

# CASE 2-5 Coping with Corruption in Trading with China

Corruption is a fact of life in China. In fact, Transparency International, a German organization that applies its Corruption Perception Index (CPI) globally,<sup>1</sup> rates China with a CPI of 3.6 and is number 79 of the 180 countries rated. New Zealand is rated the least corrupt at number 1 with a CPI of 9.4, the United States at 19 with a CPI of 7.5, and Somalia the most corrupt at number 180 with a CPI of 1.1. The country's press frequently has detailed cases of corruption and of campaigns to crack down on bribery and other forms of corruption. The articles primarily have focused on domestic economic crimes among Chinese citizens and on local officials who have been fired, sent to prison, or assessed other penalties.

There is strong evidence that the Chinese government is taking notice and issuing regulations to fight corruption. Newly issued Communist Party of China (CPC) regulations on internal supervision and disciplinary penalties have raised hopes that the new regulations will enhance efforts against corruption. The regulations established "10 Taboos" for acts of party members that violate political, personnel, and financial regulations and who are involved in bribery, malfeasance, and infringement of others' rights. The taboos included lobbying officials of higher rank, handing out pamphlets or souvenirs without authorization, holding social activities to form cliques, and offering or taking bribes. Also on the list were making phone calls, giving gifts, holding banquets or conducting visits to win support, covering up illicit activities, spreading hearsay against others, using intimidation or deception, and arranging jobs for others. Some believe that the execution of three bankers, for "a run-of-the-mill fraud," just before the Communist Party's annual meeting, was an indication of how serious the government was about cracking down on corruption.

Much of China's early efforts to stem corruption were focused on activities among domestic Chinese companies and not on China's foreign business community. Traders, trade consultants, and analysts have said that foreign firms are vulnerable to a variety of corrupt practices. Although some of these firms said they had no experience with corruption in China, the majority said they increasingly were asked to make payments to improve business, engage in black-market trade of import and export licenses, and bribe officials to push goods through customs or the Commodity Inspection Bureau, or engage in collusion to beat the system. The Hong Kong Independent Commission Against Corruption reports that outright bribes, as well as gifts or payment to establish *guanxi*, or "connections," average 3 to 5 percent of operating costs in the PRC, or \$3 billion to \$5 billion of the \$100 billion of foreign investments that have been made there. The most common corrupt practices confronting foreign companies in China are examined here.

## PAYING TO IMPROVE BUSINESS

Foreign traders make several types of payments to facilitate sales in China. The most common method is a trip abroad. Chinese officials, who rarely have a chance to visit overseas, often

prefer foreign travel to cash or gifts. (This was especially true when few PRC officials had been abroad.) As a result, traders report that dangling foreign trips in front of their PRC clients has become a regular part of negotiating large trade deals that involve products with a technological component. "Foreign travel is always the first inducement we offer," said an executive involved in machinery trade. In most cases, traders build these costs into the product's sale price. Some trips are "reasonable and bona fide expenditures directly related to the promotion, demonstration, or explanation of products and services, or the execution of a contract with a foreign government agency," but it may be another matter when officials on foreign junkets are offered large per diems and aren't invited specifically to gain technical knowledge.

Foreign travel isn't always an inducement—it also can be extorted. In one case, a PRC bank branch refused to issue a letter of credit for a machinery import deal. The Chinese customer suggested that the foreign trader invite the bank official on an overseas inspection tour. Once the invitation was extended, the bank issued the letter of credit.

## ANGLING FOR CASH

Some MNCs are asked to sponsor overseas education for the children of trading officials. One person told a Chinese source that an MNC paid for that individual's U.S. \$1,500-a-month apartment, as well as a car, university education, and expenses.

Firms find direct requests for cash payments—undeniably illegal—the most difficult. One well-placed source said that a major trader, eager for buyers in the face of an international market glut, had fallen into regularly paying large kickbacks into the Honduran, U.S., and Swiss accounts of officials at a PRC foreign trade corporation. Refusing to make payments may not only hurt sales, it can also be terrifying. A U.S. firm was one of several bidders for a large sale; a Chinese official demanded the MNC pay a 3 percent kickback. When the company representative refused, the official threatened: "You had better not say anything about this. You still have to do business in China, and stay in hotels here." Not surprisingly, the U.S. company lost the deal.

Traders of certain commodities may be tempted to resort to the black market for import and export licenses that are difficult to obtain legally. A fairly disorganized underground market, for instance, exists for licenses to export China-made garments to the United States.

Some branches of the Commodity Inspection Bureau (CIB) also have posed problems for traders. Abuses have emerged in the CIB since it started inspecting imports in 1987. A Japanese company, for instance, informed CIB officials of its intention to bring heavy industrial items into China—items that had met Japanese and U.S. standards. The officials responded that they planned to dismantle the products on arrival for inspection purposes. The problem was resolved only after the firm invited the officials to visit Japan.

<sup>1</sup>See <http://www.transparency.org> for more details about its 2010 index.

Some traders get around such problems by purchasing inspection certificates on the black market. According to press accounts, these forms, complete with signatures and seals, can be bought for roughly U.S. \$200.

Some claim that, for the appropriate compensation, customs officials in a southern province are very willing to reduce the dutiable value of imports as much as 50 percent. Because the savings can far exceed transport costs, some imports that would logically enter China through a northern port are redirected through the southern province.

The new Communist Party of China (CPC) regulations address some of these problems, but unfortunately, the new law raises more questions than answers. Two kinds of bribes are covered under the new law: The “Criminal Law of the PRC,” known as common bribery, applies to the bribery of state officials and employees of state-owned enterprises, which are most of China’s large companies. Anyone who demands or accepts money or property in return for benefits is guilty of bribery. The other is the “Law Against Unfair Competition of the PRC,” known as commercial bribery. It prohibits businesses from giving money or property to customers to sell or purchase products.

The law is confusing in that it says nothing about punishment for gifts and benefits costing less than \$600 or even whether these transactions can amount to bribes. Thus, tickets to sports events, which can cost several hundred dollars, wining and dining executives, or even pharmaceutical samples to physicians remain in a gray area. The only clue is that Communist Party guidelines prohibit members from accepting gifts exceeding \$500 but that doesn’t necessarily mean that gifts under \$500 won’t be considered a violation of the law. The trouble with China’s bribery laws is that they can be interpreted to apply to any gift at all.

## AN ILLUSTRATION

Here are some excerpts from a trial concerning a Chinese bank, a Chinese consultant, and several U.S. companies in which charges of bribery, among other issues, are involved. The list of charges, countercharges, and alleged bribery will give you a sample of the types of behavior that can arise in a transaction where bribery is rampant.

A Chinese company alleged that it got pushed out of a lucrative business deal because an American software company secretly funneled money to powerful Chinese government officials to ensure a profitable banking contract. In court filings, lawyers for the Chinese company said they had obtained copies of detailed e-mails and other records that show that the American company paid over a million dollars in fees to a consultant for services in addition to reimbursing the consultant about \$170,000 in expenses covering an array of gifts, hotels, shopping sprees, and entertainment costs.

The suit also contends that the American company arranged through the Chinese consultant for two Chinese banking officials and family members to travel on vacation to Hong Kong, Paris, Rome, Las Vegas, and the golfing resort of Pebble Beach, California. These trips were arranged by a consultant who was reimbursed for an array of gifts given to the Chinese bankers and their families. The gifts included expensive Sony cameras, luxury outfits from Versace and Burberry, and perhaps even a \$330,000 apartment in Shanghai.

The suit says an American company official e-mailed another company executive saying the chairman of China Construction

Bank was interested in playing golf at “Cobble Beach” (he thought he meant Pebble Beach). Soon after, the American company paid for the chairman’s hotel, car services, and green fees in Pebble Beach. After the chairman expressed an interest in seeing Florida, the lawsuit says the American company sent its corporate jet to fly him from San Francisco, where he had been visiting with another U.S. company, to its headquarters in Florida.

The lawsuit also charges that the American company reimbursed the consultant for tickets the chairman’s wife and son used to travel in China and the United States. The lawsuit claims it also paid for his son’s tennis club fees in Shanghai and golfing fees in Shenzhen and for the daughter of the bank’s chief information officer to travel to Europe.

The American company contended that all payments made to the consultant and all the business trips by the Chinese officials the company paid for were legitimate costs of doing business in China. It is the price the company had to pay to help secure a huge software contract with China Construction Bank worth about \$176 million.

It is important to note that this is an illustration of a civil lawsuit between two companies and does not involve charges by the U.S. government and possible violations of the FCPA. However, the report indicated that the Justice Department was looking into the charges.

## TWO COMMENTS ON DEALING WITH CORRUPTION

**Comment of a Consultant** As the head of one U.S. consulting firm asserts, “Corruption is a huge issue, it’s systemic. Whether it’s self-dealing, phantom suppliers, kickbacks, intellectual property theft or inappropriate dealings with governmental officials, crime and corruption are risks companies face when operating in China. There are many instances where, unbeknownst to the U.S. company, various payments are being made under the table. The company’s credo, the company’s standard operating procedures, the company’s code of conduct, corporate governance, best practices—all of that needs to be ingrained and it needs to be accepted. There has to be constant training and constant reminding” to the local Chinese staff. Chinese culture is “very different” from Western culture. As such, “a U.S. company cannot simply translate its compliance policies and procedures into Chinese and expect them to have the same effect as in the U.S. The entire approach must be tailored to the Chinese environment.”

**Comment of Former U.S. Foreign Service Agent** A retired agent of the U.S. Foreign Service raises questions about how strictly the Foreign Corrupt Practices Act is enforced. The economics officer of the U.S. Foreign Service says he intentionally subverted the intent of the Foreign Corrupt Practices Act so U.S. investors and exporters would not lose out unfairly to companies and agencies from other foreign countries.

“I figured out how business was actually done in corrupt countries, who was on the take, whether the going rate for host country cooperation in a particular type of transaction was 10 percent or 25 percent and who was good or bad as a go between.”

“I would tell Americans trying to do business in the host country: ‘Don’t tell me about any corrupt practices you are engaged in, because I am obliged to write that up and report you to Washington, but do tell me in detail about corrupt activities by competing foreign

companies. In return, if your information is interesting, I'll give you my best guess on how corruption works here.' By doing this I hope that I have helped level the playing field.'

## QUESTIONS

1. List all the different types of bribes, payments, or favors represented in this case under (a) FCPA, (b) Criminal Law of PRC, and (c) Law Against Unfair Competition of the PRC. Why is each either legal or illegal?
2. For those practices that you listed as illegal, classify each as lubrication, extortion, or subornation, and explain your reasoning.
3. Which of the payments, favors, or bribes are illegal under the Foreign Corrupt Practices Act (FCPA)?
4. Assuming that the FCPA did not exist, what is the ethical response to each of the payments, favors, or bribes you have identified? Read the section titled Ethical and Socially

Responsible Decisions in Chapter 5 as a guide to assist you in your decision.

5. In your view, which of the expenses detailed in the lawsuit could be in violation of the FCPA, and which could be legitimate business expenses as the American Company contends? Discuss.
6. Discuss the legal/ethical issues raised by the comments by the retired Foreign Service agent and the consultant.
7. List alternatives to paying bribes in international markets and discuss the plusses and minuses of each.

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Sources: Walter H. Drew, "Corrupt Thinking," *Foreign Policy*, May/June 2005; David Barboza, "Charges of Bribery in a Chinese Bank Deal," *The New York Times*, November 29, 2006; "India, China Ranked 72 out of 180 in Corruption Rankings," *The Hindustan Times*, October 8, 2007; "Take Great Care in Choosing Partners: Corruption Rampant, but Lately Its Drawing Government Attention," *Business Insurance*, March 26, 2007; "China's Communist Party Issues List of 'Taboos' Ahead of Politician Reshuffle," *International Herald Tribune*, January 4, 2008; "China Lists New Anti-Graft Rules," *BBC News*, January 4, 2008.