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Three Major Risks Under the Foreign Corrupt Practices Act for U.S. Multinational Companies Doing Business in China

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PANEL ON CHINA AND THE FCPA
THREE MAJOR RISKS UNDER THE FOREIGN
CORRUPT PRACTICES ACT FOR U.S.
MULTINATIONAL COMPANIES DOING
BUSINESS IN CHINA*

Daniel C.K. Chow⁺

INTRODUCTION.....	1183
I. “FOREIGN OFFICIAL”	1184
II. “ANYTHING OF VALUE”	1186
III. THIRD PARTIES AND INTERMEDIARIES.....	1188
A. Third Parties as Business Partners.....	1188
B. Third Parties as Contractors	1189
CONCLUSION	1190

INTRODUCTION

The rise of the People’s Republic China (“PRC” or China) as a global economic power and an attractive destination for multinational companies (“MNCs”) to set up business operations through foreign direct investment has led to a host of new challenges and risks for MNCs. This Article focuses on the risks that arise under the Foreign Corrupt Practices (“FCPA”),¹ which applies with special force to China due to the coalescence of several factors: China’s state-controlled economy, a pervasive business culture in which gifts and favors are

* On January 29, 2014, Fordham Law School and the Chinese Business Lawyers Association jointly hosted a panel titled “China and the Foreign Corrupt Practices Act: Challenges for the 21st Century.” This Article was prepared for Professor Chow’s presentation at the panel. For more information on the panel, visit <http://law.fordham.edu/newsroom/32206.htm>.

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1. See, e.g., 15 U.S.C. §§ 78b, 78dd-1 to -3 (2012).

expected, and in which various forms of petty corruption are common and tolerated.

The FCPA prohibits US companies from corruptly giving bribes or “anything of value” to “foreign officials” for the purpose of obtaining or retaining business.² There are three elements under the statute that create special concerns for MNCs doing business in China: (1) “foreign official”; (2) “anything of value”; and (3) the use of third parties, including parties that make pass-through payments to a foreign official.³ Each of these elements, and examples of the risks involved, are discussed below.

I. “FOREIGN OFFICIAL”

A foreign official is defined under the FCPA as “(1) an employee of a government or instrumentality thereof; and (2) any person acting in an official capacity on behalf of a foreign government.”⁴ In the case of China, this element applies with special force due to the dominance of the economy by state-owned enterprises (“SOEs”). SOEs are “business entities established by central and local governments and whose supervisory officials are from the government.”⁵ SOEs dominate in all core sectors of the PRC economy, such as oil and gas refining and exploration; banking and finance, rail and air transport, steel and metals production, electricity and water supply, and telecommunications.⁶ China has a long term national strategic goal of creating SOEs that are “national champions,” which can compete with the most successful MNCs in the global economy.⁷ At the conclusion of the Third Plenum

2. See 15 U.S.C. §§78dd-1, 78dd-2, 78dd-3 (2012).

3. See 15 U.S.C. §§78dd-1(3), 78dd-2(3), 78dd-3(3).

4. See 15 U.S.C. §78dd-1(f).

5. See OECD Working Grp. on Privatisation & Corporate Governance of State Owned Assets, *State-Owned Enterprises in China: Reviewing the Evidence* 3 (Jan. 26, 2009), available at <http://www.oecd.org/daf/ca/corporategovernanceofstate-owned-enterprises/42095493.pdf>.

6. See DANIEL C.K. CHOW, *THE LEGAL SYSTEM OF THE PEOPLE’S REPUBLIC OF CHINA* 25 (West 2d ed. 2009).

7. See US Int’l Trade Comm’n, *China: Intellectual Property Infringement, Indigenous Innovation Policies, and Frameworks for Measuring the Effects on the U.S. Economy* 5–6, Investigation No. 332-514, USITC Publication 4199 (amended) (Nov. 10), available at <http://www.usitc.gov/publications/332/pub4199.pdf>.

of the Communist Party in November 2013, the Party firmly reiterated this policy by pledging to “incessantly strengthen” the “vitality” of SOEs.⁸

The US Department of Justice (“DOJ”) has indicated that SOEs qualify as an “instrumentality” of a government⁹ and that an employee of an SOE qualifies as a government official.¹⁰ The DOJ states that the FCPA covers “payments to low-ranking employees and high-level officials alike.”¹¹ Given the dominate role of SOEs in China’s economy and the DOJ’s interpretations of the FCPA, some US companies feel compelled to take the position that “everyone they deal with is a ‘foreign official’ because they work for an SOE.”¹²

These elements of the FCPA, combined with China’s state-dominated economy, can give rise to many scenarios on a daily basis that could be potential FCPA violations. For example, suppose that an MNC sets up a business entity in China, a wholly foreign-owned enterprise (“WFOE”) or a joint venture, as required by Chinese law.¹³ The WFOE is a Chinese legal entity that is wholly owned by the MNC while the joint venture is a Chinese legal entity that is owned by the MNC and a local partner, often an SOE.¹⁴ Suppose that the MNC is in the business of manufacturing and selling chemicals and that many customers of the products are SOEs. A sales agent in the MNC might approach a purchasing agent, a low ranking employee, in the SOE and offer a kickback or a bribe if the purchasing agent places a purchase order with the MNC. The sales agent in the MNC’s China business entity knows that it makes no difference to the SOE whether the agent places an order with any

8. See Bob Davis & Brian Spegele, *State Companies Emerge as Winners Following Top China Meeting*, WALL ST. J. (Nov. 13, 2013, 1:09 PM), <http://online.wsj.com/news/articles/SB10001424052702303559504579195551704526972>.

9. See U.S. Dep’t of Justice & Sec. and Exch. Comm’n, A Resource Guide to the Foreign Corrupt Practices Act 20–21 (Nov. 14, 2012) [hereinafter FCPA Resource Guide], available at <http://www.justice.gov/criminal/fraud/fcpa/guide.pdf>.

10. See FCPA Resource Guide, *supra* note 9, at 20.

11. See FCPA Resource Guide, *supra* note 9, at 20.

12. See Declaration of Prof. Michael J. Koehler in Support of Defendants’ Motion to Dismiss Counts One through Ten of the Indictment ¶ 447, *United States v. Carson*, No. SACR 09-00077-JVS (C.D. Cal. Feb. 21, 2011).

13. See DANIEL C.K. CHOW & THOMAS J. SCHOENBAUM, *INTERNATIONAL BUSINESS TRANSACTIONS: PROBLEMS, CASES, AND MATERIALS* 489–90 (2d ed. 2010).

14. See *id.*

particular supplier and the purchasing agent may be indifferent between various suppliers since the agent is paid a fixed salary. The sales agent offers a kickback, paid to the personal account of the purchasing agent, in order to induce the purchasing agent to place a purchase order with the WFOE. These types of kickbacks are common in China's current business culture and occur innumerable times on a daily basis.¹⁵ Many SOEs engage in such tactics and most people in China are resigned to accept petty corruption as a common method of doing business. However, although these may be common practices and tolerated in China, the transaction might trigger liability under the FCPA. Although the purchasing agent is a low ranking employee in the SOE, the agent might qualify as a foreign official and the kickback might qualify as a bribe given to a foreign official for the purpose of obtaining business. The kickback could constitute a violation of the FCPA.

Under these definitions, a doctor or administrator at China's state-operated hospitals could qualify as a "foreign official." If the China business entity of an MNC gives a kickback to a doctor to induce the doctor to prescribe a medication, then this transaction could also trigger liability under the FCPA. It is common knowledge in China that doctors in state-operated hospitals receive kickbacks for prescribing medications.¹⁶ Recently, China has begun to crackdown on this practice in several high profile cases, including a current investigation of Glaxo Smith Kline, as well as sixty other pharmaceutical companies, for giving kickbacks funneled through travel agencies.¹⁷

II. "ANYTHING OF VALUE"

The FCPA proscribes the giving of "anything of value" to a foreign official in order to obtain or retain business so the gift does not have to be cash. The DOJ has interpreted the term

15. This observation is based upon the Author's own experience working as an in-house counsel at a multinational company with substantial business operations in China and on the author's recent discussions with lawyers and academics in China.

16. This observation is based on the Author's own experience.

17. See Mark Thompson, *China Says GalxoSmithKline Ran a Huge Bribery Web*, CNN MONEY (July 15, 2013, 9:42 AM), <http://money.cnn.com/2013/07/15/news/companies/glaxosmithkline-china-bribery>.

“anything of value” in an expansive manner. For example, paying for executive training programs at US universities for Chinese foreign officials when the training was not specifically related to the company’s business could fall under this definition.¹⁸ Other examples include payment of tuition and expenses for education programs in the United States for Chinese officials, payment of tuition for an MBA degree, arranging for a paid internship for a daughter of a Chinese official, and payment for sightseeing trips in the United States to tourist attractions such as the Grand Canyon and Las Vegas.¹⁹ The issue that is raised by this expansive definition is that Chinese government or business officials often ask for non-monetary favors from friends and other business associates. Asking for favors, such as helping a child or a relative, is a common practice in China and most people in China not only accept the practice but see nothing wrong with the practice. However, such a practice could give trigger liability under the FCPA, especially where there is a quid pro quo, i.e. the obtaining of business in return for a non-monetary favor given to a Chinese official.

As an example of how this element may affect MNCs doing business in China, suppose that an MNC believes that some of its products have been pirated by counterfeiters and infringers. The MNC’s China business entity approaches a government administrative agency to enforce its intellectual property rights, but an official in the agency states that it is necessary to have the knock-offs tested by a technical consulting company to certify that the products are knock-offs and are of low quality. The official suggests to employees at the MNC’s China business entity that they use a particular company owned by a relative and pay a fee for the service to the relative’s company. The employees at the China business entity know that if they use the company owned by a relative of the official, the company will issue the certification for a fee and the enforcement action can proceed.

18. See Complaint ¶¶ 16–18, SEC v. UTStarcom, Inc., No. CV 09-6094 (N.D. Cal. Dec. 31, 2009), available at <http://www.sec.gov/litigation/complaints/2009/comp2157.pdf>.

19. See Complaint ¶ 1, SEC v. Lucent Technology Inc., No. 1:04-cv-0114 (D.D.C. Dec. 21, 2007), available at <http://www.sec.gov/litigation/complaints/2007/comp20414.pdf>.

The employees also know that if they do not use the company, the enforcement action will be stalled, perhaps indefinitely. If the MNC uses the company, the official receives no direct and immediate monetary benefit from helping out a relative, but this arrangement might be deemed to be giving something of value to a foreign official. This scenario above is also common in China. MNCs need to obtain approvals or the cooperation of government officials on a regular basis and the officials might condition approval on the use of a company or business owned by a relative or friend. Liability under this element of the FCPA is also squarely raised in the recent and on-going FCPA investigation of hiring by JPMorgan and other banks of well-connected children of Chinese government officials in return for business opportunities from China's state-owned enterprises.²⁰

III. *THIRD PARTIES AND INTERMEDIARIES*

Many MNCs need to engage with third parties on a regular basis as part of their business operations in China. The use of third parties by the MNCs raises additional issues under the FCPA as the following illustrations demonstrate.

A. *Third Parties as Business Partners*

Returning to our discussion of foreign direct investment, suppose that the MNC decides to establish a joint venture in China with a state-owned enterprise as the local partner. The joint venture is a separate legal entity under Chinese law that is owned by the MNC and its local partner in direct proportion to the capital contributions of each party.²¹ The joint venture manufactures industrial products and equipment and sells its products to government bureaus and SOEs. Prior to forming the joint venture with the MNC, the SOE local partner had been giving kickbacks to officials in government bureaus and other

20. See Ben Protess & Jessica Silver-Greenberg, *On Defensive, JPMorgan Hired China's Elite*, N.Y. TIMES (Dec. 29, 2013, 9:22 PM), http://dealbook.nytimes.com/2013/12/29/on-defensive-jpmorgan-hired-chinas-elite/?_php=true&_type=blogs&_r=0.

21. See Regulations for the Implementation of the Law on Sino-foreign Equity Joint Ventures arts. 17, 18 (promulgated and effective July 22, 2001); see also DANIEL C.K. CHOW & ANNA M. HAN, *DOING BUSINESS IN CHINA: PROBLEMS, CASES, AND MATERIALS* 88–89 (2012).

SOEs in order to complete sales. After forming the joint venture, the employees of the joint venture from the local partner SOE continue to give kickbacks to officials from the government bureaus and other SOEs to induce them to purchase the joint venture's products. The kickbacks are attributable to the joint venture and the actions of the joint venture are attributable as an agent to the MNC under the FCPA.²² Based on similar facts, the DOJ sought to prosecute RAE Systems, a Delaware Corporation with its headquarters in California, for the actions of its majority-owned joint ventures in China.²³ The DOJ and RAE ultimately reached a settlement in this case.²⁴

B. *Third Parties as Contractors*

A second common scenario is the use by the MNC's China business entities of third party service providers, such as law firms, private investigation companies, and various consulting firms that might make illegal pass-through payments to foreign officials on behalf of the MNC.²⁵ For example, many MNCs use private investigation firms in tracking down counterfeiters and infringers of their products.²⁶ Investigation work is time consuming and could be dangerous as the private investigators need to assume false identities in order to penetrate the counterfeiting ring. When the counterfeiting operation has been identified, representatives of the MNC's China business entity, along with the private investigators, will approach the PRC enforcement authorities for an enforcement action, often in the form of a surprise raid and seizure. It is well-known in China that private investigation firms often make payments of

22. See, e.g., 15 U.S.C. § 78dd-1(a) (2012) ("It shall be unlawful for any issuer . . . or for any officer, director, employee, or agent of such issuer . . ." to pay bribes to foreign officials).

23. See Letter from the U.S. Dep't of Justice to Carolos F. Ortiz & Roy K. McDonald, attorneys for RAE Systems Inc. 1 (Dec. 10, 2010), available at www.justice.gov/criminal/fraud/fcpa/cases/rae-systems/12-10-10rae-systems.pdf-2001-02-16-Text Version (non-prosecution agreement).

24. See *id.*

25. Such pass-through payments are unlawful under the FCPA. See 15 U.S.C. §§ 78dd-1(3), 78dd-2(3), 78dd-3(d).

26. See Daniel C.K. Chow, *Anti-Counterfeiting Strategies of Multinational Companies in China*, 41 GEO. J. INT'L L. 763-64 (2010).

“case fees” to induce PRC officials to conduct enforcement actions.²⁷ The case fees are demanded by officials because they argue that the fees are necessary to compensate them for the use of many officers, vehicles, and for the storage and destruction of the counterfeits. If the enforcement action involves travel to an out of town location, the officials may demand reimbursement of travel expenses, lodging, and meals. If the MNC seeks to pursue a criminal case against counterfeiters, the MNC will need to approach the Public Security Bureau (the Police), which may not only ask for a “case fee” but also for a “reward” for each arrest of a suspected counterfeiter.²⁸ The private investigation companies pay these cases fees and other expenses and then bill the MNC’s China business entity for these fees under the category of miscellaneous expenses. In a large enforcement action, involving travel, these fees can be in the tens or hundreds of thousand dollars. Many MNCs conduct raids on a weekly basis.

The FCPA contains a provision that attributes liability to a US company if it makes a payment to a third party if the MNC knows or should have known that the payment will be passed through to foreign officials.²⁹ The DOJ might take a dim view of an MNC that allows third party contractors to pass through payments in the tens or hundreds of thousands of US dollars to PRC officials in order to obtain enforcement actions that such officials might otherwise not conduct.³⁰

CONCLUSION

MNCs doing business in China face many challenges under the FCPA that could create traps for the unwary. As the discussion above illustrates, the FCPA applies with special force

27. This observation is based upon the Author’s own experience as an in-house counsel for an MNC with substantial business operations in China.

28. The Author was present at a meeting with the Public Security Bureau when this request was made.

29. See 15 U.S.C. §§ 78dd-1(3), 78dd-2(3), 78dd-3(d).

30. The FCPA contains a so-called “grease payment” exception for payments to government officials to facilitate any routine government action. See 15 U.S.C. § 78dd-1(b), §78dd-2(b), §78dd-3(b). Routine government action refers to obtaining permits, processing papers, such as visas, providing phone, power, and water supply. See, e.g., 15 U.S.C. § 78dd-1(h). Paying tens of thousands of dollars to obtain an enforcement action might not fall under this definition.

to China because of China's state-dominated economy, a business culture in which favors and gifts are expected, and in which petty corruption is common and tolerated. In addition, China has recently begun a crackdown on commercial bribery by MNCs.³¹ This crackdown could ensnare many MNCs doing business in China and bring to light various clandestine bribery schemes that might also run afoul of the FCPA. This recent development creates an even greater incentive for MNCs to be diligent and invest in strong compliance programs so that they do not run afoul of the FCPA.

31. See Yin Pumin, *Clamping Down on Corporate Bribery*, BEIJING REV. (July 30, 2013), http://www.bjreview.com.cn/business/txt/2013-07/29/content_557941.htm.

