

RAE and Settlement of FCPA Violations in China

As reported on Friday, December 10, 2010 in the FCPA Blog and by others, RAE Systems, Inc., (RAE) a California-based gas detection company settled Foreign Corrupt Practices Act (FCPA) charges on this date with the Department of Justice (DOJ) and Securities and Exchange Commission (SEC) for \$2.9 million. The DOJ's letter to the RAE CEO and its legal counsel, dated December 10, 2010, declined to prosecute the company and its subsidiaries for its admitted "knowing" of violations of the internal controls and books and records provisions of the FCPA. The DOJ entered into this Non-Prosecution Agreement (NPA) based upon four listed factors, which were detailed as follows: (1) timely and voluntary disclosure; (2) the company's thorough and "real-time" cooperation with the DOJ and SEC; (3) extensive remedial efforts undertaken by the company; and (4) RAE's commitment to periodic monitoring and submission of these monitoring reports to the DOJ. We will review this enforcement action and NPA over several blog postings. Today we will discuss the facts underlying the allegations and findings of bribery and corruption.

I. The Joint Ventures and Due Diligence

a. *KLH*

The DOJ Statement of Facts, attached to the NPA as Appendix A, reports that RAE sold its products into China primarily through "two second tier subsidiaries" which were organized as joint ventures with local Chinese entities. One of these joint ventures, RAE-KLH, Limited (KLH) was originally owned 64% by RAE. This interest in KLH was initially purchased by RAE in 2004. Later, in 2006, RAE increased its ownership interest to 96%. Prior to its initial purchase of a stake in KLH, RAE conducted due diligence on the Chinese entity. This report made what the DOJ called "*troubling findings*" by noting

As the important clients are those related to the government, it is very important for the company to keep very good relationship [sic] with those government people. In normal practice, KLH will determine its internal product price, the salesmen can negotiate the price with the client based on that and can take away the difference between the internal product price and the final sales price as commission. It is the salesmen, not the company, who will decide the [sic] whether and how much amount of the commission they should give to the clients. The salesmen didn't get the commission in cash directly, but instead they get the cash by provide [sic] different acceptable invoices. These invoices will then be used as original supporting documents for accounting records. They are recorded as different expenses in the financial statements. To some extent, the financial statements have been distorted by these commissions [sic].

With the change of market regulations in China, the government influence will be less important, there is a challenge as to whether KLH could still keep these clients. Although KLH let the salesmen to deal with the kickback, still they are the employees of the company and they represent the company in the transaction.

Nevertheless, internal RAE documents simply noted that RAE knew “how much [FCPA] risk we are taking.”

All of these practices were continued after RAE obtained its ownership interest in KLH. Indeed a RAE employee who reviewed KLH after the joint venture became effective noted “If you want them to be aggressive and grow business per set goals, they will do”. This same RAE employee, commenting on the institution of a FCPA compliance program for the joint venture, stated:

It will be a challenge to restructure because it changes the way they have been "successful" and rewarded in the past. As you know, KLH sales guy [sic] behave/get compensated as distributors and get "discretionary discount structure" (any residual = compensation to keep or to dispense as they see fit to close deal. To kill the sales model that has worked for them all these years is to kill the JV deal value or hurt sales momentum.

So we need to tread carefully in designing something halfway that won't choke the sales engine and cause a distraction for the sales guys. We knew this risk all along and have accepted it upon entering the JV deal.

After these reports, RAE did provide FCPA training and did inform KLH employees not to pay bribes. However, RAE seemed to believe that “we told them about [about the FCPA]...and that’s all we can do.” As you might guess, based upon this non-action, these bribery practices continued unabated even after such conduct was reported again to RAE management. The DOJ noted that while RAE senior management did indicate such bribery payment should cease, the company made “no effective effort to actually stop the practice.” Most interestingly, the RAE Financial Controller in China was directed to perform an internal audit on these issues but “he never provided any findings.”

So just what is “troubling” about this sales method? Initially, it appears that the sales person involved in each transaction sets the price, without corporate oversight. But for FCPA purposes the most troubling aspect is that the sales person involved would receive the difference in the internal product price and final sales price as a commission. To compound the problem there was apparently a double accounting of these amounts in the books and records which distorted the company’s financial statements. This structure

allowed KLH employees to use this money “under table greasing to get deals regardless if profitable/collectible or not, kosher or not, etc.”

The DOJ reported that as late as 2008, sales representatives of KLH used monies from this commission scheme for improper purposes. These purposes included the “corrupt giving of gifts and paying for entertainment, as well as direct and indirect payment, to customers”.

b. Fushun

In December, 2006 RAE purchased a 70% interest in another Chinese company named Fushun. RAE also operated Fushun as a joint venture but included Fushun’s financial results in the consolidated financial statements that RAE filed with the SEC. For reasons not stated in the NPA, RAE did not conduct pre-acquisition due diligence on Fushun. However, sometime later, RAE obtained information that Fushun did engage in business practices improper under the FCPA and thereafter, failed to implement an effective system of internal controls at the joint venture.

II. The Payment Scheme(s)

As noted above, the KLH sales force set pricing and was able to obtain the difference between the price book pricing and the as-purchased pricing. In addition to this source of cash, which could be used for bribery and corruption, both joint ventures had reimbursement schemes through which joint venture employees would submit alleged Chinese governmental tax documents which did not support the claimed reimbursement, yet RAE would pay out cash for reimbursement purposes. From such reimbursements, gifts were made to family members of Chinese governmental officials and two contracts for “consulting services” valued over \$300,000 were used to funnel monies to Chinese governmental officials. The Fushun joint venture used this reimbursement scheme to provide gifts to officials of state owned enterprises which included “jade, fur coats, kitchen appliances, business suits and high-priced liquor.”

From all of the above information, the DOJ was able to conclude that RAE knowingly failed to implement a system of effective internal accounting controls at both joint ventures which was sufficient to provide reasonable assurances that: (i) transactions were executed in accordance with management's general or specific authorization; (ii) transactions were recorded as necessary to (a) permit preparation of financial statements in conformity with generally accepted accounting principles or any other criteria applicable to such statements, and (b) maintain accountability for assets; (iii) access to assets were permitted only in accordance with management's general or specific authorization; and (iv) the recorded accountability for assets was compared with the existing assets at reasonable intervals, and appropriate action taken with respect to any differences.

Download the DOJ's December 10, 2010 non-prosecution agreement with RAE Systems Inc. [here](#).

View the SEC's Litigation Release No. 21770 in Securities and Exchange Commission v. RAE Systems Inc., Civil Action No. 1:10-cv-02093 (D.D.C., December 10, 2010) [here](#).

Download the SEC's civil complaint against RAE Systems Inc. [here](#).

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