Doing business in and with China: Battling a corruption culture by building a compliance culture

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Culture of corruption

It was during the pause between the main course and dessert that the mild-mannered man sitting next to me, a senior in-house counsel of a US multinational company, suddenly became animated. "It seems as though every deal we try to do in China is tainted by corruption and gets killed off in the due diligence phase…it's like corruption is part of the culture!" he exclaimed.

China has an ancient authoritarian culture. For millennia power has been centralized and, since Confucian times, the primary moral imperative has been the obligation of loyalty to those within one’s “in-group”. Outside the in-group, there are decreasing levels of ethical responsibility and little (or no) moral obligation is felt towards others. Coupled with a fear of power and the inability to rely on a stable and independent legal system, this situation has given rise to an inherently dangerous and uncertain social structure. Refuge is sought in one’s network of relationships of trust and, ideally, securing the favor of those in power. As John Steinbeck once wrote, “power does not corrupt, fear corrupts…”

Poverty has exacerbated the tendency to form in-groups. Throughout Chinese history, those with political or administrative power have been underpaid, yet the power that comes with the position of “government official” has been sought after. Not only have such positions offered personal security, but the fact that others have been prepared to spend their monetary and social capital in order to win a government official’s patronage has made it lucrative.

In a socio-political environment where ties of reciprocity, not trust in shared values and a reliable legal system, are fundamental to social order, winning and maintaining the favor of others, especially those who exert power, has engendered a culture of corruption. The economic reforms of the past three decades and the ensuing cultivation of wealth, especially among those with power or in-group connections to power, have further entrenched the culture of corruption. As the central ideological pillar of Communist China has morphed into a fountain of wealth, there has been no shortage of people willing to ingratiate themselves with those who have power in order have an opportunity to drink from the fountain.

Anti-corruption campaign

Foreign media coverage of China frequently focuses on the latest corruption scandals. In recent weeks, corruption scandals involving the former mayor of Nanjing, a senior admissions official at one of China’s leading universities, and two former senior executives at Sinopharm, a state-owned Chinese drug group, have been highlighted in international media reports. This is in addition to other recent, high-profile corruption probes
involving the UK multinational pharmaceutical group, GSK, and the former chairman of China’s National Petroleum Corporation, who until recently headed the government body that oversees state companies.

It is not surprising that Xi Jinping’s first speech as China’s new President to the 12th National People’s Congress on 17 March 2013 instructed members of the Communist Party to “battle against the corruption culture” and to “fight tigers as well as flies at the same time”, a reference to the fact that China’s new anti-corruption campaign should be as robust against high-flying officials as it is against more lowly participants in corrupt conduct.

More recently, during the Third Plenary Session of the Chinese Communist Party in November 2013, the Party released its “Decision on Major Issues Concerning Comprehensive and Far-Reaching Reforms,” which included references to the need to improve systems for identifying and disciplining corruption. Around this time, President Xi is reported to have declared that the problem of corruption is “a matter of the life and death of the Party and the country”.

In January 2014, Huang Shuxian, the vice secretary of the Central Commission for Discipline Inspection, said that 182,038 people were punished in 2013 for party discipline violations, a 13.3% increase on 2012.

This all points to the Party making a concerted effort to crack down on corruption among and outside its ranks.

**Impact on foreign businesses and regulators**

While some will be sceptical about the current anti-corruption campaign, it is certain to have a profound effect on foreign companies that are doing business in and with China, and on foreign regulators that are tasked with cracking down on corruption and anti-money laundering in their own jurisdictions.

Foreign companies operating in China in sectors that are problematic from the Chinese government’s perspective (in terms of the tendency of such sectors to give rise to corrupt conduct) will continue to attract the attention of Chinese regulators and law enforcement personnel. As demonstrated by the GSK case, we have already seen this in the pharmaceutical sector, where the Chinese government’s desire to crack down on corrupt marketing practices has been linked to frustrations with overpricing. Any foreign companies operating in these problematic sectors risk becoming the next exemplar for exposing corrupt conduct. Foreign companies must therefore have in place extremely vigorous anti-corruption policies and practices, and develop a “bottom-up” culture of compliance.

For a number of reasons, China is experiencing capital flight. Some commentators have attributed part of the capital that is leaving China to corruption. Unverified statistics estimate that the equivalent of US$41.2 billion was transferred out of China in the first 11 months of 2012 by corrupt officials.

Bo Zhiyue, an expert on Chinese politics at the National University of Singapore, is reported to have said: “If you define corruption as discrepancy between salary and assets, then 99.95% of officials, all through different ranks, are corrupt. So it’s impossible to get rid of all of them.” If such views are supported by fact, or even broadly representative of fact, then it is likely that foreign regulators will face challenges in addressing capital inflows that have been tainted by corruption, as the “tigers” (and even the “flies”) who have the means to move their illegally gained funds outside China attempt to do so.

Not only will foreign regulators need to be prudent in their assessment of certain capital inflows from China, but foreign companies seeking to partner with businesses that are funded, or partly funded, by tainted sources will,
in certain circumstances, need to be exceptionally diligent in their investigations into the financing of their Chinese business partners.

**Developing a compliance culture**

All of this boils down to an increasing need for real understanding of the socio-cultural nuances of corrupt conduct and anti-corruption policies and procedures in China, as well as the legal and regulatory frameworks for catching and preventing corrupt conduct.

For foreign companies doing business in China, the key corruption-related risks involve

- Kickbacks, gratuities and other facilitation payments
- Conflicts of interest manifested through undisclosed related-party transactions
- Misappropriation of intellectual property rights and other assets
- Extortion and other abuses of power
- Tax irregularities.

Although these risks are faced throughout the world, they are particularly prevalent in China given the prominence of personal relationships over contractual and legal obligations, the scope of discretion and power afforded to government officials, the rapid growth (especially in second and third-tier cities), the “get rich quick” mentality that has evolved with rapid growth, and the challenges in stemming high turnover rates and attracting talent.

To manage these risks, foreign companies doing business in China need to ensure that

- Appropriate anti-corruption policies and procedures are given the same priority as the pursuit of profits, growth and key personnel.
- Employees fully understand the policies and procedures and feel comfortable with their ability to put them into practice.
- Systems and checks are put in place so companies have long corporate memories that are capable of handling high employee and management turnover.
- They invest in proper anti-corruption screening of employees, suppliers and other business partners in China.
- The company chops, *i.e.*, the company seals that are capable of binding companies once affixed to a written document, are carefully and properly controlled.
- They establish reliable whistle-blower systems and crisis management teams.

The above measures resemble anti-corruption programs in most parts of the world, but in China it can be especially challenging to implement these steps because Chinese staff often have different views to non-Chinese staff on what constitutes unacceptable behavior. Common examples include

- “The company I set up doesn’t create a conflict of interest because I was doing a favor to my employer by selling product to my employer at a discount to other competitors”
- “I didn’t make any money through the shadow company, so I have done nothing wrong!”
- “Everyone else makes these payments to secure sales, so why shouldn’t we?”

Further, rumor and speculation are very common in Chinese workplaces, so it can be difficult to distinguish genuine concerns from casual conversations. In addition, hierarchical social structures in China are often
replicated in the workplace, which can mean that Chinese staff often assume that senior management is aware of an issue or should be aware of an issue, so there is no need for more junior staff to risk their reputation (or anyone else’s for that matter) by raising the issue to their superiors.

The rapid growth China has experienced has created expectations of even more growth, which has increased the pressure to deliver higher sales volumes and lower cost structures. The need to deal with this pressure is often given greater priority than the need to comply with compliance obligations.

Businesses that are able successfully to integrate their compliance and commercial objectives will be best placed to handle the increased risks associated with the current anti-corruption campaign in China.

**Legal and regulatory framework**

China has a plethora of anti-corruption laws and regulations. Tacitus had a point when he observed, “The more corrupt the state, the more numerous the laws.”

China’s anti-corruption legal and regulatory framework centers around the Anti-Unfair Competition Law, the Criminal Law, the Interim Provisions on the Prohibition of Commercial Bribery, the policies of the Chinese Communist Party and numerous judicial and regulatory opinions and pieces of subordinate legislation. Failure to comply with these laws and regulations can give rise to onerous administrative and even criminal penalties. Foreign companies operating in China also need to be mindful of who implements these laws and regulations and how that is done in practice. For instance, in matters that could give rise to criminal consequences, foreign companies need to consider whether, and at what stage, to involve the local police. Often—though not always—it is considered prudent for a company to carry out its own internal investigation before turning a matter over to the local police. This is because, once a matter is turned over to the police, the company will lose control of how it is investigated.

Business leaders and in-house counsel will continue to be frustrated by the culture of corruption in China. If, however, they develop a deeper knowledge of that culture and its sub-cultures, and an awareness of how they differ from corrupt conduct and anti-corruption initiatives in Western countries, they will be able to understand what actions need to be taken in order to better protect foreign businesses that have Chinese business partners or are directly active in China, and perhaps lessen their frustration.
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