



## Foreign Corrupt Practices Act Criminal and Civil Actions: RAE Systems Inc. Agrees to Pay Over \$3 Million to Resolve Cases

Insights

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On December 10, 2010, it was announced that RAE Systems Inc. (RAE) agreed to pay over \$3 million in criminal and civil fines, penalties and disgorgement to settle and resolve charges made by the U.S. Securities and Exchange Commission ("SEC") and the U.S. Department of Justice under the Foreign Corrupt Practices Act (the "FCPA") and the Securities Exchange Act of 1934 (the "Exchange Act"), subject to court approval. These charges arose from allegations that between 2004 and 2008 RAE engaged in numerous bribery and financial improprieties through two of its joint ventures in China. (United States Securities and Exchange Commission vs. RAE Systems, Inc., Case: 1:10-cv-02-03, December 10, 2010). RAE, who did not admit or deny liability in this matter, brought this matter voluntarily to the attention of the U. S. government. Cheryl J. Scarboro, Chief of the SEC's FCPA Unit, made the following statement regarding this case: "RAE Systems develops products to detect harmful emissions, yet it did not have adequate measures in place to detect and root out internal wrongdoing. Companies that fail to respond to red flags can be held liable for the acts of their joint venture partners."

**Background of Case.** RAE, a company headquartered in California that manufactures chemical and radiation detection monitors for the global market, had operations in the People's Republic of China ("China"). Beginning in 2004, RAE started acquiring ownership stakes in two Chinese companies, KLH and Coal Mining Safety Instruments ("Fushun"), and formed two joint ventures: RAE-KLH and RAE-Fushun. In 2004, when RAE entered into negotiations with KLH, its due diligence indicated a number of concerns, including: 1) KLH's main clients were large state-owned enterprises and government departments; 2) KLH sales personnel historically financed their sales activities and sales-related travel throughout mainland China using cash advances and reimbursements; 3) KLH sales personnel often obtained cash advances from KLH's Accounting Department and used such cash advances to bribe government officials in order to obtain or retain business; 4) KLH sales personnel, in order to write off sales expenses for tax accounting purposes, were required to obtain government-issued tax receipts, known as "fapiao" for all sales expenses; and 5) KLH personnel often failed to list the true items on which they spent their cash advances.

Based on its due diligence findings, RAE instructed RAE-KLH management and personnel to follow the norms of major multi-national companies doing business in China by utilizing finder's fees, commission, and consulting fees, and stopping the bribery practices. RAE also conducted compliance training and took a number of other steps to try to ensure its joint ventures were not

violating the FCPA and other laws with their practices. However, according to the Complaint, the bribery continued, and in 2005, RAE's CFO emailed a report to headquarters which stated, in part, "[t]here is the possibility that cash [at RAE-KLH] may also be used for grease payments, to supplement sales employees' incomes as bribes", explaining that the suggestion of some abuse was derived from, among other things, the "aging balance of un-receipted advances . . ." Also according to the Complaint, RAE also acquired Fushun, and the bribery continued at both RAE-KLH and RAE-Fushun. The Complaint included the following charges:

- Although RAE responded to the specific allegation concerning an alleged money-laundering contract by returning the money, it neither performed an audit into the general allegation that the bribery was continuing, imposed internal controls, nor made significant changes to the practice of sales personnel obtaining cash advances or submitting inaccurate fapiao to justify cash advances.
- The bribery continued, and RAE-KLH sales personnel often made cash advances to officials to obtain and retain business, including a third-party agent's efforts in 2007 resulting in RAE-KLH obtaining two contracts with government clients; booking approximately \$640,000 in gross margin that would have not otherwise accrued to RAE-KLH without the third-party efforts; and booking additional sales revenue resulting in \$142,048 in total gross margin that also would not otherwise have accrued to RAE during this period.
- Examples of some of the gifts, entertainment, and payments to government officials by joint venture representatives and third parties to obtain or retain business included luxury items such as jade, fur coats, kitchen appliances, suits, and high-priced liquor, as well as computer equipment.
- RAE violated federal anti-bribery, books and records, and internal controls provisions for making \$400,000 in improper payments through two of its Chinese joint venture entities to Chinese officials from 2004 through 2008 in order to "obtain or retain business" in the form of contracts with the Chinese government. The resulting contracts were worth approximately \$3 million in revenue and garnered more than \$1.1 million in illicit profits.
- RAE agreed to pay approximately \$1.25 million to settle the SEC's civil charges. In a related criminal case against RAE, the U. S. Department of Justice announced that RAE had agreed to a pay an additional \$1.7 million in criminal fines, an injunction, and other compliance steps. RAE also consented to the entry of a permanent injunction against FCPA violations, and to comply with certain FCPA compliance program requirements.

**General Advice for Companies to Avoid FCPA Liability.** Companies subject to FCPA jurisdiction can take many steps to avoid civil and criminal FCPA and related claims, including:

- Training company managers and employees in FCPA requirements, as well as what actions they should take if they suspect FCPA violations either by their own company or by business partners whose actions could possibly subject the company to FCPA legal actions, including:

- Employees should be taught it is unlawful to make payments to a third party knowing that all or a portion of the payment will go directly or indirectly to the foreign official.
- The term “knowing” includes a company or its agents’ action acting or failing to act in conscious disregard and deliberate evidence that would cause the SEC and other governing agencies to conclude that the company acted with “its head in the sand”.
- Based upon audits, complaints, or observations by managers and employees, companies should be aware of the following red flags that should lead them to investigate further:
  - A lack of transparency in expenses and accounting records of proposed business or joint venture partners or Company business organizations.
  - Unusual financial relationships or payment patterns.
  - Unusually high business, sales, or other commissions.
  - Reported or suspected history of corruption in the countries where business relationships exist or are contemplated.
  - The refusal by a foreign joint venture or representative to provide promise or certification of no unlawful act, offer, or payment to foreign public officials, or other action that could possibly cause a violation of the FCPA by the U. S. business entity.
  - The seeming lack of job qualifications of business partners’ agents or representatives.
  - The recommendation by an official of a potential government customer of business partner.
- Companies subject to the FCPA are encouraged to take all necessary precautions to ensure they:
  - Form and maintain business relationships with reputable and qualified partners and representatives.
  - Create and follow robust and regular auditing procedures.
  - Establish global complaint procedures that allow for both anonymous and non-anonymous complaints.
  - Investigate potential foreign representatives and joint venture partners to determine if they are in fact qualified for their specific positions, the number of their clients, the reputation of their clients, and their reputations with the United States Embassy or Consulate, local bankers, clients, and other business associates.
  - Receive the advice of counsel for any questions they might have about FCPA compliance or concerns about third-party payments