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Briefing note September 2014

Third-party intermediaries in China: Mitigating a necessary risk

Virtually every article written on successfully doing business in China mentions the importance of using an intermediary (zhongjian ren) to make introductions, provide language and cultural interpretations, and facilitate relationship-building (guanxi). Intermediaries are emphatically recommended for this type of business relationship building but more critically for help in navigating local regulations and regulatory authorities, penetrating an enormous market, lobbying the government, and as sales agents, distributors, and joint venture partners. In some situations, a local agent is required by law or regulation. It is accepted wisdom that without an intermediary well-versed in Chinese language, customs, and laws, a non-Chinese company cannot possibly be successful.

On the other hand, every article ever written on implementing a compliance plan under the US Foreign Corrupt Practices Act (FCPA) in China just as emphatically describes sales agents, consultants, distributors, and any other third-party intermediary as a tremendous risk for compliance. Third-party agents are involved in 90% of all FCPA cases and appear in a slightly higher percentage of all FCPA prosecutions involving China. This is probably the natural result of doing business in a country in which third-party intermediaries are so common, the cultural tradition of gift-giving and entertainment is so ingrained, and the government owns or controls so many businesses that the person across the table is in all likelihood a government official regardless of the nature of her business.

Companies should take careful measure of the FCPA compliance risks of using third-party agents in China. They should consider how to mitigate those risks in light of the reality of doing business here. Above all, there should be no misperception that engaging an intermediary to pay bribes will shield a company from FCPA liability.

The FCPA third-party provisions

The FCPA specifically provides that a company subject to the FCPA can be held responsible for 1) the "authorisation of the giving of" a prohibited payment by a third-party and 2) for the acts of a third-party, if the company knew that the money or thing of value given to the third-party would be used, directly or indirectly, to make an illicit payment. The language of the third-party provision is very broad. It has been applied to agents, foreign sales representatives, consultants, distributors, joint venture partners, foreign subsidiaries, contractors, and service providers.

Authorisation is defined similarly broadly as it can include explicit directions or implicit assent to a third-party to make an illicit payment. All of the surrounding circumstances will be examined to ascertain authorisation, including whether the company manifested in any way its intent to object to or repudiate a known plan to pay bribes. Passive acquiescence may be sufficient for liability depending on the parties' relationship and the nature of the business in which they are engaged.

Even without authorisation, explicit or implicit, where the company made payments to a third-party, the key issue that triggers liability is whether the company had knowledge that the money would be used for bribes on its behalf in connection with the sale of the company's goods or services. The FCPA defines knowledge beyond "actual knowledge," but also includes the concepts of "conscious disregard" and "deliberate ignorance." In the words of the FCPA, if a company is aware that a person is engaging in bribery, of a "high probability of the existence of such circumstances," or that bribery is "substantially certain to occur," then the company is deemed to have sufficient knowledge under the FCPA for liability. Companies must not disregard or deliberately ignore "red flags" that come to its attention indicating that it is highly probable that its foreign marketing consultants, distributors or other third-parties are engaging in bribery. The presence of red flags triggers a responsibility to undertake a due diligence review into suspicious activity.

Keep in mind that the liability for third-party conduct is even more strict under the UK Bribery Act. For companies that carry on a part of their business in the UK, the Bribery Act does not require knowledge—actual or otherwise—of improper payments in order to trigger corporate liability for the acts of "associated persons," i.e., persons who are acting on behalf of or providing services to the company. For companies who are subject to the UK Bribery Act, even more care therefore must be taken with regard to dealing with third-parties.

Significant US cases involving intermediaries

US v. Bourke: One of the most instructive third-party FCPA prosecutions involved Frederic Bourke, who invested $8 million in a partnership with Victor Kozeny to win a privatisation auction to gain control over the Azerbaijan State Oil Company. Mr. Kozeny bought vouchers and options to bid on shares of the Company. He then agreed to transfer two-thirds of the vouchers and options to the Azeri government, along with two-thirds of any profits realised. In addition to these promises, officials received US$11 million in other wire transfers, jewelery, and travel. Evidence was presented at trial that Mr. Bourke was a sophisticated businessman (former owner of Dooney & Bourke handbags), that Mr. Kozeny (nicknamed the "Pirate of Prague") had a widely-reported history of paying bribes, and that Azerbaijan had a high risk for corruption, as does the oil and gas industry. The jury found that Mr. Bourke had "consciously disregarded" all the above red flags and therefore had sufficient knowledge. After serving nearly a year in US prison, he was released in March 2014. His main co-conspirator, Mr. Kozeny, is still avoiding extradition in the Bahamas.

Biomet Inc.: According to the US Securities and Exchange Commission (SEC), two subsidiaries of medical device company Biomet Inc., Biomet China and Scandimed AB, sold medical devices through a distributor in China who provided state-employed doctors with money and travel in exchange for their purchases of Biomet products for nearly a decade. In one email between this distributor and Biomet, the distributor stated, “A kind word on Biomet from [the doctor] goes a long way for us. … Dinner has been set up … but dinner aside, I’ve got to send him to Switzerland to visit his daughter.” In another similar instance, Biomet’s distributor arranged a trip to Spain for 20 Chinese surgeons in 2007, where a substantial part of the trip was devoted to sightseeing and other entertainment. In 2012, Biomet settled the FCPA charges for combined criminal fines, disgorgement of profits, and prejudgement interest of USD 23.8 million. But just two years later, in July 2014, Biomet stated that it is under investigation by the SEC for possible violations of the terms of this settlement.

Diebold: Similarly, and according to the US Department of Justice (DOJ), a subsidiary of Diebold Inc., a US provider of security systems (including ATMs), allegedly provided, from 2005 to 2010, payments, gifts, and non-business travel valued over USD 1.6 million to employees of state-owned banks in order to secure and retain business in China. Some of these payments and benefits were made through third parties designated by the banks, including leisure trips inaccurately recorded as employee “training.” The SEC found that Diebold lacked

sufficient internal controls to detect and prevent these illicit payments and that many Diebold executives in charge of operations in Asia knew that these improper gifts were being provided. In October 2013, Diebold paid criminal and administrative penalties totalling USD 48 million.

These third-party FCPA cases indicate a negative view of intermediaries failing to provide actual "services" rather than influence. The US authorities also negatively view (i) intermediaries being paid a percentage of the contract price rather than actual work done; (ii) intermediaries receiving high commissions that are passed on, directly or indirectly, to foreign officials; (iii) lack of written contracts with intermediaries; (iv) inaccurate or vague descriptions of the role of intermediaries in the company's books and records; (v) employees circumventing internal controls with respect to contracting intermediaries; and (vi) intermediaries not being subjected to due diligence scrutiny. All such practices are risky business when dealing with intermediaries.

Other recent enforcement action involving intermediaries

The concern for the improper use of intermediaries is not limited to US enforcement agencies. In the most prominent corruption case in China involving a multinational company, Chinese authorities are investigating British pharmaceutical manufacturer GlaxoSmithKline (GSK) for use of third party intermediaries to pay bribes. According to China's Ministry of Public Security, between 2007 and 2013, GSK used travel agencies, which specialized in altering corporate travel expenses (e.g., fictitious conferences or overly expensive training sessions) to channel bribes to doctors, hospital staff, and government officials. These payments allegedly resulted in higher drug prices and illegal revenue of more than USD 150 million. The UK has also announced an investigation of GSK. Both investigations are ongoing and send a strong message to multinational companies operating in China that they should carefully scrutinize their current practices of dealing through intermediaries.

Recommendations

Because local agents are so critical to successfully doing business in China and may be required in some circumstances when transacting with the PRC government or state-owned companies, effective third-party anti-corruption compliance policies are particularly important.

Due diligence: Before engaging an agent, robust due diligence should be undertaken to ascertain and confirm the agent's qualifications and ability to perform the contracted services, as well as the agent's reputation for integrity and its relationship to any government officials. This can be undertaken via a questionnaire to be completed by the agent, by a third-party forensic investigative service, through public source information and the internet, or by making inquiries to US agencies in the country. The level of compensation that is requested must be determined to be reasonable and consistent with the fair market value for the services to be provided.

Pre-engagement due diligence is critically important because it may be the best opportunity to identify and avoid risks raised by transacting with particular third- parties.

Contractual provisions and certifications: Engagement of third-parties should always be in writing, with provisions making clear that the company and its agents are prohibited from giving or accepting bribes. The scope of the agent's expected services and her compensation for actual services performed should be detailed. The agent should agree not to hire subcontractors without the company's approval, to inform the company if any payments of any kind are made to government officials and if the agent takes on any government office or position.

If possible, include a representation that the agent certify that she understands the FCPA (and any other applicable anti-corruption laws), is in compliance with all applicable anti-corruption laws, and will continue to

comply. Undertakings for annual compliance certifications, rights to audit the agent's expenses and invoices, and termination clauses when a bribe is discovered should also be considered.

It may be difficult to obtain these representations and obligations from resistant third-parties in China. If the third-party has particularly strong bargaining power, the likelihood of success may be small which is why pre-engagement due diligence is so important—it may be the only opportunity to mitigate risks. Nevertheless, the company should seek to demonstrate that it attempted to obtain the warranties and should take the third-party's refusal into account when calculating the risk of the interaction. Other risk mitigation strategies should be considered, including continuous monitoring and review.

On-going monitoring: The agent's expenses and invoices should be carefully reviewed before payment, including the back-up invoices and documentation where appropriate. Lack of transparency as to expenses or accounting records and long lists of government "fees" included on invoices can be red flags. Any irregular payment requests such as false documentation, payment into offshore accounts or to third-parties are also red flags. Consideration should be given to including agents in company compliance training. When an incident of possible non-compliance is reported, it should be thoroughly investigated and the investigation and its resolution should be documented.

Conclusion

Using a a zhongjian ren may be wise, appropriate and even mandatory when doing business in China, but the particular risks associated with intermediaries must be recognised and resolved. Robust and tailor-made compliance programs with specific guidance regarding the use of such third-party agents are critical to avoiding liability for the misconduct of those agents.

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