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Analysis on Third Party Business Compliance Management Practices

By David Pan and Kevin Huang

Chinese subsidiaries and branches of MNCs have to trade and interact with a variety of third parties in the course of their operations. If any of these third parties commits an act of bribery, receives bribes or acts as an intermediary for bribery, the good reputation of the MNC may be impaired. Even worse, the MNC may be punished by Chinese or foreign government anti-bribery authorities. Therefore, improving third party business compliance management plays an important part in the Anti-Bribery Compliance Program ("**ABCP**") of MNCs.

1. Risk Assessment

From the perspective of the ABCP of an MNC, third parties include the domestic shareholder(s) of a joint venture invested by the MNC, raw materials suppliers, logistics freight forwarders, customs agents, distributors or marketing agents, the third parties which provide intermediate services for the MNC's business or transactions, customers, contractors or subcontractors of the MNC's projects, or the co-bidders with the MNC. Third parties can take various organizational forms including limited liability companies, joint-stock companies, partnerships, and in very few cases, natural persons. Additionally, third parties can have different enterprise forms, including but not limited to state-owned, private-owned or multi-national.

MNCs should consider the following elements when formulating their Third Party Risk Management ("**TPRM**") strategy: the competition level of the third-party trading market, the frequency of transactions (one-time or long-term regular transactions), the probability of bribery and corruption in the transaction areas, the association of the third party or its actual controller with the governing authority of the transaction, and the overall business compliance level of the third party's operating area.

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In order to use their compliance resources effectively, MNCs should formulate different TPRM models which are commensurate with the risk levels of the third parties. Specifically, for high-risk third parties, the management model can adopt onsite investigations. For medium-risk third parties, the management model can adopt document and material 'red flag' review. For low-risk third parties, the management model can include the third party conducting a self-assessment, and then submitting a self-assessment report and rectification plan.

2. Due Diligence in Advance

We advise MNCs to conduct due diligence in their first transaction with the third party, or in every transaction with a third party graded 'high-risk', for the purposes of managing their compliance risk. The scope and content of due diligence will vary according to the type of transaction and the functional role of the third party, but due diligence will usually examine the necessity, legality and reasonableness of such transaction with the third party. In the case of a third party that provides services to the MNC, due diligence will usually cover the following issues:

- Is the service lawful?

  Taking the manufacturing and processing services of a medical equipment manufacturer as an example, relevant laws and regulations of the People's Republic of China ("**PRC**") prescribe a list of productions of high-risk implantable medical equipment, and prohibit toll manufacturing of such equipment. If the services provided by a third party are de facto original equipment manufacturing, such services are unlawful.

- Is the service a transaction that is prone to bribery?

  Generally, services providing sales or project brokerage, joint bidding or assistance in bidding, assistance in obtaining customs, tax, visa or other licenses or permits, and travel, advertising, external training, media relations or external entertainment are regarded as highly risky areas prone to bribery.

- Is the third party service necessary for the MNC's business?

  In the well-known GlaxoSmithKline (GSK) case and in other commercial bribery cases, employees made up fictitious transactions with an independent travel agency to obtain cash for bribes or to bribe third parties through the travel agencies, for the purposes of eluding the supervision of their company's ABCP. Therefore, due diligence should identify whether a transaction with a third party is necessary for the MNC.

- If applicable, is the third party obligated to obtain all necessary licenses or permits required by the relevant laws and regulations to provide the service? Is the third party service team competent enough to provide the service?

- Is the fee paid to the third party a fixed amount, or is it a certain percentage of the final transaction value? Is the payment in line with customary market practice? Has the amount of the payment deviated from the normal level of the market?

- Does the transaction contain any of the following 'red flags'?

  - The MNC is required by the third party or its business personnel not to execute any written contract;

  - The overall risk of commercial bribery is high where the transaction is taking place;

  - The third party has a record of law-breaking or non-compliance in relation to business in the country of the transaction or other jurisdictions;

  - The third party is recommended by a government official or his or her close relative, state-owned enterprise or the MNC's director, senior manager or is the MNC's customer, or is owned or controlled by the aforesaid personnel; and/or

  - The MNC is required by the third party or its business personnel to pay the service fee to another party rather than the third party.

3. Provisions on Compliance

After due diligence is completed, the MNC should formulate detailed compliance provisions in the transaction agreements with the third parties to effectively manage the risk of third party commercial bribery. In general, the compliance provisions should include the following clauses (for the sake of convenience, the MNC is referred to as the "**entrusting party**" while the third party is referred to as the "**entrusted party**" in the following clauses):

- Compliance with Laws Clause

  This clause should express the entrusted party's obligation to comply with all applicable anti-bribery laws in the transaction with the entrusting party. It is advisable that such clause should specify the *Criminal Law of the PRC*, the *Anti-Unfair Competition Law of the PRC*, the *Interim Provisions on Prohibition of Commercial Bribery*, the *Foreign Corrupt Practices Act 1977* (United States) and the *Bribery Act 2010* (United Kingdom). It is also recommended that such clause should include the general stipulation that the entrusted party shall comply with all applicable anti-bribery laws, local laws, departmental regulations, governmental policies and other applicable industry standards.
  There may be some cases where, in practice, the entrusted party will resist inclusion of a clause mandating that they comply with the *Foreign Corrupt Practices Act*, the *Bribery Act 2010* and other foreign laws because such entrusted party is unfamiliar with the foreign laws or internal approval requirements. In order to avoid protracted negotiations, we advise the entrusting party to directly incorporate the contents and requirements of foreign laws which it wishes to apply directly into the terms or appendices of the contracts.

- Compliance with MNC's ABCP Clause

In transactions with an entrusted party graded 'high-risk' (such as agents or dealers), in addition to the Compliance with Laws Clause, the entrusting party will usually require the entrusted party to comply with its ABCP. The ABCP clause sometimes is deemed as a standard clause in nature. Therefore, if the entrusted party is in violation of the ABCP, it will usually question the legitimacy of the ABCP in order to avoid responsibility.

We advise the entrusting party to expressly stipulate the following terms in Compliance with the MNC's ABCP Clause: (1) that the entrusting party has provided a detailed description of the ABCP to the entrusted party; and (2) that the ABCP aims to encourage the entrusted party to comply with the relevant anti-bribery laws and business ethics rules, and does not exempt the entrusting party from liability, nor does it increase the liabilities of the entrusted party or exclude the main rights of the entrusted party, and the ABCP does not contain any content with the aforesaid effects.

- Payment Clause

In contracts with the entrusted party, the entrusting party should specify the basis for calculation of the purchase price, service fee, commission and other payments in the Payment Clause, to meet the reasonable requirements of the relevant anti-bribery laws and regulations. In the case of a service commission, the commission should be proportional to the amount of the service or sales provided and consistent with the normal level of the relevant market. In addition, in accordance with the relevant laws and regulations of the PRC, kickbacks or rebates paid "off the books" may be identified as commercial bribery. Therefore, the entrusting party and the entrusted party should correctly conduct proper bookkeeping when paying and receiving sales discounts, and issue invoices.

- Prohibition on Improper Payment and Bookkeeping Clause

This clause should state that the entrusted party shall not pay or promise to pay cash or property benefits to government officials, the governing authority personnel or the persons who have close relationships with the aforesaid people, or other institutions or individuals related to the transactions.

This clause usually states that the prior written consent of the entrusting party must be obtained before the entrusted party or its personnel can make a payment to related parties for the purpose of the transactions. At the same time, the entrusted party shall properly record the costs and payments in relation to the transaction in its financial books so that the entrusting party can conduct an audit.

- Audit Clause

The Audit Clause should state that the entrusting party is entitled to audit the entrusted party's financial books and records related to the transaction. Such audit may be conducted by the entrusting party's internal financial personnel or by other independent professionals. Generally, the scope of the audit shall include the entrusted party's internal controls and implementation and transaction-related costs, in particular the travel expenses of the entrusted party's employees and entertainment expenses.

In practice, the entrusted party may agree to accept a special audit conducted by an independent professional, rather than disclose to the entrusting party the details of all costs and expenses related to the transaction. After the audit is completed, the independent professional will not disclose all audit details but will merely inform the entrusting party whether there are circumstance where the entrusted party paid or promised to pay cash or property benefits to government officials, governing authority personnel or persons who have close relationships with the aforesaid people, or other institutions or individuals related to the transactions.

In addition, if the entrusted party and the entrusting party are competitors in the same industry, there exists a risk that the entrusting party may violate the anti-monopoly law in circumstances where it audits and acknowledges the entrusted party's production costs. In this case, we advise the entrusting party to engage an independent party to conduct the audit.

- Termination Clause for Breach of Contract

This clause entitles the entrusting party to terminate the contract when the entrusted party violates the compliance provisions. This clause shall be separate and independent of other termination clauses in the contract.

Chinese courts have decided in some cases that, even if the parties have agreed to terminate the contract, the extent of default should be taken into consideration when deciding whether the non-defaulting party is entitled to exercise its termination rights or not. In this regard, we advise the entrusting party to require the entrusted party to make a representation and warranty of complying with the provisions of compliance in the transaction contract. Any act of the entrusted party that violates the representation and warranty would constitute a fundamental breach of contract, so the entrusting party is entitled to terminate the contract.

- Indemnity Clause

The Indemnity Clause should state that if the entrusted party violates the compliance provisions, the entrusted party shall compensate the entrusting party for all its losses suffered due to the entrusted party's breach.

The Indemnity Clause is an Anglo-American legal concept, and may be independent of the underlying major transaction of the parties to the contract. In fact, if the transaction agreement is subjects to the laws and regulations of the PRC, it is likely that Chinese courts will not enforce the Indemnity Clause but will simply impose compensation liability upon the defaulting party where there is an actual breach of contract. Therefore, if the entrusting party wishes to adopt an Indemnity Clause in a contract, it may consider selecting an Anglo-American legal jurisdiction as the governing law. Under PRC law, a choice of foreign governing law is permitted where the contract involves "foreign elements".

- Miscellaneous Clause

In addition to the aforesaid clauses, if necessary, the entrusting party should require the entrusted party to adopt an ABCP consistent with the entrusting party in the contract, and to encourage its employees to actively report any illegal activities. The Miscellaneous Clause can state that the entrusted party is obliged to accept the entrusting party's continuous compliance training.

4. Supervision and Management

Signing a contract containing provisions on compliance is a solid foundation for third party compliance management. In order to effectively control and manage the risk of third party business compliance, MNCs should pay more attention to supervision and management after the signing of the contract.

- All Employees' Compliance of the Third Party

It is usually the case that corruption is recognized when it occurs at the highest levels, but is ignored when it occurs at the lower grassroots level. To ensure that the third party complies with the provisions on compliance, the MNC should supervise the third party to ensure that all its employees and staff related to the performance of the transaction agreement comply with the provisions on compliance, including employees at the grassroots level and contractors. These problems can be illustrated by the following case study.

[Case Study 1]

Company C is a Chinese subsidiary of a US MNC, which mainly engages in the production and sale of raw materials for shoe soles. Company D is a Chinese subsidiary of a European MNC with the business scope of manufacturing and sales of sports shoes and casual shoes, having manufacturing plants in Guangdong and elsewhere in China. According to the global cooperation agreement signed by and between their parent companies, Company C and Company D carry out business cooperation in China, agreeing that Company C supplies the resins for sport shoe soles to Company D. Both parties have conducted commercial compliance due diligence and signed a supply contract containing provisions on compliance. After the signing of the supply contract, the supply contract had been performed well until one day the staff at Company D's workshop started to request that the sales and customer service staff at Company C pay them "benefits" or "kickbacks" on a regular basis. If their demands were not satisfied, the staff at Company D's workshop would sabotage the raw materials supplied by Company C, resulting in an increase in the failure rate of Company C's products.

Company C was alarmed by the situation. Company C tried reporting to Company D's management regarding the corruption at the grassroots level, and Company D dismissed several contractors following investigations. However, the staff at Company D's workshop took further intentional actions, resulting in Company C's failure to perform the contract. Company C then terminated the supply contract following consultation with Company D.

- Compliance Training

MNCs should pay close attention to third party compliance training to improve the third party's awareness and performance of compliance procedures.

In practice, some MNCs include business compliance module courses in the regular training of their dealers and agents. In order to encourage third parties to participate in training, we advise MNCs to take into account the participation rates and assessment results of third parties when deciding whether to renew their transaction agreements and the renewed terms and conditions. Furthermore, through such training the MNC can actively guide qualified third parties to join the same compliance system as the MNC, such as ISO37001. The adoption of the same compliance system is helpful for reducing the costs of the MNC's third party compliance monitoring.

- Compliance Audit

MNCs should pay more attention to compliance audits of third parties, especially third parties graded 'high-risk', to examine whether there are any 'red flags' or irregularities. Red flags include but are not limited to the following: (1) the actual rate of payment is significantly higher than the amount agreed to in the contract; (2) the company pays cash to a third party frequently or pays a large amount of cash to such third party; (3) a third party pays cash to other institutions or individuals frequently or pays a large amount of cash to such institutions or individuals for transaction purposes; (4) the company pays to other institutions or individuals rather than the third party; (5) a third party or other institution is designated to provide trading services to the company; (6) several service providers with the same functions are engaged in one single transaction with the third party; and (7) a third party asks to change the transaction business service model.

MNCs should be wary of collusion between their employees and third parties using contract loopholes to avoid audits.

[Case Study 2]

Company E is a Chinese subsidiary of a US MNC, one of whose businesses is manufacturing and selling detection equipment for underground safety production. Company F is a trading company located in North China, and a subsidiary of a large state-owned mining enterprise group. Company F is responsible for the procurement of safe production equipment for the state-owned enterprise. For the purposes of Company E's supply of safety inspection equipment to Company F, Company E conducted a commercial compliance due diligence on Company F, and included typical provisions on compliance in the supply contract. Two years after the execution of the supply contract, Company E received a notice from Company F, requiring Company E to co-bid with Company G, an affiliated company of Company F, for the state-owned enterprise group's new supply project of mining equipment. According to the supply contract, Company F has the right to transfer all or part of the rights under the contract to its affiliated company. Sales managers of Company E quoted such provisions of the supply contract, and using the deadline for submission of bids as a justification, demanded that the legal compliance department of Company E to agree to co-bid without conducting due diligence on Company G…The legal compliance department of Company E, under pressure, persisted to conduct a quick due diligence investigation of Company G, finding that Company G was suspected to be a "shell company" newly established and was not qualified to bid due to deficiencies in registered capital, technical staff and other aspects… Further investigation conducted by the legal compliance department of Company E showed that Company G may have been established by some senior managers of Company F and the sales managers of Company E. By these means, they attempted to fraudulently portray Company G as Company F's affiliated company, and to bid with Company E for the state-owned enterprise's procurement projects. Moreover, the principals of Company G were planning to bribe the leaders of the state-owned enterprise group to win the bid.

In this case, if Company E agreed to co-bid with Company G, it would be commercial bribery and a conflict of interest between the personnel of Company F and Company E. Company E would have been implicated due to the Company G's bribery of the state-owned enterprise group, and subject to FCPA punishment. However, in this case, the prudence and vigilance of Company E's legal compliance department prevented commercial bribery and corruption from taking place.

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