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Confronting FCPA and Anti-Corruption Risk in China M&A Deals

BY DAVID WANG, NATHANIEL EDMONDS, ANANDA MARTIN & JOHN TSO

Fighting corruption around the globe is an increasingly high priority for U.S. enforcement agencies and China lies at the center of that effort. In the last decade, the U.S. Department of Justice ("**DOJ**") and the U.S. Securities and Exchange Commission ("**SEC**") have charged more entities and individuals doing business in China with violations of the Foreign Corrupt Practices Act ("**FCPA**") than any other country except Nigeria.

The increased enforcement focus is a significant challenge to acquirers in China, where government involvement in the economy is pervasive and regulatory barriers are legion. In addition to tax, anti-trust and other regulatory concerns, prudent acquirers must now consider the FCPA's broad application to China-related transactions. Only by taking appropriate pre- and post-closing measures can buyers hope to avoid becoming the focus of a U.S. – or even Chinese – anti-corruption investigation. Fortunately, by (i) conducting rigorous due diligence, (ii) negotiating strong compliance-related contractual provisions and (iii) implementing robust policies and procedures upon closing, acquirers can manage, if not eliminate, the risk of successor liability, financial loss and reputational damage.

The FCPA's Broad Application in China

The FCPA applies to (i) U.S. issuers (companies listed on a U.S. stock exchange or required to file periodic reports with the SEC); (ii) a citizen, national, or resident of the United States and any business entity organized under the laws of the United States; and (iii) any non-U.S. person or concern that takes an act in furtherance of an improper payment while in the territory of the United States. The FCPA prohibits such entities and individuals from offering, paying or promising to pay money or anything of value directly or indirectly to obtain or retain business, or to gain any other improper advantage from a foreign government official with corrupt intent. The FCPA also requires U.S. issuers to maintain accurate books and records and devise internal accounting controls that accurately reflect transactions for themselves and their consolidated subsidiaries and affiliates.

An analysis of whether a target company falls within the jurisdiction of the FCPA can be straightforward. The target company may employ a U.S. citizen or have a U.S. subsidiary that brings it within the ambit of the FCPA. However, such analysis may be more complicated when trying to determine whether prohibited business activity actually took place "while in the territory of the United States." For example, phone calls to and emails routed through the United States authorizing improper payments, or wire transfers cleared through U.S. banks, may be sufficient to establish a U.S. nexus. Careful analysis of a target's operations, sources of revenue, corporate structure, and management are all required to identify the contours of its FCPA footprint.

The U.S. government has been largely successful in securing judicial recognition of its broad interpretation of the FCPA's application. In a recent decision, the Eleventh Circuit generally agreed with the U.S. government's position that an entity is an instrumentality of a foreign government if it is "controlled by the government of a foreign country" and "performs a function the controlling government treats as its own," confirming that the FCPA applies to a wide variety of state-owned entities.[1] In a jurisdiction like China, where state-owned companies employ approximately 70 million people nationwide and even low-level employees of state-owned enterprises may be considered "foreign officials" for the purposes of the FCPA, the potential for anti-corruption violations is considerable.

The FCPA and Successor Liability

Given the FCPA's broad application in China, it is critical that acquirers understand the specific risks they are buying. In the FCPA context, successor liability does not create liability when none existed before. A target company that was not previously subject to the FCPA does not become so retroactively simply because it is acquired by a U.S. entity or issuer. However, the acquirer could still find itself at risk if it fails to identify the target's corrupt business practices during the pre-acquisition process and those practices are allowed to continue post-closing. In contrast, if the target is already subject to the FCPA, at the time of closing, an acquirer assumes a host of liabilities, including those arising from the target's preexisting FCPA violations. Those liabilities, however, may be mitigated if the acquirer takes proper remedial measures.

In 2004, RAE Systems Inc. ("**RAE**"), a California-based manufacturer of chemical and radiation detection equipment, sought to expand in China by acquiring a majority stake in a Chinese joint venture. In the course of due diligence, RAE learned that the joint venture company relied on under-the-table payments to secure deals with government customers. Despite this red flag, RAE failed to implement adequate internal controls in the joint venture to terminate the corrupt practices. Two years later, when RAE formed a second Chinese joint venture, RAE failed to conduct any compliance due diligence. The corrupt practices were allowed to continue and RAE ultimately paid a US$2.9 million fine to settle criminal charges with the DOJ and civil charges with the SEC. While the joint venture companies' pre-acquisition improper payments did not subject RAE to successor liability *per se*, RAE's failure to investigate and remediate its partners' corrupt practices ultimately made RAE the target of U.S. regulators' enforcement actions.

An acquirer may also assume significant liability under Chinese anti-corruption laws when it acquires a Chinese company. While Chinese law does not explicitly address successor liability for anti-corruption violations, the Research Office of the Supreme People's Court has issued guidance stating that, where a company that has engaged in criminal activity merges with another company, the predecessor company and its principals responsible for the wrongdoing may still be prosecuted for violations post-merger.[2] Accordingly, properly assessing and remediating anti-corruption risks can help address anti-corruption liability under both U.S. and Chinese law.

Step 1: Compliance Due Diligence

Given the heightened risk of anti-corruption enforcement, more acquirers are making compliance risk analysis an integral part of their pre-closing due diligence process. Typically, such due diligence involves using written questionnaires to identify (i) former or current government employees of the target company, (ii) state-owned customers or suppliers (iii) regulatory and licensing requirements (iv) key government contracts, and (v) third party intermediaries. Understanding how third party intermediaries are used allows the acquirer to scope a target company's exposure to FCPA risks, violations of which often occur through the use of third parties intermediaries interacting with government officials. The next level of analysis often includes a review of the target's existing anti-corruption policies and procedures, reputational due diligence regarding directors and officers, and interviews with key managers, customers and suppliers. This legal and reputational due diligence can help determine the necessity of selective transaction testing of the target's books and records in high risk categories such as entertainment, miscellaneous and cash expenditures.

While certain anti-corruption risks can be identified in pre-closing due diligence, others can only be identified post-closing. As the DOJ recognized in FCPA Opinion 08-02 (the so-called "Halliburton Opinion"), in some cases, critical information about the target's anti-corruption risks may be unattainable until the transaction is final. The Halliburton Opinion sets forth a clear (but ambitious) timetable for identifying and addressing such risks post-closing. Accordingly, after the ink dries on the purchase agreement, the acquirer's first action item should be an internal audit of the target's business practices. As an owner, an acquirer will have a different perspective and deeper level of access to books, records, information and employees that could potentially reveal corrupt business practices not identified in pre-closing due diligence.

Any corrupt business practice identified post-closing should be immediately terminated and the acquirer should discuss with legal counsel appropriate remedial measures, including terminating the employees involved, strengthening the company's internal controls, severing problematic business relationships or, in the rare instance, even voluntarily reporting to government regulators. While there is no such thing as a "safe harbor" for pre-acquisition activity under the FCPA, U.S. enforcement agencies place great emphasis on the acquirer's good faith attempts to identify and eradicate corrupt practices in line with their degree of access and control. The best time to go to the U.S. regulators is when problems are identified in a company that has just been acquired.

Step 2: Contractual Protections

Pre-closing due diligence dictates the contractual provisions that an acquirer should seek. These generally include representations, warranties and covenants regarding past and future actions of the target and its directors, officers, employees and agents with respect to compliance with anti-corruption laws. The acquirer should also seek an indemnity to cover any violation that is identified during pre-closing due diligence or that may be uncovered in the future. If a significant compliance issue arises in pre-closing due diligence, a purchase price holdback or indemnity escrow may be used to cover potential liabilities. Ultimately, a purchase price adjustment may be necessary to more accurately reflect the target's value in light of potential compliance risks. In a worst-case scenario, where the parties cannot reach agreement on remedial measures or contractual safeguards, a well-informed acquirer can, and sometimes should, walk away.

Step 3: Policies and Procedures

Concurrently with the post-closing internal audit, an acquirer should also implement a comprehensive compliance program tailored to address both general and specific business risks. An anti-corruption policy that includes a code of conduct, internal reporting and approval procedures, strong financial controls, whistle blowing and monitoring mechanisms and an audit process indicates to the DOJ and the SEC the acquirer's commitment to eliminating and preventing corrupt business practices. Here, implementation is critical. Adopting policies that appear robust on paper but in reality remain untranslated and undistributed can be viewed by the U.S. regulators as worse than having no policy at all. Regular training sessions, rigorous third party due diligence, compliance audits and risk assessments are essential to ensuring that the compliance program is effective.

The FCPA and China's Anti-Corruption Laws

Chinese authorities have begun aggressively enforcing their own domestic anti-bribery laws against both Chinese and non-Chinese entities. Foreign companies operating in China must now confront the additional possibility of becoming the target of a Chinese anti-corruption investigation.

The Chinese government relies on a number of government offices in the enforcement of anti-corruption laws. The Public Security Bureau and the People's Procuratorate are primarily responsible for investigating and prosecuting criminal bribery while the State Administration for Industry & Commerce ("**AIC**") enforces commercial anti-bribery laws. Other government agencies enjoy concurrent authority with the AIC over misconduct within the industries that they supervise (i.e., the China Banking Regulatory Commission handles corruption matters related to the banking industry). The Ministry of Commerce also plays a significant role when corruption charges are issued against foreign companies operating in China.

Fortunately for U.S. acquirers, there is broad overlap between the conduct prohibited under U.S. and Chinese anti-corruption laws, with both regimes generally prohibiting the offer of anything of value in order to induce a government representative to confer an improper benefit.[3] However, important differences exist, particularly regarding who is considered a government official. U.S. enforcement authorities take the position that even low-level employees of state-owned enterprises may be considered "foreign officials" under the FCPA. In contrast, only those engaged in "government affairs," i.e., those in positions of management authority, are typically classified as "state functionaries" under Chinese law. Further, companies operating in China must comply not only with laws barring payments to government officials but also domestic commercial anti-bribery laws. Accordingly, any anti-corruption policy designed for the Chinese market should specifically address both official and commercial bribery.

Conclusion

In addition to the significant regulatory penalties at stake, ancillary costs such as legal fees associated with internal investigations and defending against shareholder derivative suits can run into the tens of millions of dollars and consume significant management resources. The mere reputational risk of being associated with corrupt activities can jeopardize future business opportunities for any multinational corporation or global investment fund. Accordingly, adopting a thorough due diligence program, comprehensive contractual provisions and robust post-closing policies and procedures are powerful strategies for preserving deal value and avoiding regulatory scrutiny.

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BEIJING
David Wang: davidwang@paulhastings.com
Jenny Sheng: jennysheng@paulhastings.com

SHANGHAI
Jia Yan: jiayan@paulhastings.com
Ananda Martin: anandamartin@paulhastings.com

WASHINGTON, D.C.
Nathaniel Edmonds: nathanieledmonds@paulhastings.com

[1] *United States v. Esquenazi*, No. 11-15331 (11th Cir. May 16, 2014). *See* Paul Hastings Client Alert, "Appellate Court Clarifies FCPA 'Instrumentality' Definition," available at http://www.paulhastings.com/docs/default-source/PDFs/stay-current-esquenazi-client-alert.pdf.

[2] *Response to the Question of How to Hold Criminally Accountable Enterprises with Criminal Acts that have been Merged*, promulgated by the Research Office of the Supreme People's Court on November 18, 1998.

[3] Although the Supreme People's Court and the Supreme People's Procuratorate have held that "property" includes currency, tangible goods and assets that can be denominated in currency, such as housing renovation, membership cards, vouchers, gift cards and payment of travel expenses, it is unclear whether intangible benefits, such as job opportunities, would fall within the scope of this definition.

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