

TOP 3 OF 2010-(DING DONG) AVON CALLING

This is the second installment of our three part series on the Top 3 Foreign Corrupt Practices Act (FCPA) matters of 2010 to date and their significance for the FCPA compliance professional. In Part I we focused on the Gun Sting matter. Now we turn our attention to the Avon bribery scandal in China.

As early as October 2008, Avon reported, in a Statement of Voluntary Disclosure, that it was investigating an internally reported allegation by an undisclosed whistleblower that corrupt payments had been made in its China operations. These allegations claimed that certain travel, entertainment and other expenses may have been improperly incurred. Although the details of the Avon case have not been disclosed, direct selling was not allowed in China under a law passed in 1998. The National Review reported that Avon was able to secure permission in late 2005 to begin direct selling on a limited basis. Later the Chinese government issued direct-selling regulations and granted Avon a broader license in February 2006 to make such sales.

In its 2009 Annual Report, Avon noted that the internal investigation and compliance reviews, which started in China, had now expanded to its operations in at least 12 other countries and was focusing on reviewing “certain expenses and books and records processes, including, but not limited to, travel, entertainment, gifts, and payments to third-party agents and others, in connection with our business dealings, directly or indirectly, with foreign governments and their employees”. The FCPA Professor, citing the Wall Street Journal, reported that Avon suspended four employees, including the President, Chief Financial Officer and top government affairs executive of Avon's China unit as well as a senior executive in New York who was Avon's head of Internal Audit.

One of the significant pieces of information to come out of the Avon matter is the reported costs as reported in the 2009 Annual Report the following costs have been incurred and are anticipated to be incurred in 2010:

<i>Investigate Cost, Revenue or Earnings Loss</i>	
Investigative Cost (2009)	\$35 Million
Investigative Cost (anticipated-2010)	\$95 Million
Drop in Q1 Earnings	\$74.8 Million
Loss in Revenue from China Operations	\$10 Million
Total	\$214.8 Million

Marketwatch also reported that after these additional investigations were made public Avon's stock prices fell by 8%. Lastly, in addition to the above direct and anticipated costs and drop in stock value, the ratings agency Fitch has speculated about the possibility of a drop in Avon's credit ratings. In a June 1 Press Release, Fitch noted that not only could the above listed investigative costs come out of Avon's ordinary cash flow, thereby putting a strain on the company, but that Fitch would expect companies

such as Avon to make every effort to comply during an agreed upon deferred prosecution period with the Department Of Justice (DOJ) given the severity of an indictment.

An indictment for FCPA violation(s) would be viewed as 'Event Risk', a term used by Fitch to describe the risk of a typically unforeseen event to the analyst which, until the event is explicit and defined, is excluded from existing ratings. An indictment would be an externally triggered event that would generate a rating review based on materiality and impact.

But what does all of this mean for the Chief Compliance Officer sitting in his office in the US? It should mean quite a bit. There are several lessons from which you can learn and immediately implement in your FCPA compliance program if you have not previously done so.

1. **Who is a "foreign governmental official"?** China poses a major challenge for US companies trying to comply with the law. The DOJ has consistently interpreted the FCPA as extending to any employee working for a state-owned business. Further, in a communist country, the DOJ has taken this interpretation a step further by opining that all employees are state employees and therefore a foreign governmental official. This means that from top to bottom, all persons in China are covered by the proscriptions of the FCPA. This interpretation has never been tested in a US court but it puts the broad swaths of the Chinese economy directly under the FCPA. Couple this with the pressure felt by foreign companies to sponsor trips by Chinese regulators, who do not seem to be shy in asking for perquisites, and you have a situation which is ripe for a FCPA violation.
2. **Travel, Gifts and Entertainment under the FCPA.** The FCPA includes an affirmative defense for payments to officials related directly to "the promotion, demonstration, or explanation of products or services" that are "reasonable and bona fide" 15 U.S.C. §§ 78dd-1(c)(2)(A) and 78dd-2(c)(2)(A). That defense is loaded with uncertainty and very difficult for companies to safely use. It may well be that Avon provided trips to the US for the Chinese Regulators with regulatory oversight for Avon's China operations, or gifts and entertainment which did not fall under the FCPA exemption. If so, the FCPA compliance professional should review the company policy on such matters.
3. **Internal Enforcement of Company FCPA Compliance Policy.** One of the employees suspended was the (former) head of Internal Audit. In addition to a strong FCPA compliance policy, a company should continually monitor its compliance program, through a strong internal audit program, to use as a first line of defense to not only prevent FCPA violations before they occur but also detect FCPA compliance violations.

A key 'best practices' FCPA compliance program component is to utilize internal audit to monitor for FCPA compliance issues on a regular basis to not only assess compliance but to also identify anything which warrants further investigation.

Taken a step further, a continuous controls monitoring program can assist a company to identify unusual expenses, budgeted items, or any other event which is outside an established norm and **Red Flag** such expense, item or event for further investigation.

All of the facts of the Avon matter should be carefully studied by the Chief Compliance Officer of any company doing business in China. The case stands for the proposition that a company should not only have a robust FCPA compliance policy in place but that it must continually monitor the policy to ensure compliance.

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