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Third-Party Corruption Risks When Doing Business in China

Navigating China and U.S. Anti-Corruption Laws When Using Foreign Agents,
Distributors and Other Intermediaries

THURSDAY, JUNE 16, 2011

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

Kathryn Cameron Atkinson, Member, **Miller Chevalier**, Washington, D.C.

Susan M. Ringler, Senior Counsel for International Compliance, **ITT Corporation**, McLean, Va.

Edward J. Fishman, Partner, **K&L Gates**, Washington, D.C..

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Third-Party Corruption Risks When Doing Business in China

June 16, 2011

Corruption Risks Created by Third Party Agents

Kathryn Cameron Atkinson, *Member*
Miller & Chevalier, Chartered
katkinson@milchev.com
202-626-5957

Doing Business in China: Third Party Corruption Risks

- Corruption risks created by third party agents
- Third party due diligence
- Contracting with third parties
- Monitoring of third-party risk
- Best practices for minimizing third party risk

FCPA Enforcement Snapshot

- Continuing commitment to enforcement
- 40 DOJ/31 SEC enforcement actions in 2010
- Over 100 companies under investigation
- Fines, penalties increasing
- Disgorgement of “profits” now standard
- Successor liability for acquirers
- Continuing obligations, *e.g.*, monitor or self-monitoring and reporting

FCPA: Antibribery Elements

- No ***Issuer, Domestic Concern***, or person in U.S.
- May ***corruptly***
- Take action ***in furtherance of*** payment or a promise, offer, or authorization of payment
- Of a bribe or ***anything of value***
- ***Directly or indirectly***
- To a ***foreign official***
- To ***obtain or retain business*** or ***improper advantage***

China: Corruption Snapshot

- TI Ranking: 78 out of 178 (score of 3.5 indicates relatively high level of corruption)
- At least 3% of China's annual GDP is lost to corruption
(Source: Business Corruption Portal, *available at* <http://www.business-anti-corruption.com/country-profiles/east-asia-the-pacific/china/snapshot/>)
- 18 corporate cases involving China in the last 5 yrs (13 of those involving 3d parties), 20 corporate cases involving China in the last 10 years
- 2006 to 2010: 146 of 200 DOJ/SEC FCPA enforcement actions involved 3d parties

Unique Aspects of Doing Business in China

- Mandarin language
- Cultural expectations
 - Personal connections, gifts as legitimate hospitality, “face”
- Different forms of government and legal systems
 - Opaque, decentralized
 - Local v. national political scenes
- Red tape

Special FCPA Risks in China

- **Broad definition of foreign official:**
 - Employees of “instrumentalities” of the Chinese government (e.g., employees of a state-owned tobacco company)
 - Political party officials
- **Use of intermediaries:**
 - Consultants, distributors, travel agents, design institutes
- **Travel:**
 - Sightseeing trips, meetings at resorts, family members
- **Gifts and entertainment:**
 - Chinese New Year’s gifts, gift cards, karaoke
 - Internships, employment for family members
- **Financial red flags:**
 - Fake fapiaos, offshore bank accounts, corporate cash desks, deceptive pricing arrangements, lump sums characterized as “consulting” fees, third party accounts

FCPA Third Party Liability

- FCPA provides for vicarious liability for 3rd party payments:
 - Payment “while knowing” there is a “high probability” that the payment will pass through to an official
- For example, payments through distributors (InVision), sham consultants (UTStarcom), design houses (ITT), and travel agents (IBM)

Chinese Anti-Corruption Laws

- Criminal Penalties

- PRC Amended Criminal Law (1997, amended 2011)
- Supreme People's Court interpretations (2007 and 2008)
- *Guidance from* Supreme People's Procuratorate and Ministry of Public Security rules

- Administrative Penalties

- Anti-Unfair Competition Law (1993)
- Provisional Regulation regarding Prohibition of Commercial Bribery (1996)
- Regulation on Punishment of Civil Servants of Administrative Organs (2007)
- Implementing rules on combating commercial bribery issued by various governmental agencies

Chinese Anti-Corruption Laws

- Facilitating or “grease” payments
 - No provision allowing such payments
 - Provisional Regulation regarding Prohibition of Commercial Bribery permits “small value” promotional gifts in accordance with commercial customs
 - “Small value” is undefined
 - Official must register receipt of “small value” gifts
 - Gifts may not be intended to influence the official’s performance of public duties

China's Version of the FCPA

- China's Amended Criminal Law (February 2011):
 - Amendment to existing law to prohibit bribery of foreign officials as well as Chinese officials
 - Applicability: Chinese citizens (worldwide), foreign citizens within China, and all companies organized under the laws of China (including JVs)
 - Effective May 1, 2011

Recent FCPA Cases involving China

- **Rockwell Automation (May 2011)**

- Facts: Former Chinese subsidiary made payments to state-owned enterprises that could influence contract awards by state-owned customers; also funded sightseeing and other non-business trips for employees at state-owned companies, including trips to New York City, Washington D.C., and Hawaii.
- Outcome: \$2.8 million in disgorgement, interest, and civil penalties.

- **IBM (March 2011)**

- Facts: A subsidiary and JV in South Korea paid cash for contracts and recorded the amounts as legitimate business expenses. In China, subsidiaries created slush funds with local travel agents and other business partners through false and/or inflated invoices. Slush funds were used to pay for foreign travel by officials and gifts (cash gifts, cameras, computers).
- Outcome: \$10 million in disgorgement, pre-judgment interest and civil penalties.

Recent FCPA Cases involving China

- **RAE Systems (2010)**

- Facts: Two RAE JVs provided gifts totaling \$400,000 over five years to officials in order to obtain contracts. Gifts included a computer, jade, fur coats, kitchen appliances, business suits and high-price liquor.
- RAE chose not to conduct due diligence on one JV. For the other JV, it did conduct due diligence, but ignored facts indicating that bribery was part of its way of business (\$500,000 in cash advances not supported by fapios, allegations of bribery from a former manager)
- Outcome: \$3 million in criminal and civil penalties, required to self-monitor and report its remediation efforts.

Recent FCPA Cases Involving China

- **ITT (2009)**

- Facts: Company's Chinese subsidiary offered payments to employees of design institutes that assisted in designing large infrastructure projects in China so institutes would favorably rate subsidiary's water pumps to SOEs responsible for development projects. Some of the institutes were SOEs. After project SOEs paid subsidiary for water pumps, subsidiary made wire transfers to design institute's employees or provided checks made out to "cash." Over \$200,000 spent on such payments.
- Outcome: \$1.67 million in civil penalties, disgorgement and interest.

Recent FCPA Cases involving China

- **UTStarcom (2009)**

- Facts: Company's Chinese subsidiary spent \$7 million on 225 ostensibly work-related training trips for Chinese government customers. Trips to Las Vegas, Hawaii and other tourist destinations were in reality for entertainment purposes. Company also provided lavish entertainment and gifts, including rare bottles of French wine, to Thai officials while bid was under consideration, among various other improper payments. Company also paid salaries and benefits to Chinese officials who did not perform work.
- Outcome: \$3 million in criminal and civil penalties, required to self-monitor and report its remediation efforts.

Recent FCPA Cases involving China

- **Avery Dennison (2009)**

- Facts: Company's Chinese subsidiary engaged in various schemes to obtain Chinese government contracts. Among other improper payments, the subsidiary provided several pairs of shoes to officials of an entity that conducted inspections of Company's products, and paid for several sightseeing trips for other government officials.
- Outcome: \$318,000 in disgorgement and interest, \$200,000 civil fine.

- **Lucent Technologies (2007)**

- Facts: Company spent \$10 million funding the travel of over 1000 Chinese officials, who were either prospective or existing customers, to Disneyland, Las Vegas, and the Grand Canyon.
- Outcome: \$1 million criminal fine, \$1.5 million civil fine, required to implement a rigorous compliance regime.



Third-Party Corruption Risks When Doing Business in China

Strafford Publications

Susan Ringler

ITT - Sr. Counsel for International Compliance

703-790-6317

Susan.Ringler@itt.com



Engineered for life

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Addressing Third-Party Corruption Risk

- Anti-Corruption Training for ITT staff and Third-Party Representatives
- Independent Due Diligence Review of Third-Parties with Renewal Process
 - Agents, Distributors, Consultants, Customs Brokers, Freight Forwarders, in-country service providers
- Third-Party Contracts with Standard Anti-Corruption clauses and certifications
- Appropriate Monitoring/Risk Mitigation for Third-Parties and Exercise of Audit Clause, as appropriate
- Oversight, Oversight, Oversight – China is a dynamic and ever changing environment

Third-Party Due Diligence – Preliminary Considerations

- Issues to consider before initiating your due diligence review process for a particular third party in China:
 - Challenging environment for implementing compliance measures;
 - Critically important to train your international sales and marketing team in China about the PRC laws and FCPA – *AND your due diligence process*;
 - **Who is a government official:** whether to research ownership of every third-party before deciding whether due diligence is necessary or treating all third parties as government owned or controlled
 - Availability and integrity of publicly available records;
 - Language considerations;
 - Sophistication of third parties;
 - Have your business team advise your potential third-parties about the due diligence process; why it is being conducted; the third-party's role; Company's expectations.

What Level of Review is Required?

- **Conduct an Internal Risk Analysis for your China Third-Parties in order to appropriately allocate resources:**
 - Joint Venture and Consortium Partners
 - Commission Agents
 - Distributors: exclusive v. non-exclusive
 - Consultants
 - Customs Brokers, Freight Forwarders, Expeditors
 - Professional Service Providers

Conducting the Due Diligence Review

Well document your review process. Consistent application.

- **Agents and Distributors:**

- Interview conducted by Legal or Business team –

- Certification by business that they are not aware of any corruption/improper conduct issues;

- Discussion of US and China (PRC) anti-bribery laws and your company Code of Conduct. Provide third-party with a copy of your Code in Mandarin;

- Provide summary of the U.S. Foreign Corrupt Practices Act (in Mandarin) and have the third-party sign off that they have received it.

Conducting the Due Diligence Review

Review at least the following information:

- **Business Ownership**
- **Description of the Business**
 - Copies of required business registration(s)
 - CVs (resume) for owners, partners, shareholders and Board
 - Reference Information:
 - 3-4 external business references
 - 1 financial reference, and/or recently audited financial statement, if available
- **Personnel Information:** identification of “Key People” working for the business (owners, partners and shareholders, board members and key employees)
- **Compliance Information:** about past and current regulatory compliance (debarments, litigation, written policy on bribery, method of payment and country of payment)
- Also review potential conflict of interest issues between your business team and third-party candidates

Review Third-Party Registrations

- Review the third-party's registration documents:
 - Chinese 2004 Administrative Procedures on Intermediaries requires that any individual or commercial entity that intends to serve as an Intermediary be registered with the local office of the State Administration of Industry and Commerce ("SAIC") unless the scope of the general business license already permits the company to engage in intermediary activities.
- The 2004 Foreign law also requires any individual or commercial entity that engages in import and export activities to register with the Ministry of Commerce or its local authorized agency.

Monitoring of Third-Parties

The background review and company approval is the first step in your relationship with a third-party

- Once approved, the Monitoring of the third-party by the business is critical to your program:
 - annual on-line training
 - annual in person meeting by the business with the third-party
 - annual Compliance Certification – both by the third-party and more generally by your on the ground sales and marketing team working with third-parties
 - Consider whether to execute your contract audit clause
 - Conducting periodic internal reviews of commission payments/discounts offered to distributors for any ‘red flags’.

Monitoring of Third Parties

- **Gift/Hospitality giving culture: keep an eye on gifts, hospitality and travel provided by the third-party to your customers:**
 - Karaoke
 - Red envelopes
 - White envelopes
 - Gifts at contract signing
 - Moon cakes
 - Golf outings, meals and entertainment

Consider a Certification with the contract.

- **Periodic updates to the due diligence review information:**
 - May find frequent company name changes as well as changes in ownership and key personnel. It is important to conduct additional inquiries about these changes.
- **Media searches**

Joint Venture and Consortium Partners

- **Some additional considerations:**
 - Typically your end user customer is a government entity
 - Joint and several liability
 - Degree of ownership by your company in the potential project
 - Understand why the business team is of the view that this is an appropriate partner
 - Whether partners are selected by the government
 - Use of design institutes in China
 - Subcontractors
- **Consider a more rigorous review given the potential risk**
 - Use of outside service provider to conduct both: (1) an open records review; and (2) interviews of sources familiar with the third-party regarding the candidate's financial situation and its reputation from an ethics and compliance perspective. Is the company known to engage in corrupt practices?

Joint Venture and Consortium Partners

- **Be aware that many large government entities in China work through subsidiaries, branches and affiliates. It is very important to know the exact entity that will be your partner.**
 - There may be situations where the branches, subsidiaries and affiliates are required to pay kickbacks to the parent entity.
- **Consortium Contract**
 - Compliance Certifications
 - Consider a Compliance Program attachment so that the parties understand and agree to certain monitoring and training:
 - On-line training in Mandarin
 - Periodic reviews
 - Audit clause
 - Availability of resource for reporting improper conduct

Risk Mitigation is an Ongoing Process

- Addressing anti-corruption risk is a continuous and on-going process:
 - Reassessment of FCPA compliance risk
 - Monitoring program adequacy
 - Proactive program management and improvement to mitigate risks
 - Reviewing internal controls and their adequacy to address the risks
 - Close cooperation with Finance and Internal Audit
 - Close cooperation between Legal, Compliance and your on the ground international sales and marketing teams.

CONTRACTING WITH AND MONITORING THE ACTIVITY OF THIRD PARTY AGENTS IN CHINA

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Ed Fishman
K&L GATES LLP
1601 K Street, NW
Washington, DC 20006-1600
(202) 778-9456
ed.fishman@klgates.com

Overview of Presentation Topics

- Review “Best Practices” for Contracting with Third Party Intermediaries in China
- Discuss Practical Challenges of Monitoring Third Party Activity in China
- Dealing with Potential Misconduct by Chinese Intermediaries and Minimizing Associated Risk

Contracting with Third Parties in China

What are the key risk mitigation steps?

- Completion of robust anti-corruption and conflict of interest diligence prior to engagement
- Written agreement approved by U.S. and Chinese counsel (English and/or Chinese versions)
- Enforceable dispute resolution provisions
- Audit and other active monitoring rights that will be accessible in the event of a dispute

Contracting with Third Parties in China

How to best impose FCPA compliance obligations?

- Contractual representations and warranties
- Certification of compliance (see attached sample)
- Provide copy of anti-corruption policy (translated into Chinese) and require confirmation of receipt/understanding by third party
- Provide customized training (in Chinese) to representatives of third party

Contracting with Third Parties in China

What special considerations for Chinese JVs?

- Management and control provisions in JV Agreement
 - Which party has control of day-to-day activities?
 - How should governance provisions be structured?
- Allocation of compliance obligations
 - Which party will be responsible for obtaining permits and licenses?
 - Will JV be subject to compliance policies and procedures of US partner?
- Books and records of the JV
 - What financial documentation standards will be applied to the JV?
 - What internal control requirements will be imposed on the JV?

Monitoring Compliance by Third Parties in China

What best practices for monitoring FCPA compliance?

- Compliance audits and inspections
 - Practical challenges to enforcing contract rights in China
- Review and approval of government interactions
 - What level of oversight is appropriate when dealings often based on relationships (“guanxi”) ?
- Periodic review of expenditures and supporting documentation
 - Challenges with obtaining receipts (“fa piao”) in cash-based economy
- Process for approving travel, gifts and entertainment
 - e.g. IBM (China) – collusion with third party travel agents
- Obtaining periodic activity reports
 - What level of detail is appropriate?

Enforcing Compliance in China

What to do when Chinese third party engages in potential wrongdoing?

- Review and investigation of relevant facts
 - Avoid making decisions or disclosures based on partial review
 - Consider difficulties in obtaining access to relevant evidence
- Evaluate contractual options
 - Review strength of dispute resolution mechanisms (e.g. termination and recovery)
 - Consider local law and public relations issues (e.g. violation of Chinese anti-competition or other laws; public disclosure; potential harm to reputation)
 - Practical impact of terminating third party or disavowing their conduct
- Evaluate FCPA voluntary disclosure considerations
 - Jurisdictional considerations
 - Disclosure to outside auditors

Mitigating Third Party FCPA Risk in China

What are some key considerations for mitigating third party FCPA risk in China?

- Effective and robust due diligence
- Clear allocation of compliance obligations
- Good visibility into activities of third party
- Effective review and approval mechanisms
- Enforceable dispute resolution provisions
- Prompt response to potential “red flags”

QUESTIONS?

- Contact:

Ed Fishman

K&L Gates LLP

1601 K Street N.W.

Washington, D.C. 20006

(202)778-9456 (direct)

ed.fishman@klgates.com

Appendix: Sample Third Party Certification

- **“Applicable Anti-Corruption Laws”** means collectively, (i) the U.S. Foreign Corrupt Practices Act (“FCPA”), (ii) laws enacted pursuant to the Organization of Economic Cooperation and Development (OECD) Convention on Combating Bribery of Foreign Public Officials in International Business Transactions (“OECD Convention”), and (iii) any other applicable laws or regulations of relevant jurisdictions prohibiting bribery and corruption of public officials.
- **“Government”** includes, without limitation: (a) any government, including all levels and subdivisions of government from national to local; (b) any government agency, department, committee or other instrumentality; (c) any government-owned or government-controlled entity; (c) any political party; and (d) any public international organization (including, for example, the United Nations, the World Bank, and the International Monetary Fund).
- **“Government Official”** means an employee, official, legislator, member, agent or representative of any **Government**, or any candidate for any such position.
- **“Third Party Agent”** includes **[Third Party Agent]**, and any predecessors and all subsidiaries or affiliates of these entities. **“Third Party Agent Personnel”** includes all employees, officers, directors, shareholders, representatives and agents of **Third Party Agent**.

Appendix: Sample Third Party Certification

- **Third Party Agent** is familiar with and understands the requirements and prohibitions of the **Applicable Anti-Corruption Laws**;
- In connection with its role as agent for **Company**, **Third Party Agent** has complied and will at all times stay in compliance with the requirements and prohibitions of the **Applicable Anti-Corruption Laws** for as long as it remains an agent for **Company**;
- **Third Party Agent** understands and certifies that it cannot and will not, under any circumstances, make, offer, promise, or authorize a payment or gift of money or anything of value (including, but not limited to, any loan, reward, advantage or benefit of any kind) to (i) a **Government Official**, (ii) a family member of a **Government Official**, or (iii) to any other person or entity with the knowledge or belief that such thing of value might subsequently be given to a **Government Official** or a family member thereof for purposes of obtaining or retaining business, or obtaining a business advantage, for **Company** or any other party;

Appendix: Sample Third Party Certification

- **Third Party Agent** understands and certifies that it cannot and will not assign any right to compensation or reimbursement from **Company** to any third party;
- **Third Party Agent** understands and certifies that it must keep complete and accurate books and records related to its services and activities on behalf of **Company**;
- **Third Party Agent** certifies that it will, upon request, make its books and records available to **Company** or its designees for inspection to verify compliance with **Applicable Anti-Corruption Laws**;
- **Third Party Agent** certifies that it will notify **Company** immediately of any request received by **Third Party Agent** to make, authorize or facilitate a payment of money or anything of value in violation of **Applicable Anti-Corruption Laws**;
- No **Third Party Agent Personnel** are **Government Officials** or family members of a **Government Official**. If any **Third Party Agent Personnel** becomes a **Government Official** during the term of the Agreement, **Third Party Agent** will promptly inform **Company**;

Appendix: Sample Third Party Certification

- **Third Party Agent** certifies that neither **Third Party Agent** nor any **Third Party Agent Personnel** has ever been implicated, accused, investigated, charged, arrested, or prosecuted for bribery or making corrupt payments to any **Government Official**;
- **Third Party Agent** certifies that neither **Third Party Agent** nor any **Third Party Agent Personnel** has ever been fined, penalized, or convicted for any violation of any **Applicable Anti-Corruption Laws**; and
- **Third Party Agent** certifies that neither **Third Party Agent** nor any **Third Party Agent Personnel** has ever been or is currently under investigation for alleged corruption, bribery or fraud.