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# FCPA Enforcement Activity and Severity of Penalties Relating to Business Activities in China Likely To Increase Dramatically As Global Trade With China Surges To Record Levels

This year marks the 30th anniversary of the enactment of the Foreign Corrupt Practices Act of 1977 ("FCPA"). During the last several years, U.S. authorities have made enforcement of the anti-bribery and recordkeeping provisions of the FCPA a significant priority by initiating numerous investigations and enforcement proceedings. The severity of criminal and civil penalties arising from such enforcement activity has increased dramatically.

Over the last year, the Chinese government also has intensified its campaign against corruption and significantly increased enforcement of its anti-bribery laws. This has resulted in high-profile dismissals or detentions of some very senior officials in government agencies and state-owned enterprises, as well as the arrests of several executives of multinational companies.

China's anti-bribery laws apply to both domestic and foreign companies. Thus, U.S. companies and foreign companies that do business in China must comply with both local as well as home country laws (including, for U.S. and many foreign companies, the FCPA). China's economy as well as foreign trade and investment in China are growing rapidly. By many accounts, China will become the largest economy in the world in less than five years.[1] Chinese government authorities are procuring goods and services at a record pace in preparation for the Beijing Olympics and as part of an unprecedented boom in infrastructure development.

From an FCPA compliance standpoint, businesses face similar risks in China as in many other parts of the world and the steps businesses should take to reduce those risks are similar. In China, as the market for selling goods and services to government-owned or government-controlled entities expands, and the global competition among firms intensifies, companies must ensure that their internal compliance programs keep pace with their increased level of business activity.

This Alert provides a brief overview of the key provisions of the FCPA, describes some of the potential risks of doing business from an FCPA compliance standpoint, and outlines various steps that companies subject to the FCPA can take to mitigate those risks.

1 Including Hong Kong, China already is the third-largest export market in the world for U.S. businesses behind Canada and Mexico. See "U.S. Exporters Feel Favorable Trade Winds," Washington Post at Section D page 1 (January 30, 2007).

## Overview of FCPA

The FCPA was enacted in 1977 following a series of admissions that large U.S. companies paid bribes to foreign government officials, politicians and political parties in order to obtain or retain business. The FCPA has two primary components -- the anti-bribery provision enforced primarily by the U.S. Department of Justice ("DOJ"), and the "books and records" and "internal controls" provisions enforced primarily by the SEC. The anti-bribery provision generally applies to (i) any U.S. or non-U.S. company issuing securities registered with the U.S. Securities and Exchange Commission ("SEC") under Section 13 of the Securities Exchange Act of 1934 or filing reports with the SEC under Section 15(d) of the Securities Exchange Act of 1934 (collectively, "Issuers"), (ii) any other entities organized under U.S. law or having a principal place of business in the U.S., or any U.S. citizens, nationals or residents (collectively, "Domestic Concerns"), and (iii) any U.S. or foreign agent of the foregoing entities.[2] The accounting provisions of the FCPA generally apply to Issuers, wholly-owned or controlled subsidiaries of Issuers, and their respective directors and officers.

## FCPA Anti-Bribery Provision

The anti-bribery statute generally prohibits Issuers, Domestic Concerns and their officers, directors, employees and agents from corruptly offering "anything of value" to a foreign government official, foreign political party or candidate for foreign office to influence an official act or secure an improper advantage in order to obtain or retain business. An employee of a state-owned or state-controlled corporation qualifies as a foreign government official under the FCPA.

The anti-bribery statute contains an exception for making small "facilitating payments" to induce low-level foreign government officials to perform ministerial or routine acts. For example, paying a small sum of money to a foreign customs agent to expedite the paperwork necessary to receive a shipment of imported goods would most likely qualify as a "facilitating payment." However, making payments to influence a discretionary function (such as awarding a contract for supplying goods) most likely would not fall within the exception.[3]

Under the vicarious liability provisions of the anti-bribery statute, a U.S. company or foreign issuer may be liable for corrupt payments made by foreign affiliates or third party agents if the company knew or should have known of the "high probability" that such payments were made. This standard was enacted to prevent companies from adopting a "head in the sand" approach regarding the activities of their foreign affiliates and agents. The DOJ has identified a number of "red flags" that could be sufficient to put a company on notice of corrupt conduct by its foreign affiliates or agents. These "red flags" include a pattern of corruption in the country at issue, a refusal by those affiliates or agents to provide FCPA compliance certifications, abnormally large commissions or cash transactions with third party agents, lack of transparency in expenses and accounting records, and requests for payments to a third party rather than the intermediary.

## FCPA Accounting Provisions

The FCPA's accounting provisions generally require Issuers to maintain accurate "books and records" and to establish and maintain an effective system of "internal controls" to account for transactions and assets. These requirements are designed to ensure the integrity and transparency of financial information presented to the investing public and to prevent and detect foreign bribery and other improper financial activity.

The "books and records" statute requires Issuers to maintain "books, records and accounts which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer." The "internal controls" statute requires Issuers

2 The anti-bribery provision of the FCPA also applies to any other foreign national or entity that takes an act in the U.S. in furtherance of a corrupt payment. See 15 U.S.C. §§78-dd-1, 78-dd2, 78-dd3.

3 In addition to the safe harbor for such "facilitating payments," it is an affirmative defense to an anti-bribery violation if the conduct at issue was lawful under the written laws of the applicable foreign jurisdiction.

to devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances that transactions are executed and recorded as authorized by management. [4]

The FCPA's accounting provisions do not contain a materiality standard, and no proof of knowledge or intent is required to establish a civil violation. Moreover, the SEC has the authority to enforce the accounting provisions even if there is no jurisdictional basis (i.e., no U.S. connection and no "red flags") for an anti-bribery violation. To the extent there is a "willful" violation of the "books and records" or the "internal controls" provision, the DOJ would have criminal enforcement authority.

In most situations involving improper foreign payments, the SEC typically charges a company with violating both the "books and records" provisions and the "internal controls" provisions of the FCPA. The SEC takes the position that the use of funds for a purpose other than that recorded on its books is sufficient to support a "books and records" violation. In other words, an improper payment to a foreign government official that is not described as a "bribe" on a company's books and records is a violation (in the SEC's view) of the "books and records" provision and most likely also will result in a violation of the "internal controls" provision of the FCPA.

## Penalties and Other Adverse Consequences of FCPA Violations

A violation of the anti-bribery provision could result in criminal fines of up to $2 million *per violation* for covered U.S. and foreign companies, and criminal fines of up to $250,000 and imprisonment for up to 5 years *per violation* for covered individuals. Alternatively, there is a statutory maximum fine equal to twice the economic gain or loss attributable to the anti-bribery violation.[5]

A violation of the accounting provisions could result in civil penalties of up to $500,000 for covered U.S. and foreign companies and $100,000 for individuals. Moreover, in addition to the issuance of a cease and desist order, the SEC has the authority to order a disgorgement of any profits (plus prejudgment interest) attributable to the violations of the accounting provisions. The disgorgement remedy has been a significant and frequently used remedy in the last few years. A "willful" violation of the accounting provisions could result in criminal fines of up to $25 million for covered U.S. and foreign companies, and up to $5 million and imprisonment for up to 20 years for individuals.[6]

In addition to the foregoing criminal and civil penalties, an FCPA violation could have a significant negative impact on a company's reputation and goodwill, could result in lawsuits from disgruntled competitors, and could have a substantial impact on a company's ability to operate and expand its business through debarment proceedings or the termination of employees involved in the improper conduct. Moreover, a company could be subject to multiple, parallel enforcement proceedings in other jurisdictions under anti-corruption laws implemented as a result of the OECD Convention or other international regimes. Finally, a potential merger or acquisition could be jeopardized by the discovery of potential FCPA violations.[7]

## FCPA Risk Not Limited to U.S. Companies

The risk of violating the FCPA is not limited to U.S. companies. As noted above, the anti-bribery and accounting provisions apply to any non-U.S. company that issues securities registered with the SEC under Section 13 of the Exchange Act of 1934 or files reports with the SEC under Section 15(d) of the Exchange Act of 1934. Thus, many non-U.S. companies that are active participants in the U.S. financial markets may be subject to FCPA requirements. In addition, any non-U.S. company that acts in the U.S. in furtherance of a prohibited payment scheme will be subject to the jurisdiction of the U.S. authorities under the FCPA.

4 The FCPA accounting provisions only apply to Issuers and certain subsidiaries and affiliates. Issuers are required to ensure that their wholly-owned subsidiaries, and any other affiliates over which they have actual control, comply with the accounting provisions. In addition, Issuers are required to make good faith efforts to ensure that affiliates owned fifty percent (50%) or less comply with the accounting provisions. See 15 U.S.C. § 78m.

5 See 18 U.S.C. § 3571(d).

6 See 15 U.S.C. § 78u, u-2, u-3.

7 Lockheed Martin's proposed acquisition of Titan Corporation was scuttled after it was discovered during the due diligence phase that Titan had engaged in potential serious violations of the FCPA.

A recent FCPA settlement involving Statoil, a Norwegian oil company whose securities trade on the New York Stock Exchange, highlights the potential risk faced by non-U.S. companies under the FCPA.[8] Statoil agreed to settle parallel investigations by the DOJ and the SEC arising out of a bribery scandal involving an Iranian official. According to the SEC administrative settlement order, Statoil allegedly made approximately $5 million in payments from a U.S. bank account to a high-level Iranian oil official through a "consulting contract" with an offshore intermediary company. The Iranian official allegedly helped Statoil obtain an oil field development contract in Iran by providing Statoil employees in Iran with copies of bid documents from competitors and other non-public information. The SEC also alleged that Statoil local management concealed the true nature of the consulting arrangement, that senior management refused to take appropriate action to cease the improper arrangement, and that Statoil mischaracterized the payments as "consulting fees" in its books and records.

Statoil agreed to pay a $10.5 million criminal fine as part of a deferred prosecution agreement with the DOJ[9] and also agreed to disgorge $10.5 million in alleged profits in a parallel SEC settlement. The SEC settlement also required Statoil to retain an independent compliance monitor for a three-year period to review and evaluate Statoil's internal controls, recordkeeping and financial reporting policies as relevant to FCPA compliance. The compliance monitor, after developing a review plan in consultation with DOJ and SEC staff, is required to issue written reports of its findings and Statoil is required to adopt any recommendations made in those reports. This type of compliance monitor arrangements is becoming common in FCPA settlements, even with respect to non-U.S. companies.

The Statoil matter is significant for a number of reasons. First, it represents the first time that U.S. authorities have brought criminal FCPA charges against a non-U.S. company that issues securities in the U.S. Second, the $21 million settlement and the imposition of a compliance monitor is one of the harshest penalties ever imposed under the FCPA on a foreign issuer. Third, the Statoil situation involved a criminal settlement with Norwegian authorities for the same conduct. The involvement of non-U.S. jurisdictions in the investigation and prosecution of such matters is a trend that will continue given the recent proliferation in anti-corruption legislation outside the U.S.

## Recent FCPA Matter Involving China

In October 2006, Schnitzer Steel Industries, Inc. ("Schnitzer") and its Korean subsidiary entered into a deferred prosecution agreement with the DOJ and a settlement agreement with the SEC as a result of alleged improper payments in China.[10] Schnitzer is an Oregon-based steel company that sells scrap metal through its Korean subsidiary to entities in China that are owned in whole or in part by the Chinese government. Over a five year period, Schnitzer's Korean subsidiary allegedly made approximately $200,000 in cash payments and other expensive cash gifts (including $10,000 in gift certificates) to managers of government-owned steel mills in China in order to induce those mills to purchase scrap metal from Schnitzer. According to the SEC settlement, Schnitzer falsely described those payments in its books and records as "sales commissions," "refunds" or "rebates." The SEC also stated that, after Schnitzer's compliance department uncovered the improper payments, a senior executive authorized additional payments and told employees to increase entertainment expenses in lieu of cash payments.

In settling the alleged violations of the anti-bribery and accounting provisions of the FCPA, Schnitzer agreed to disgorge to the SEC approximately $7.7 million in profits and prejudgment interest. As part of a deferred prosecution agreement with the DOJ, Schnitzer agreed to retain an independent compliance monitor to review the company's FCPA compliance policies and procedures for a three-year period. Schnitzer's Korean subsidiary also agreed to pay a $7.5 million criminal penalty as part of a plea agreement for violating, among other laws, the FCPA anti-bribery provisions and the federal wire fraud statute.

The Schnitzer settlement illustrates a number of areas for careful consideration. First, it involves alleged payments to managers of government-owned business enterprises in China. A similar situation arose in May 2005 in the DPC Tianjin matter, where a Chinese

8 See In the Matter of Statoil, ASA, SEC Administrative Proceeding File No. 3-12453 (October 13, 2006).

9 Statoil was given credit for $3 million of this $10.5 million penalty as a result of a payment it made to Norwegian criminal authorities.

10 See In the Matter of Schnitzer Steel Industries, Inc., SEC Administrative Proceeding File No. 3-12456 (October 16, 2006).

subsidiary of a U.S. company was charged with violating the FCPA anti-bribery provision as a result of alleged payments to physicians and laboratory personnel employed by government-owned hospitals in China.[11] These cases highlight the risks of transacting business in China from an FCPA compliance standpoint, since many of the commercial enterprises remain wholly or partially owned by state or local government entities. Second, the Schnitzer settlement is noteworthy because the settlement agreements allege that Schnitzer had provided no FCPA training or education to any of its employees, agents and subsidiaries. This alleged lack of training, coupled with apparent actions by senior company officials to authorize continued improper payments after initiating an internal investigation, may account for the magnitude of the total settlement amount (approximately $15 million).

## Potential FCPA Risks in China

From an FCPA compliance standpoint, many of the potential FCPA problems are common throughout the world, but in China businesses are more vulnerable, largely because of the structure of the Chinese economy. First, as mentioned above, many business enterprises in China remain owned or controlled by government authorities. As the Schnitzer and DPC Tianjin settlements illustrate, the FCPA definition of a "foreign official" extends to managers and employees of government-owned enterprises such as hospitals or steel mills.

Second, it is common for foreign companies operating in China to rely on joint venture partners or local third party agents to navigate the local market and government approval processes. The reliance on such partners or agents, who may not be thoroughly familiar with the requirements of the FCPA, creates a substantial risk that their interactions with Chinese government officials could result in questionable payments or other conduct that could violate the FCPA. This is a particular concern if the U.S. or other non-Chinese company does not have any on-the-ground presence in China, but merely acts through third-party distributors or other agents that may be competing for business (and their commissions) with Chinese companies.

Third, it is common business practice in China to exchange gifts with and attend social and other entertainment events with customers and potential customers. This is an area of major concern from an FCPA compliance standpoint. The Schnitzer matter allegedly involved the provision of improper gifts, including a gift certificate worth $10,000 and watch worth $2,400, to manager of Schnitzer's scrap metal customers. From a books and records standpoint, the Chinese system of receipts ("fa piao") results in less detail than is customary under standard U.S. practices and therefore heightens the FCPA risk associated with petty cash, per diem and other payment practices.

Fourth, Chinese authorities recently have focused their attention on the enforcement of China's anti-bribery laws. The New York Times recently reported that more than 20 employees of several multinationals were arrested in Shanghai on suspicion of paying bribes to obtain business.[12] In the last few years, Chinese authorities have arrested several government officials (including the chairman of China Construction Bank) in connection with suspected bribery arrangements, some of which have involved U.S. companies. The active involvement of Chinese authorities in this area will likely bring potential FCPA violations to the attention of U.S. authorities through shared information or voluntary disclosures by the companies involved.

## Mitigating FCPA Risk

There are a number of steps that companies subject to the FCPA can take to mitigate the risk of compliance problems in connection with their operations in China and other parts of the world. These steps include, but are not limited to, the following:

- Strengthen FCPA Compliance Program. A comprehensive internal compliance program is the cornerstone of any strategy to minimize FCPA risk. In addition to reducing the likelihood of an FCPA violation, an

11 See In the Matter of Diagnostic Products Corporation, SEC Administrative Proceeding File No. 3-11933 (May 20, 2005); Department of Justice Press Release, "DPC (Tianjin) Ltd. Charged With Violating The Foreign Corrupt Practices Act" (May 20, 2005). These alleged payments in the amount of $1.6 million were made to induce those employees to buy medical products and services from DPC Tianjin, which is a wholly-owned subsidiary of a U.S. company.

12 See "Shanghai Bribery Inquiry Ensnares Big Firms" by David Barboza, New York Times (January 19, 2007).

adequate compliance program will be a mitigating factor in assessing the culpability of a company and its senior executives in the event that an FCPA violation does occur. Where feasible, the FCPA compliance policy should be tailored to any particular risks arising from such operations in the particular country (including the use of third party agents and the potential application of any local anti-bribery laws).

- FCPA Training and Education. As noted above, the alleged fact that Schnitzer had no FCPA training or education for its employees, agents and subsidiaries most likely contributed to the severity of the penalty imposed in that matter. A detailed FCPA compliance policy is not very helpful if the policy is not disseminated effectively to and understood by all relevant employees and third party agents, including employees and agents in overseas locations such as China (which may necessitate translating the policy into Chinese or, at a minimum, holding live training and education sessions with those individuals).

- Due Diligence on Sales Agents and Other Third-Party Consultants. The unsupervised use of sales agents, tax consultants, lobbyists, and other third party consultants is a breeding ground for potential FCPA problems. A company should have qualified U.S. and foreign legal counsel review and approve any contracts or other arrangements with such consultants. Any such contract should include, among other requirements, a representation and warranty that the consultant (i) has reviewed, understood and agrees to comply with the company's FCPA policy, (ii) agrees to certify such compliance on a regular basis, (iii) is not a foreign official or related to a foreign official, (iv) agrees to comply with any applicable local laws, and (v) agrees to indemnify the company for any breach of the foregoing representation and warranty. Moreover, a company must perform thorough due diligence on these consultants through proper channels.

- Due Diligence in M&A Transactions. The U.S. authorities take the position that companies inherit FCPA successor liability as a result of an M&A transaction. Thus, potential FCPA liability should be considered prominently in M&A due diligence activities. This due diligence should include a thorough review of the target company's internal controls, its dealings with third party agents and consultants and any dealings with foreign government officials.

- Appointment of Chief Compliance Officer. One compliance technique favored by many multinational companies is the appointment of a Chief Compliance Officer that is responsible for overseeing compliance with FCPA and other ethical and corporate responsibility issues. The Chief Compliance Officer also may be responsible for responding to FCPA issues reported on any confidential "hot-line" or other reporting mechanism established by the company to monitor compliance.

- Prompt Response to Possible FCPA Violations. If a potential FCPA violation comes to a company's attention, the company should conduct a prompt and thorough initial investigation to determine the nature of the potential violation, the adequacy of the controls in place to prevent such occurrences, and the steps necessary to remedy control deficiencies. The investigation should be conducted with local assistance to account for language and other cultural issues. Decisions must be made quickly about whether to

discipline any involved employees, change any internal controls, and/or report the matter to U.S. or foreign authorities. These are complex strategic decisions that should be made with the advice of experienced FCPA and foreign local counsel.

A thorough understanding of the particular market and industry is necessary in order to devise and implement a workable and effective FCPA compliance policy. The familiarity, experience and capabilities of our lawyers in the China, Hong Kong and Taiwan markets enable us to be of unique assistance with respect to our clients' operations in these markets.

## Conclusion

As the Chinese government market for goods and services expands and competition intensifies, U.S. companies and their foreign affiliates, as well as foreign companies that issue securities registered with the SEC, need to remain cognizant of the FCPA and the negative impact that potential FCPA issues arising from their activities can have on their financial health, operational health and reputation. U.S. and foreign companies must ensure that they take the necessary steps to promote and monitor compliance with the FCPA, and to respond swiftly and adequately to potential violations, and thus avoid the possibility of serious criminal and civil penalties.

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