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Channeling the Channel-Partner Risk: Addressing Anti-Corruption Risk with Channel Partners in the Technology Sector

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In the software and hardware businesses, the use of channel partners – entities that pair with manufacturers to market and sell products, services and technology – often presents unique compliance challenges. Unlike ordinary re-sellers, channel partners tend to participate more in cooperative market development efforts with manufacturers, and their participation in transactions is sometimes necessitated by local content requirements. Recent DOJ and SEC enforcement actions have targeted the technology sector and cases involving improper conduct by channel partners have highlighted the risks inherent in discounting and price inflation and the use of "market development funds."

To assist with navigating these risks, this article explores some of the recent enforcement actions in the software and hardware sector, identifies the principal themes in those actions and proposes compliance practices to mitigate channel partner risk.

Liability for the Conduct of Channel Partners

Channel partners are third parties that partner, often on a non-exclusive basis, with a technology or other manufacturer or producer to market a company's products or services to end-customers in a particular sales territory. Although the channel-partner category includes re-sellers and distributors, in the software and hardware businesses the term is often used to describe entities that play a more active role in market development, such as participating in co-branding and hosting product demonstration or training events. Channel partners typically also have more direct interaction with end-customers – private and public sector alike – on behalf of a manufacturer during the bidding and negotiation stages. Moreover, channel partners can also act as systems integrators, selling technology solutions as part of a bundle of various companies' products or services (e.g., technical support, training or application customization).

Because of local content and market requirements in certain countries, many multinational technology manufacturers rely on channel partners as a matter of local law or practice to function as the point of contact between the manufacturer and the end-customer – a role that creates particular risk in the context of public-sector customers and tenders. In some instances, channel partners also have additional, higher-risk responsibilities such as assisting with customs clearance and product registration.

Depending on the circumstances, a manufacturer can face potential FCPA liability if it authorized a channel partner's misconduct or knew that the channel partner was engaging in misconduct on the company's behalf. The requisite knowledge for liability may be established by demonstrating that the manufacturer should have known, based on the circumstances, that there was a high probability of improper conduct.

Corrupt Scheme Patterns Relating to Channel Partner Relationships

A review of recent FCPA enforcement actions involving software and hardware companies reveals two key risk areas that are particularly relevant to the economics of channel partner relationships: 1) discounts and price inflation and 2) market development funds.

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Discounts and Price Inflation

A manufacturer can provide channel partners with funds to use as bribes by providing substantial discounts on products or services that the channel partner does not pass along to the end-customer. Similarly, a channel partner can inflate the ultimate end-user price by inserting fictitious or unnecessary third parties or services into the transaction. Frequently, discounts are requested by channel partners on the grounds that additional price concessions are needed in the face of stiff competition. A risk inherent in this type of discounting is that the channel partner could use all or part of its enhanced margin to fund illicit payments to representatives of the end-customer. In the case of fictitious parties or services added to the deal, which may also have the effect of inflating the end-user price, the risk again is that the inflated prices could be used to conceal illicit payments.

Regarding discounting risks, for example, in proceedings against SAP SE (a German software company), the SEC in 2016 alleged that SAP's vice president of global and strategic accounts sold software to a local partner at an 82 percent discount and falsely stated on internal justification forms that the discount was necessary to compete with other software companies in establishing a relationship with the Panamanian government. The SEC alleged that the VP and the local channel partner created a slush fund with the resulting money, enabling them to bribe foreign officials and receive kickbacks of their own.

With respect to the use of fictitious parties or services, in a 2012 enforcement action involving Oracle Corporation, the SEC alleged that Oracle India instructed local distributors to withhold part of the revenue from Oracle's 2006 sales to an Indian government ministry and to use that revenue for bribes. According to the SEC, the distributor created fictitious invoices from third-party vendors to conceal the diversion of the extra revenue.

As an additional enforcement example, a 2011 SEC complaint against IBM alleged that after a South Korean government official helped IBM win a personal computer supply contract, there was an effort to conceal a business partner's improper payment to the official with a fictitious description of services. According to the SEC's allegations, an IBM business partner paid the government official approximately $14,000, with the payment recorded inaccurately in the company's books as "installation fees."

Market Development Funds

Manufacturers often provide their channel partners with credits or rebates intended to fund market development activities, including sponsorship of training sessions or seminars in which channel partners demonstrate company products or services. Although such sessions are routine and legitimate, recent enforcement examples indicate that they can be misused as a means to provide improper benefits. For example, a customer training session or factory visit might be structured to include a significant sightseeing or leisure component, with premium-class air and hotel accommodations, or other extravagant treatment for customer representatives. In some cases, these expenses are concealed by recording them improperly as legitimate "market development" charges.

For example, in a 2016 enforcement action against PTC Inc., a Massachusetts software provider, the SEC and DOJ alleged that market development funds, though nominally used for travel to attend training at PTC's headquarters near Boston, were primarily used to sponsor recreational travel to tourist destinations throughout the United States. On one particular trip, two PTC China sales employees allegedly accompanied six Chinese government representatives on a trip that consisted of one day at headquarters followed by travel to New York, Las Vegas, Los Angeles and Honolulu. Within a year of the trip – which cost PTC over $50,000 – PTC booked more than $1 million in contracts with the government entity, the government alleged.

Nortek, Inc., a Rhode-Island-based company that manufactures residential and commercial solutions for heating, air conditioning, security and audio/visual systems, also faced allegations of improper payments in the form of cash, gifts, travel, accommodations and

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entertainment. According to allegations contained in a non-prosecution agreement with the SEC, Nortek's subsidiary made at least one improper payment per month over the course of five years to government officials from customs, tax, fire, police, labor, health inspection, environmental protection and telecommunications departments.

See The FCPA Report's three-part series on travel and entertainment corruption risks: "*Five Hallmarks of an Acceptable Hospitality Expenditure*" (Mar. 9, 2016); "*Three Musts for a Strong T&E Policy and Five Ways a Company Can Customize Its Program*" (Mar. 23, 2016); and "*Internal Controls to Ensure the Program Is Working*" (Apr. 6, 2016).

Addressing the Risk From Channel Partners

Addressing the risk inherent in channel partner relationships requires a multi-pronged approach. As with any third-party relationship, anti-corruption compliance efforts begin with robust due diligence on the front-end along with appropriate contractual provisions and safeguards to help ensure that the third party both understands its compliance obligations and is bound to follow them. Because of the greater level of cooperation and longevity inherent in channel partner relationships, additional and more specific compliance procedures may be appropriate.

Fixed Discounting

To address the risk inherent in steep discounts, companies can consider moving to a fixed discounting system, whereby the channel partner is subject to a tiered discounting framework that may be linked to the size of the deal, overall sales volume or other metrics. Such a discount structure – which may be presented in the form of a discount matrix – increases predictability in the manufacturer's pricing and reduces the opportunity for anomalous, non-transparent pricing that may conceal corrupt conduct. For instance, a simple discount matrix could provide that channel partners with annual sales of up to a fixed amount (X) are entitled to 10 percent discounts on company products, with higher set discounts available for marginal sales above X.

Discount Approval

For transactions that may require more pricing flexibility, companies can consider a formalized discount approval process, whereby the channel partner must justify and document in writing any non-standard discount requests. Such justifications should fully describe the transaction, the specific parties involved in the deal and the basis for the request. As an added safeguard, requests for substantial discounts should be reviewed by compliance professionals and be subject to regular audit.

Margin Verification

Where non-standard discounts are provided to the channel partner, companies should consider a periodic after-the-fact sampling of transactions where possible to determine if the discount was passed through to the ultimate end-user. Failure to pass through the discount could suggest that the non-standard discount was not necessary to facilitate the partner's success in winning the deal and, absent a reasonable business justification, could raise the risk that portions of the discount were retained by the channel partner as additional profit or diverted for improper payments.

In the context of a public tender, the final end-user price is often a matter of public record. These public records can be reviewed and compared to the price offered the channel partner and, where the final end-user price appears high, the company can demand specific transaction documents from the channel partner to perform a more detailed review, perhaps within the ambit of an audit clause.

As part of this review, companies should carefully scrutinize the entire transaction to determine if fictitious or unnecessary third parties or services could have been included in the deal as a means to inflate the final sales price and provide a possible fund for illicit payments.

See The FCPA Report's three-part series on enforcing third-party audit rights: "*What to Do Before an Audit (Part One of Three)*" (Nov. 9, 2016); "*Conducting an Onsite Audit (Part Two of Three)*" (Dec. 7, 2016); and

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"*Forestalling Problems, Documenting the Audit and Responding Appropriately (Part Three of Three)*" (Mar. 1, 2017).

Discount Transparency

In order to ensure that discounts are not used to fund corrupt payments, companies might also consider ways to provide greater transparency in the discounts offered to channel partners. For example, where a channel partner requests a non-standard discount, the company could, as a standard practice, notify the putative end-customer about the discount arrangement. Such transparency could help ensure that the discount is passed through to the customer.

Market Development Fund Controls

On the issue of market development funds, legal and compliance personnel should collaborate with their counterparts on marketing and finance teams to ensure that all expenditures by channel partners reimbursed through market development funds are adequately supported with receipts and other documentation, and that the expenses incurred are for legitimate business purposes (such as training or product demonstration) pursuant to company policy and are otherwise reasonable.

Moreover, companies might also require that channel partners periodically certify compliance with company policy governing expenditures for marketing activities. In situations where multiple manufacturers contribute funds for a single event or trip sponsored by a non-exclusive channel partner, companies should ensure that the entire event, and not just the portion funded by or specifically related to the company, comports with anti-corruption policies and is otherwise reasonable.

But Be Wary of Antitrust Issues

It is important to bear in mind that in some markets, conversations between a manufacturer and its channel partners regarding pricing and discounts to be offered to end-customers could potentially raise issues for consideration under U.S. and foreign competition laws. Companies should consult with local counsel regarding the applicable law in the markets in which they conduct business.

As a general rule, a company's efforts should be the least intrusive necessary to verify a contractual arrangement and to minimize the risk that the channel partner could be creating a slush fund for improper payments. It is important that proper compliance efforts be undertaken to ensure that communications with channel partners not stray into efforts to force the channel partner to impose particular price structures on end-customers, or to follow territorial or customer allocations not allowed in the given jurisdiction, or to engage in any other conduct that could be perceived as collusive or "fixing" a price for goods or services.

See "*Russian Risks: Reconciling the Novo Nordisk Standard with the FCPA*" (Jul. 10, 2013).

Conclusion

Channel partners may be a key and necessary component of the international sales and distribution process for software and hardware companies. Because of the particularized compliance risks arising from the use of channel partners, manufacturers should consider greater controls over discounting and the use of market development funds. Moreover, a review of these controls can be integrated into the company's annual internal audit work plan and the control environment should be reviewed as part of the company's periodic compliance risk assessment process. With proper focus on the appropriate economic aspects of channel partner relationships, manufacturers can ensure that these relationships do not present undue risks to ongoing business and compliance efforts.

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