The economy of the People’s Republic of China has been the fastest growing economy of any major nation for the past quarter century. Its average annual Gross Domestic Product growth rate has been in excess of 10%. China’s economy has grown into the second largest in the world (after the United States) with that GDP being $10.21 trillion (2006), when measured on a purchasing power parity basis. By the end of 2006, when measured in exchange-rate terms, it ranked fourth (behind the United States, Japan, and Germany) with its nominal GDP of $2.527 trillion. In 2006, China was the world’s third largest trading nation, with total trade surpassing $1.76 trillion. In 2007, China’s trade surplus jumped 47.7% to $262.2 billion. Industrial production grew at 22.9% in 2006. China’s per capita income has grown at an average annual rate of more than 8% over the last three decades, drastically reducing poverty. China’s domestic stock markets in Shanghai and Shenzen have reached all time highs. In November 2007, PetroChina’s IPO on the Shanghai Stock Exchange valued the company at approximately $1 trillion, making it the most valuable company in the world.

In addition to these startling macroeconomic developments, other signs point to China’s startling development. The country has approximately 400 million cell phone users, 120-150 million registered Internet users (many more are unregistered), 20,000 blogs, and 2900 television stations. There are approximately 9,000 construction sites in Beijing alone and 80% of the world’s cranes are located in China. At present, China is buying one-half of the world’s cement and steel. Recently, China had its first lunar launch. There is an enormous drive toward innovation and toward venturing outside of China. In short, China’s development has been nothing short of mind-boggling.

Corruption in China.
Notwithstanding these astonishing developments, there is a corrosive aspect to China’s development. The developing world has long struggled with the problem of corruption and its insidious side-effects. Unfortunately, China is no exception. Communist Party Secretary General Hu Jintao confirmed in a speech in 2004 that “the country’s corruption situation remains severe, and the anti-corruption task remains arduous.” Acknowledging these issues, China has recently taken a hard line on corruption by severely punishing officials involved in corruption. The Communist Party of China has also joined this effort, as evidenced by the January 3, 2008 declaration by the Party identifying “10 Taboos” public officials should avoid.

The rapid pace of change, growing economic prosperity, and historical practices and traditions make China unique with respect to the potential for graft, bribes and corruption. Similar to other developing countries, rapid growth and the influx of capital inevitably lead to corruption. Moreover, business in China traditionally involves entertaining and gift-giving. In fact, the more clever and expensive the gift, the higher the status and prestige awarded to the giver. Additionally, cash and barter transactions are commonly used and as a result, surreptitious payments are easy to hide. Further, traditional norms often promote the practice of nepotism and the use of connections to get things done. In certain industries, “Huikou” (kickbacks) are common business practice. When these factors are combined with a bitterly competitive domestic economy, bribery and similar activities become a tempting method of gaining a competitive edge in the marketplace.

The Chinese Government, at all levels, and its State-Owned Enterprises, play active roles in China’s business activities. The country’s local officials
With millions of dollars at stake, business people are often tempted to use illegal payments or gifts to obtain necessary permits, licenses and approvals...
requires that a person or company has actual knowledge or a “firm belief” that improper actions have occurred or are “substantially certain” to occur. 15 U.S.C. §§ 78dd-1(f), 78dd-2(h), 78dd-3(f). The FCPA provides that the knowledge required can be “established if a person is aware of a high probability of the existence” of improper actions. Id. Conscious disregard or “willful blindness” is no defense to a charge of violating the FCPA.

Failure to comply with the FCPA can result in severe penalties. Under the anti-bribery provisions, individuals face criminal fines up to $250,000 and imprisonment up to five years, and companies may be fined up to $2 million for each violation. Under the accounting provisions, individuals face criminal fines up to $5 million and imprisonment up to twenty years, and companies may be fined up to $25 million for each violation. Federal law allows even higher “alternative” maximum fines equal to twice the gain to the defendant or the loss to third parties resulting from the violation. In addition to criminal penalties, both companies and individuals are also subject to civil fines. Increasingly, the U.S. Government has also demanded disgorgement of profits gained through any acts that violate the FCPA. Other potential sanctions on companies include disqualification from U.S. government contracting and the denial of export licenses.

The marketplace consequences of violating the FCPA can be equally serious. The internal investigations necessary to bring a company back into compliance are costly and time consuming. Public companies will generally need to disclose violations, with attendant damage to reputation and goodwill. Local businesses in the country where the violations occurred, particularly businesses with government ties, may shun a U.S. company that has publicly admitted to bribery, even if the company has taken appropriate remedial measures. For companies publicly traded in the U.S., DOJ and/or SEC investigations over FCPA violations also bring the concomitant shareholder lawsuits claiming breach of fiduciary duty, negligence and fraud. Conduct that violates the anti-bribery provisions of the FCPA may also give rise to claims for violation of the Racketeer Influenced and Corrupt Organizations Act (“RICO”) and subject the violator to treble damages.


a. Who is covered by the FCPA? Individuals and companies can find themselves within the jurisdiction of the FCPA based on nationality or territorial jurisdiction principals. The jurisdictional reach of the FCPA extends the law to issuers of securities registered in the U.S., domestic concerns (companies headquartered, organized, incorporated, or with a principal place of business in the U.S.), and U.S. nationals. These entities and individuals can be held liable for actions taken inside or outside of the U.S. if they take any acts in furtherance of a corrupt payment using U.S. means of interstate commerce (mail, telephone calls, electronic transmissions, etc.).

The FCPA also potentially applies to any company or individual in the world if it causes, directly or through an agent, an act in furtherance of a corrupt payment to take place within the territory of the U.S. This territorial form of jurisdiction was added with the 1998 amendments to the FCPA.

In addition, U.S. parent companies may be held liable for the acts of foreign subsidiaries if the parent exercised control or direction over the subsidiary. Further, any U.S. companies or nationals acting on behalf of a foreign subsidiary would fall under the FCPA’s jurisdiction.

By these standards, most U.S. companies investing in China through either wholly foreign-owned enterprises (WFOE), Sino-foreign joint ventures (JVs) or representative offices (ROs) should assume that their business activities in China are covered by the FCPA. Even when a parent company holds only a minority investment in a JV, for example in industries where foreign majority ownership is restricted by law, the company typically includes significant corporate governance protection for its minority rights in the applicable contractual arrangements, and can use those provisions to exercise control over the company. As a result, the DOJ and SEC will expect most U.S. companies to force their subsidiaries in China to conform to the FCPA and will hold them liable for failure to do so.
b. Who is a “foreign official”? The FCPA prohibits payments to “foreign officials” and foreign political parties, including officials and candidates of those parties. The term “foreign officials” includes individuals, regardless of rank or position, who are an “officer or employee of a foreign government or any department, agency, or instrumentality thereof ... and any person acting in an official capacity for, or on behalf of such ... instrumentality.” The DOJ has not only interpreted this to include an officer or employee of foreign governments, but also officers and employees of commercial enterprises that are government-owned.

Although there has been extensive privatization, a large part of the Chinese economy remains in government hands in the form of State-Owned Enterprises (“SOE’s”). In every SOE there is a communist party organization that parallels many management functions. All of the officials in the party committee are appointed by the Chinese government, and therefore all officials are “officials of a foreign political party” within the parameters of the FCPA. In addition many individuals have both company and Communist Party roles. Accordingly, a U.S. company must assume that virtually everyone acting for an SOE (at least an unlisted SOE) is a foreign official. Many sectors of the Chinese economy are entirely state owned such as hospitals, medical institutions and transportation companies. SOE’s listed on a Chinese stock exchange are more complicated. Most directors are appointed by the government or the Communist Party. Under these circumstances, the DOJ and SEC would likely view state-owned or controlled, domestically listed SOE’s as “officials of a foreign political party” within the parameters of the FCPA and treat officers and directors as “foreign officials”.

c. What is an improper “payment” or “gift”? The FCPA prohibits paying, offering, promising to pay (or authorizing to pay or offer) money or anything of value. The focus is on the purpose of the payment instead of the particular duties of the official. The person making or authorizing the improper payment or gift must have “corrupt” intent and the payment or gift must be intended to cause the recipient to misuse his or her official position. The FCPA permits “reasonable and bona fide” expenditures such as travel and lodging expenses incurred on behalf of a foreign official and directly related to the (A) promotion, demonstration or explanation of products and services; or (B) the execution or performance of a contract with a foreign government or agency thereof. These principals seem simple, but the determination of whether particular expenditures are, “reasonable and bona fide” or “directly related” to “promotional activities” is quite complex.

Travel and expense payments for side-trips or for family travel are especially problematic. Expenses related to this type of travel have been the source of many recent investigations. For example, in December 2007, Lucent Technologies, Inc., agreed to pay a $1.5 million civil penalty to the SEC in connection with improper payments made for Chinese officials’ travel and entertainment expenses. While the expenses were booked as legitimate business expenditures, the SEC alleged that in reality, they were tourist trips to locations such as Hawaii, Las Vegas, the Grand Canyon, Niagara Falls, and Universal Studios.

d. Who has responsibility for local agents and partners? The FCPA prohibits corrupt payments through intermediaries. It is illegal to make a payment to a third party while “knowing” that the payment will go, directly or indirectly, to a foreign official. The same broad reading of “knowledge” and “official” that are discussed above also apply to this prohibition.

U.S. businesses in China should take measures to ensure that their local agents and partners do not pass on part of their remuneration to government officials in exchange for business or other “favors.” U.S. companies place themselves in the best position by making a good faith effort to prevent this activity -- by performing reasonable due diligence on their agents and partners, obtaining proper representations and warranties in contracts that the agent has and will comply with the FCPA, and, where possible, checking the books and records of its agents. In China, the use of agents may create exposure if there is: (1) a lack of due diligence; (2) failure to enter into a documented agreement; (3) lack of invoices or receipts to support payments to agents; or (4) misrepresentation of such payments in the company’s books.
The use of “zhongjian ren” (intermediaries) is very common in China. Zhongjian ren are usually hired because they have important relationships or connections that can lead to business or the establishment of business relationships. The ability to develop these relationships and be trusted by others is often referred to as “guanxi”. For historical reasons, it is very difficult to earn the trust of the Chinese, especially for a “yang ren” (foreigner). An intermediary can use his or her guanxi to bridge the trust gap between a local Chinese company or government official and a foreign company. In essence, the intermediary is “vouching” for his or her client. These intermediaries are often crucial for obtaining government permits and approvals. Sales in China often require a complex web of local agents and independent middlemen. Accordingly, the risk of FCPA violations in this environment is very high.

4. Danger Signals U.S. companies operating internationally must attune themselves to the danger signs of FCPA violations in an environment such as China. While far from an exhaustive list, examples of danger signals include:

1. large sales to governmental agencies or SOE’s with high unit price and low frequency;
2. a request for commission payments to be made to bank accounts in other countries or to people or companies who did not perform the services;
3. excessive payments or commissions for services rendered or insufficient staff to perform the services to be rendered; vague deliverables in contracts;
4. losing bidders hired as subcontractors;
5. favorable treatment of one supplier over another;
6. lack of relevant experience of a successful bidder;
7. unnecessary third parties performing services;
8. lack of documentation from agents;
9. a representative or distributor refuses to confirm that he or she will comply with the FCPA;
10. a representative or distributor has family or business ties with government officials;
11. a representative or distributor requires that his or her identity not be disclosed;
12. a potential government customer recommends or requires that the U.S. company use a particular representative or distributor;
13. a representative or distributor cannot provide references to verify claimed experience;
14. a representative or distributor makes requests such as backdating or altering invoices; or
15. a representative or distributor requests that an invoice be inflated.

FCPA Compliance Program
To prevent FCPA violations, U.S. companies should establish a comprehensive FCPA compliance program to ensure compliance with the statute. Sanctions imposed on corporations for violation of federal statutes, such as the FCPA, can often be mitigated by maintaining effective compliance policies and programs and enforcing them in a consistent and vigilant manner. Not all policies are created equal. In this complex area of the law, it is crucial to have experienced legal counsel to advise concerning an effective policy that will offer protection from needless costs and negative publicity. Compliance policies should be tailored to individual companies and take into consideration potential exposure points inherent in different industries.

Case Studies
By examining several possible scenarios below, information can be gleaned about what is and what is not proper conduct under the FCPA regulations. Please note: any names used below are purely fictitious. In addition, nothing described in this article constitutes legal advice and should not be considered a substitute for legal counsel.

Scenario #1 – U.S. Mediaco, a U.S. based media production company, opened negotiations with the Chinese company Shanghai Prodco. As part of this process, U.S. Mediaco invited, at its expense, the Chief Executive Officer, the Chief
Financial Officer, the Manager of Production, and the Creative Director of Shanghai Prodco to visit its media production facilities and studio in Los Angeles. After accepting the invitation, several of the Chinese executives, who collect fine wine, expressed a desire to visit the Napa Valley area in Northern California for a few days during the trip.

U.S. companies fall under the jurisdiction of the FCPA. In addition, it appears likely that the officials of Shanghai Prodco are “foreign officials.” Assuming that Shanghai Prodco is an SOE (and in China, most of the media industry is still in government hands), its representatives would fall within the U.S. Government’s definition of “foreign officials.” Finally, it is also necessary to determine whether the side trip to Napa constitutes an improper “payment” or “gift.” Because the trip is unrelated to the business of the U.S.-based company, the safest course for U.S. Mediaco is to treat the side trip as an improper payment or gift. It might be possible for the U.S. company to argue that the wine tasting created the best environment for business discussions and building a working relationship, but it would be a risk.

Scenario #2 – In its effort to expand its business, California Techco enters into negotiations with Beijing Generic Bank to provide software and support services. In connection with these negotiations, the Beijing Generic Bank president, Mr. Zhang, mentions to Mr. Ryan, President of California Techco, that his oldest son is applying for admission to a well-known U.S. University. Mr. Ryan is an alumnus of the University and sits on the advisory board of its business school. The President uses his influence and the son is admitted to the University. Beijing Generic Bank purchases $3 million worth of software and services from California Techco.

As before, the U.S. company is covered by the FCPA. In addition, because Chinese banks, even those recently listed on the Shanghai Stock Exchange and Hong Kong Stock Exchange, are SOE’s under Chinese Government control, the U.S. Government would likely view the officers of Beijing Generic Bank as foreign officials. The more difficult question is whether Mr. Ryan’s influence with the U.S. University constitutes an improper payment or gift. The U.S. Government has taken a broad view of the FCPA’s anti-bribery provisions’ statement that an improper payment can be “anything of value.” Although Mr. Ryan’s influence with the University cannot necessarily be quantified, a court could consider Mr. Ryan’s influence (especially if the son is accepted) to be something of value under the FCPA.

Scenario #3 – California Techco, the company discussed in Scenario #2, decides to engage the assistance of Mr. Jianhua of XYZ Consultants to handle its negotiations with Beijing Generic Bank. Mr. Jianhua is known for his connections in the Chinese banking industry and guanxi. The principals of XYZ Consultants, especially Mr. Jianhua, have strong relationships with the executive management of the largest Chinese banks. These banks are prime targets for California Techco products. California Techco requires that XYZ Consultants sign its standard form consulting agreement like any other vendor and pays the company a large commission.

Without California Techco’s knowledge, the President of Beijing Generic Bank, Mr. Zhang, suggests to Mr. Jianhua that he should pay for the college tuition of the Mr. Zhang’s son. Mr. Zhang believes that the large commission Mr. Jianhua is receiving from California Techco should more than cover this expense and still leave plenty of profit for Mr. Jianhua. Mr. Zhang further states that two other competitors for the business of China Bank have already offered to do so. In order to obtain the lucrative contract, Mr. Jianhua, without telling California Techco, agrees to this request. California Techco subsequently receives the contract from Beijing Generic Bank.

The payment of the college tuition for Mr. Zhang’s son would qualify as an improper payment or gift if given by California Techco. The issue presented by this scenario is whether California Techco is liable for the actions of its agent. California Techco could, of course, argue that it was unaware of Mr. Jianhua’s unlawful behavior. Two facts, however, should be highlighted. First, Mr. Jianhua has a reputation for his connections and guanxi. Although this may make him an attractive consultant, it also raises a red-flag that should prompt some investigation by California Techco. California Techco would be in a stronger position if it had a policy requiring due diligence prior to hiring third parties for this type of consulting. Second, the use of a standard
In the event that improper activities are discovered, corrective action must be taken. This may require the company to terminate relationships, contracts or employees.

Scenario #4 - Miami MedTech, a U.S. manufacturer of heart stents for use in heart bypass surgery, contacts Dr. Lee, the Purchasing Manager for a large hospital in Beijing about the purchase of heart stents. Dr. Lee acknowledges that the U.S. made heart stents are needed by the hospital. He advises Miami MedTech, however, that Miami Medtech must sell them through a Chinese distributor, H.K. Distributor. Dr. Lee is a 10% owner of H.K. Distributor and his brother is the founder.

In China, most hospitals are either owned and operated directly by the Chinese Government or are owned and operated by SOE’s. Accordingly, U.S. prosecutors would likely consider Dr. Lee to be a foreign official, especially because he apparently has decision-making authority over purchasing Miami Medtech’s heart stents. The more difficult question is whether the purchase through the distributor would constitute an improper payment or gift. In the U.S., it is common for U.S. manufacturers to direct customers to buy products through distributors. Such practice avoids conflict among the manufacturer’s sales channels and often manufacturers are not set up to sell directly to customers other than very large customers. The challenge in this scenario is Dr. Lee’s, and his brother’s, ownership of the distributor and whether the sale through this particular venue constitutes an improper payment or gift to Dr. Lee. As Dr. Lee’s relationship with H.K. Distributor raises a huge red flag that an improper payment could be made, Miami Medtech should learn as much as it can about this relationship and should document everything it learns. Miami Medtech should also inquire about the past relationship between the hospital and the distributor and whether the hospital is aware of the Lee’s relationships. It should also attempt to determine whether there are legitimate business reasons for the items to be sold through the distributor. This transaction is fraught with risk and the more information gathered, and documented, the easier it will be for Miami MedTech executives to make a more informed decision.

Scenario #5 - Miami MedTech opens a foreign subsidiary in Hong Kong, H.K. MedTech. H.K. MedTech wishes to begin retail sales of popular medical devices. Before it can do so, however, it must obtain a license from local government authorities. When H.K. MedTech approaches these authorities for the required license, the local official responds that he will be happy to grant the license in exchange for a $5,000 side-payment. Without consulting with U.S. management, the regional manager for H.K. MedTech withdraws $5,000 from the company’s U.S. bank account, and delivers this money to the local Hong Kong official.

The issue presented by this scenario is whether the payment of $5,000 for H.K. MedTech’s license to sell products in China falls within the FCPA’s jurisdiction. There are several ways in which exposure exists. First, the payment falls within the FCPA’s territorial jurisdiction because an act in furtherance of the corrupt payment took place within the territory of the U.S. Even if no U.S. national (or company) was involved in this payment, the fact that money for the bribe was withdrawn from a bank account in the U.S. is enough to trigger jurisdiction. Second, the actions of the subsidiary might fall within the jurisdiction of the FCPA if the U.S. parent company exercised sufficient control. Third, the individuals involved in the payment could face exposure under the FCPA if they are U.S. nationals. As this scenario makes apparent, the activities of foreign subsidiaries can be problematic and U.S. based parent companies should have a sufficient FCPA compliance program to deter, detect and remedy such difficult situations.

Responding to a Violation of the FCPA

No compliance program is infallible. Accordingly, companies doing business in China and other developing countries may uncover suspicious behavior, potential misconduct or even blatant violations of the FCPA. In such events, the first step is to engage outside counsel with expertise in the FCPA. Outside counsel should immediately conduct an objective investigation to determine if any wrongdoing occurred and to stop any continuing violations. In the event that improper activities are discovered, corrective action must be taken. This may require the company to terminate relationships, contracts or employees. It will also involve an examination of existing policies to determine any weaknesses.
In addition, the company must determine whether to report the violation to the SEC or DOJ. It is important to have experienced legal counsel guide the company through these delicate steps to place the company in the best possible position. Further, if a disclosure is required, the company will greatly benefit from the services of counsel who have been there before.

**Conclusion**

Although progress has been made, the attempts by the Chinese government to crack down on corruption among local, provincial and central government officials in the country have not eliminated this difficult problem. This reality presents significant legal and business challenges for U.S. companies. Many U.S. business people contend that they are playing on an uneven playing field in China. They further contend that the FCPA severely restricts what U.S. companies can do to obtain business while Japanese and European companies act with impunity. In fact, according to the Department of Commerce, since 1994, U.S. companies lost at least 294 overseas commercial contracts valued at $145 billion as a result of their refusal to pay bribes. There is no doubt that this environment creates temptation for salespeople and other employees of U.S. companies to cross the line. Nevertheless, this temptation must be resisted. Aside from possible criminal and civil liability under Chinese law, such companies, their subsidiaries, employees and advisors also face exposure to the anti-bribery and record keeping provisions of the FCPA. The best defense against these dangers is a robust and effective FCPA policy. No matter how lucrative the potential investment or contract to be obtained, U.S. executives should avoid the even higher costs (including potential prison sentences) associated with investigating and resolving FCPA violations, before engaging in dangerous behavior.

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