

Settlements

Anti-Corruption Compliance Lessons from the Avon Settlements

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More than six years ago, in October 2008, Avon Products, Inc. (Avon Products) first disclosed that it was under FCPA scrutiny in China. On December 17, 2014, the company finally resolved the investigation, with a deferred prosecution agreement (DPA), a guilty plea by its wholly-owned subsidiary, Avon Products (China) Co. Ltd. (Avon China), and a settlement agreement with the SEC. In total, Avon Products and Avon China agreed to pay \$135 million in U.S. criminal and regulatory penalties.

The Avon enforcement action offers a number of important lessons for multi-national companies, including the substantial repercussions from failure to take prompt remedial action upon learning of a potential FCPA violation, the importance of considering specific regulatory circumstances when designing a risk-based compliance program, and the harsh reality that penalties and disgorgement paid to U.S. regulators can be dwarfed by other costs of cleaning up corruption problems.

The Resolutions

Avon China pleaded guilty to one count of conspiracy to violate the books and records provision of the FCPA, and agreed to pay \$67.6 million to resolve the charges. At the same time, parent company Avon Products entered into a DPA with the DOJ in which the company admitted its role in the conspiracy and its failure to implement proper internal controls, and agreed to a penalty of \$67.6 million. The criminal penalties imposed upon Avon China are to be deducted from the penalty amount to be paid by Avon Products, thus, the DPA did not result in any additional payment. Significantly, the DPA requires Avon Products to retain an independent compliance monitor. See *"How to Find*

a Business-Minded Compliance Monitor and Minimize Reporting Requirements When Negotiating an FCPA Settlement (Part One of Three)," The FCPA Report, Vol. 2, No. 4 (Feb. 20, 2013); Part Two of Three, Vol. 2, No. 5 (Mar. 6, 2013); Part Three of Three, Vol. 2, No. 6 (Mar. 20, 2013).

Avon Products' resolution with the SEC included an additional payment of \$67.4 million in disgorgement and prejudgment interest to resolve an SEC complaint charging one count of violating the books and records provision and one count of violating the internal controls provision of the FCPA. Avon Products resolved the SEC complaint without admitting or denying the allegations set forth by the SEC. See *"Four Ways the SEC Enforcement Landscape Is Changing and Why They Matter,"* The FCPA Report, Vol. 2, No. 24 (Dec. 4, 2013).

Bribery and Door-to-Door Sales in China

Licenses to Conduct Direct Sales

The criminal information against Avon China alleges that in or around 1998, the Chinese government outlawed direct door-to-door sales, the method used by Avon to distribute its beauty products. The Chinese government began to ease the prohibition on direct sales in 2005, first with a single "test license" for one company, after which the government lifted the ban and allowed companies to apply for licenses to conduct direct sales. According to the information, Avon China was awarded the first and only test license in or around March 2005, obtained its national direct selling license in or around February 2006, and obtained all of its provincial and municipal approvals to conduct direct sales between approximately February 2006 and July 2006.

Gifts and Payments to Chinese Government Officials

The DOJ and SEC allege that Avon China provided gifts and other things of value to Chinese government officials in order to obtain direct selling licenses as well as other business benefits. According to the SEC, altogether, Avon China “provided approximately \$8 million dollars in cash and things of value to Chinese government officials during the time period from 2004 through the third quarter of 2008.” The SEC alleges Avon China gave officials Gucci bags, Tiffany pens, and Louis Vuitton merchandise, among other gifts totaling \$400,000. Of that amount, “approximately \$70,000 to \$90,000 . . . is attributable to tickets or corporate boxes at the China Open tennis tournament, given to . . . government officials in 2004 and 2005 ‘to thank them for their support[,]’” according to the SEC. The SEC also alleges that Avon China provided at least \$1.7 million worth of Avon products to government officials.

The \$8 million overall total also included “approximately 9,600 payments totaling \$1.65 million for meals and entertainment involving government officials,” according to SEC allegations. Among other examples cited in the SEC’s complaint is “\$4,147 . . . for a Pearl River cruise for 200 State and regional . . . officials” from one of the government agencies responsible for implementation of the direct selling regulation. In addition, the SEC alleges that Avon China “made a cash payment of approximately \$12,500 to an . . . official in Hunan Province[.]”

Sightseeing in China and the U.S. for Chinese Government Officials

As alleged in the criminal information against Avon China, “[i]n or around September 2006, Avon China employees falsely described the approximately \$90,000 spent on a trip for four officials . . . in Avon China’s books and records[.]” The trip was described as a business-related site visit and study trip to Avon’s headquarters in New York City and its research and development facility in upstate New York.

In reality, “the officials never visited Avon’s headquarters, only spent one morning at Avon’s research and development facility, and spent the rest of the 18-day trip sightseeing and being entertained by an Avon China employee in New York, Vancouver, Montreal, Ottawa, Toronto, Philadelphia, Seattle, Las Vegas, Los Angeles, Hawaii, and Washington, DC.” See *“Scientific Instrument Company Bruker Settles Civil FCPA Action for \$2.4 Million, Raising Recurrent FCPA Themes,”* The FCPA Report, Vol. 3, No. 25 (Dec. 17, 2014) (describing sightseeing trips for Chinese officials).

The information also alleges that Avon China employees falsely described in Avon China’s books and records various personal trips for government officials to tourist destinations in China, including “approximately \$15,400 [that] Avon China paid for government officials to travel to Guangzhou, Shenzhen, and Sanya[.]” That trip was described as a “site visit/inspection” but in fact included “charges for a tour guide, sightseeing van, and items purchased at the beach.”

Business Benefits to Avon China

In addition to securing licenses to conduct direct sales, Avon China is alleged to have obtained various other business benefits in exchange for the gifts, payments, travel and entertainment that the company gave to Chinese government officials. The DOJ alleged that “[i]n or around December 2006, [an] Avon China Executive . . . expressed concern to the Corporate Affairs Group that an article a leading government-owned newspaper intended to run about Avon China improperly recruiting sales associates could cause Avon China to lose its direct selling license.” “[I]n order to convince the newspaper not to run the article . . . Avon China [paid] . . . approximately \$77,500 . . . to become a ‘sponsor’ of the paper at the request of a government official at the paper who was in charge of determining whether the potential article would run[.]” See *“Identifying and Mitigating Anti-Bribery Risk in Journalism and Newsgathering,”* The FCPA Report, Vol. 1, No. 6 (Aug. 22, 2012).

According to the SEC, Avon China also provided cash and things of value to Chinese government officials in order to avoid potential fines against the company. The SEC alleges that Avon China implemented a “zero penalty policy” in order to “ensure that Avon had a clean corporate image in China.”

Lessons Learned from the Avon Settlements

1) Repercussions from Covering Up Bribes and Failing to Remediate

As set forth in the charging documents, Avon China and Avon Products failed to take remedial action when executives were first made aware of the improper practices. The DOJ’s press release highlights this point, explaining that “[t]he companies also admitted that in late 2005 Avon [Products] learned that Avon China was routinely providing things of value to Chinese government officials and failing to properly document them. Instead of ensuring the practice was halted, fixing the false books and records, disciplining the culpable individuals, and implementing appropriate controls to address this problem, the companies took steps to conceal the conduct, despite knowing that Avon China’s books and records, and ultimately Avon [Products’] books and records, would continue to be inaccurate.”

According to the statement of facts accompanying the Avon Products DPA, in June 2005, “a senior audit manager in Avon [Products’] internal audit group reported to Avon [Products’] Compliance Committee, which was comprised of several senior Avon [Products] executives, that Avon China executives and employees were not maintaining proper records of entertainment for government officials and that [an] Avon China Executive . . . had explained that the practice was intentional because information regarding that entertainment was ‘quite sensitive.’”

In September 2005, Avon Products’ internal audit group issued a draft report that contained conclusions including: “(1) high value gifts and meals were offered to government officials on an ongoing basis; (2) the majority of the expenses related to gifts, meals, sponsorships, and travel of substantial monetary value for Chinese government officials to maintain relationships with the officials; (3) a third-party consultant was paid a substantial sum of money to interact with the government but was not contractually required to follow the FCPA, was not actively monitored by Avon China, and was paid for vague and unknown services; and (4) the payments, and the lack of accurate, detailed records, may violate the FCPA or other anti-corruption laws.”

At the insistence of Avon China executives, and with the agreement of Avon Products executives, the internal audit team was directed by an Avon Products executive to delete from the draft report the discussion of providing things of value to government officials and of potential FCPA violations. The internal audit team was also directed to retrieve and destroy all copies of the draft report, or instruct the individuals in possession of the draft report to destroy their copies. The Avon Products DPA goes on to explain that despite the findings in the draft audit report, as well as similar findings later in 2005 and in 2006, Avon Products executives “did not instruct any Avon China executives or employees to stop the conduct identified in the Draft Audit Report.”

Although Avon Products ultimately made a voluntary disclosure to the DOJ and SEC in October 2008, this step was not taken until after Avon Products’ CEO received a letter in May 2008 from a former executive, who had been terminated by Avon China, setting forth allegations regarding improper payments to Chinese government officials. While it is difficult to isolate and quantify credit for self disclosure, in this case it is likely that any such credit was reduced in light of the fact that Avon China and Avon Products initially failed to take appropriate remedial actions upon learning of the improper payments.

The DOJ and SEC may have seen the subsequent decision to self disclose as resulting primarily from fear that the former employee who wrote to Avon Products' CEO would become a government whistleblower, rather than from a desire to be a good corporate citizen.

The \$135 million settlement amount should serve as a reminder for other companies of the importance of promptly investigating and remediating upon learning of potential FCPA violations. When a company's internal auditors identify relevant information indicating a potential anti-corruption issue, the auditors must be given a real voice and their findings must be addressed, not ignored or worse, concealed.

The self-disclosure calculation must be made on a case-by-case basis with consideration of several factors, but a failure to remediate followed by a belated disclosure is not likely to serve a company well in settlement negotiations with the DOJ and SEC. See "*When Should a Company Voluntarily Disclose an FCPA Investigation?*" The FCPA Report, Vol. 3, No. 4 (Feb. 19, 2014).

2) Inadequate Attention to High-Risk Regulatory Circumstances

Another lesson that can be drawn from the Avon enforcement action is the importance of focusing the attention and resources of a company's compliance department on high-risk areas. Assessments regarding risk level should be made based on a number of different metrics, and it is not enough to look only at the general level of corruption risk in a particular country.

China is clearly a high-risk jurisdiction (ranking 100 out of 175 countries in Transparency International's 2014 Corruption Perceptions Index), but in the specific case of a company that conducts direct door-to-door sales, China's strict regulatory regime with regard to direct sales should also have been seen as a special risk factor warranting additional compliance attention. China lifted the prohibition on direct sales only relatively recently, and obtaining permission to carry out such sales requires both a national license from the Chinese

government and numerous provincial and municipal approvals. Those government touchpoints create opportunities for corruption and as such require heightened compliance scrutiny. See "*Understanding and Tackling China's Corruption Challenges*," The FCPA Report, Vol. 3, No. 5 (Mar. 5, 2014).

3) Ancillary Costs from Internal Investigation and Shareholder Litigation

After Avon Products' disclosure of alleged FCPA violations in public filings beginning in 2008, shareholders filed suit alleging claims for securities fraud based largely on the conduct underlying the potential FCPA violations. See "*Non-FCPA Liability for Alleged FCPA Violations*," The FCPA Report, Vol. 1, No. 1 (June 6, 2012); "*Avon Class Action Dismissal Illustrates Challenges of FCPA-Related Shareholder Derivative Suits*," The FCPA Report, Vol. 3, No. 21 (Oct. 22, 2014). Although such claims have generally gained little traction in the courts (and thus far the Avon shareholder plaintiffs' litigation has been no exception), there are nonetheless costs associated with settling or litigating such cases to obtain a dismissal.

In addition to the cost of defending shareholder litigation, Avon Products also incurred very high costs in carrying out its internal investigation. In February 2014, the company reported that it had spent a staggering \$344 million on the investigation. Although the enforcement action has been resolved, the fallout will continue to cost the company significant money for some time, as it pays for a compliance monitor over the next 18 months. And whether Avon may face charges by the Chinese authorities for violating their anti-bribery laws (à la GlaxoSmithKline's \$490 million fine imposed following a conviction for bribery in China this past September) remains to be seen. All in, Avon's costs in connection with the FCPA investigation will most certainly be upwards of half a billion dollars, and that is without factoring in the reputational costs.

By failing to properly identify its risks in China, and then ignoring potential problems there, Avon missed a real opportunity to avoid further misconduct and all the ancillary consequences that go along with that.

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