element, "corruptly" involves the intent of a payor to induce a foreign official to misuse his/her position. Note that actual payment does not have to occur for the FCPA to be violated. It is sufficient that a company or an individual offers, promises or authorizes, either directly or indirectly, the payment of anything of value. In addition, payment made to any intermediary knowing the payment will be used for bribery is considered a violation of the FCPA. Therefore, it is not a defense that payment was only promised; that a company official did not directly authorize the payment; or that the payment was made through an intermediary.

Under the Act, "foreign official" is broadly defined and can be (1) an officer, employee or person acting in an official capacity for a foreign government department, including any agency, military branch, court, legislature, or public international organization, such as the World Bank, IMF, etc; (2) an employee of a State-owned enterprise; (3) an outside consultant acting in an official capacity on behalf of a foreign government; or (4) foreign political party candidates. In China, state-owned enterprises or partially state-owned enterprises are more common sources of arguably improper payments under the FCPA.

Bribery under the FCPA requires a knowing act. "To know" in this context requires that the individual or company has actual knowledge or awareness that something is substantially certain to occur, a firm belief that something is substantially certain to happen, or awareness of a high probability of the existence of such circumstances. Conscious disregard of what is taking place or deliberate ignorance concerning the actions of the company or individual employees is not a defense to a charge of bribery.

Exception: Facilitating Payments

Facilitating payments, often called "grease payments", are nominal payments to speed normal procedures, such as customs, visas, etc. In China, there are many occasions when use of these types of facilitating payments are necessary because of the multiple approval levels (national, provincial, city and local) in the bureaucratic process. Such grease payments must be both properly documented and should be rare. Facilitating payments if not properly authorized and documented may be construed as an improper payment.

Exception: Expenses

In addition to facilitating payments, the FCPA allows payments to or on behalf of foreign officials and employees of state-owned enterprises for legitimate, bona-fide and reasonable expenditures, such as travel and lodging, clearly incurred in relation to a business purpose.

Expenses cannot be a substitute for what would otherwise be considered a bribe. Thus, a plant visit to explain a new product and associated expense may be acceptable but expenses related to a golf weekend in Phuket will certainly pose FCPA concerns. Thus, as with facilitating payments, expenses should be properly documented and reasonable in light of the stated purpose of the expense.

For such exceptional expenses under the FCPA, companies should have clear policies and ideally, an approval process that protects against abuse. The individual proposing the payment should not have independent decision making authority as that person may be too close to the transaction to assess its appropriateness from an objective position. Company employees need to ask themselves how a third person in the US, unfamiliar with China market norms, will objectively view the transaction.

Deceptive Record-keeping

The FCPA's record-keeping requirements are essentially consistent with good general accounting principles. A company must have in place a system of internal accounting controls that will provide reasonable assurances that transactions are properly authorized and accurately recorded on the company's books. Companies are required to keep their books in a manner that accurately and fairly reflects the transactions.

The Act's provisions are designed to prevent the company from (1) failing to record improper transactions; (2) falsifying records to conceal improper transactions; and (3) generating records that fail to specify the qualitative aspects of a transaction that might reveal the true purpose of a particular payment. In this way, the Act's anti-bribery section is strengthened by the deceptive record-keeping section because companies can no longer use "creative accounting" methods to disguise improper payments.

Accounting transparency can be challenging in China. Documentation problems include: transactions designed for tax avoidance, broad accounting categories for products and services, lack of official receipts, lack of documented due diligence, lack of due diligence, absence of written agreements, and off-the-record accounts and transactions. These local difficulties, however, are not a defense to charges under the Act. Companies must demand from those with whom they do business proper documentation of the transaction. In turn, companies must fairly and accurately record those transactions in the company accounts.

Jurisdiction

Companies

The FCPA governs both US issuers of securities and subsidiaries of US companies in China, including wholly foreign owned enterprises and joint ventures. In addition, the FCPA may have jurisdiction over companies that have a nexus with the US or entities that have "knowledge and participation" in the US market, such as wire transfers, email traffic, sales in the US market, or involvement of US sites. Therefore, it is not a defense to charges under the Act that a company is incorporated in a non-US jurisdiction. Rather, by entering the US via

electronic or commercial means, foreign companies open themselves to liability for violations of the Act.

Individuals

Individuals can also be charged in their individual capacity for violations of the FCPA. Any US citizen or green card holder, on a world-wide basis and regardless of employer, can be held liable for violations of the FCPA. Further, any foreign national who is an officer, director, employee or shareholder of an American business is subject to the FCPA as well as any foreign national who is acting in the territory of the US by entering the US interstate commerce stream.

Liability for Acts of Third Parties

The company can also be liable for acts of agents, distributors or other intermediaries. Employees can not do indirectly what they would be prohibited from doing directly. In China, use of agents may be problematic under the FCPA, if there is: (1) lack of due diligence; (2) failure to enter into a documented agreement; (3) lack of invoices or receipts to support payments to agents; and (4) misrepresentation of such payments in the company books. If the agent is "all *guanxi* and no service," then there is a strong likelihood that the agent may put the organization at risk for violation of the FCPA.

Penalties

Individuals and/or corporations found to be in violation of the FCPA can face substantial criminal and/or civil penalties. Individual defendants can be fined up to USD \$250,000 and corporations are barred from indemnifying its employees from fines levied under the Act. In addition, individual defendants, in criminal cases, can be sentenced up to five years per count with no parole.

Corporate defendants can be held responsible for the cost of the litigation against them, fined up to USD \$2,000,000 per count, fined up to twice the amount of the gains, have their export licenses suspended, or be prohibited from bidding on government contracts. In addition, the SEC may seek disgorgement of profits.

It is important to note that substantial penalties have been imposed even when the amounts in question have not been material to the company's finances – or even significant in themselves. Therefore, engaging in any violation of the FCPA, no matter how small or large, can subject both the individual and the corporation to personal and corporate financial risk.

Conclusion

Employees, both expatriate and local, as well as agents, contractors, partners and subsidiaries must be trained about the requirements of the FCPA. Without effective education in the business environment in China, employees and business partners are more likely to make incorrect judgments, putting themselves as well as the company at risk for a violation. US companies and their subsidiaries and representative offices must establish strong internal accounting controls. US employers must ask the tough questions of employees and work with

them to find a legal solution that still allows them to be competitive. This cannot be a one time conversation or a few comments after a training session. It should be a continuing dialogue that helps the company develop a sound strategy for meeting the market requirements within the confines of the FCPA.

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