Case Study regarding Third Parties

Introduction- Section 1

Healthcare Co is a leading pharmaceutical manufacturer headquartered in the United States. It sells high-quality pharmaceuticals to hospitals.

Healthcare Co has entered into the Chinese market years ago, but has only focused on Tier 1 cities until recently. This year, the management decides to break into the Tier 2 cities in China in response to the rapidly growing demands for high-quality pharmaceuticals in these cities. X City, among others, is a market in which Healthcare Co is particularly interested.

Healthcare Co does not engage in direct sales in China, and it cannot find any national distributor covering X city. Therefore, Healthcare Co has to rely on local distributors. After market investigation, Healthcare Co has found three candidate distributors.

Through initial due diligence and preliminary negotiation with each of them, Healthcare Co finds that:

- Distributor A
    - It is a subsidiary of a local state-owned enterprise (SOE).
    - This local SOE operates in many sectors and does not seem to have any direct connection with the healthcare regulator or any hospital.
    - Market rumor says that the Chairman of the SOE was investigated for accepting bribes two years ago.
    - Distributor A strongly resists any FCPA/UKBA or auditing provision, on the ground that, as a PRC SOE, it should not be bound by foreign laws or audited by a foreign company.
- Distributor B
    - It is a private company founded by several former employees of the major local hospitals.
    - It regularly organizes healthcare lectures and seminars, and invites well-known doctors to speak at these events. For the purpose of such events, Distributor B regularly engages a small local event planning and advertisement company, with which it has a long-term relationship.
    - Its management told Healthcare Co that they give festival gifts to and sometimes organizes trips with their former colleagues who still work at the hospitals. They believe this is a very good way to maintain their personal friendship, which ultimately also helps the business.
- Distributor C
    - It is a private company with no direct connection with local hospitals.

- Its CEO represents that they have a very good relationship with local healthcare regulators.
- It makes donations to a local healthcare charity every year.
- Its CFO discloses that when there are difficulties in obtaining satisfactory invoices / fapiao for certain payments, they allow employees to submit irrelevant invoices in order to meet accounting requirements.
- In addition to commissions, Distributor C requires reimbursement of marketing expenses.

Please discuss, for each of the three distributors:

1. What further due diligence is necessary, and how to do it?
2. What contractual provisions should be included in the distributor agreements, and how to negotiate them?
3. If each is engaged, how should Healthcare Co monitor its activities?

Section 2

Healthcare Co. has chosen Distributor C. At the time of negotiation, FCPA clauses are presented to them as well as the training materials for all the employees.

Distributor C is resisting the FCPA clauses as they are not a US-based company and consider its requirements and restrictions inapplicable to them. Moreover, they are resisting the process of using Healthcare Co's training materials for all the employees handling Healthcare Co brands as they have their own established processes and procedures and they handle multiple brands, not just Healthcare Co.

They propose to use revised training materials deleting some parts of the training related to bribery and FCPA. Additionally, they want to allow their employees to continue the use of of Expense reports, without accurate invoices/ Fapiaos because the lack of such reports won't affect the amount of the expenses and it is just a record keeping issue.

The other issue is the reimbursement of the marketing expenses, which they propose to be done quarterly in an invoice type of format but without itemized receipts

Please discuss, for this stage:

4. What should Healthcare Co do regarding the FCPA clauses in the contract?

5. How to manage the lack of transparency in the expense reporting?

6. How should Healthcare Co monitor the marketing expenses?

Section 3

After several rounds of negotiations, Distributor C agreed to sign the FCPA related contract clauses, provide full training for all their employees handling Healthcare Co brands, and require itemized receipts for marketing expenses.

They have now been working with Healthcare Co for three months. The first monitoring report came to Healthcare Co's Regional Office and it shows significant expenses in travel and entertainment of HCPs without itemized receipts including international and local trips.

Additionally, Distributor C seems to have given significant discounts for tenders which were not properly approved by management of Healthcare Co brands. The rationale was that they lowered the prices to be competitive and to provide additional services to hospitals to ensure product utilization. There are invoices for cold chain facilities as the hospitals seem not to have them and they are required for Healthcare Co products.

At the time of receiving this report, the regional manager handling the interaction consults with the legal / audit and compliance team about the reports and next steps

Please discuss, for this stage:

7. What should Healthcare Co do regarding the invoices without itemized receipts?

8. Would you ask for an audit? If so, why and which topics to include in the audit?

9. How to evolve after these findings? What to do next?