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DISCOUNTS

Understanding and Mitigating Third-Party Discount Risk

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Juniper Networks (Juniper) recently settled allegations with the SEC that it violated the FCPA's internal accounting controls and recordkeeping provisions, agreeing to pay $11.7 million. The Juniper enforcement action is a cautionary tale on the corruption risk of giving non-standard discounts to third parties and failing to implement a policy for giving these types of discounts.

Under ideal circumstances, companies retain third parties to leverage their on-the-ground relationships with end-user customers to resell company items and/or services. In exchange, companies will offer discounts to the third parties and the third parties will sell the items or services at list price and use a portion of the discount for their own profit margin. The amount of the discount may vary based on the third party's sales volume. The problem arises when third parties use discounts to create slush funds to make improper payments to government officials.

The Juniper case is not the first time the U.S. government has imposed penalties on a company for failing to analyze and monitor discounts to third parties. However, the U.S. government's expectations of companies that engage distributors has changed over the years. In the Sanofi enforcement action, the SEC explicitly noted that no standardized commercial policy existed for distributor discounts – signaling the expectation that a commercial policy should have existed. In more recent enforcement actions, company policies were deemed to be ineffective because despite having company policies in place, improper payments still managed to be made. The following article analyzes several enforcement actions, including the mechanisms for making the improper payments and discusses possible compliance measures to mitigate risk.

Third-Party Discounts in Enforcement Actions

Juniper Networks (2019)

Juniper is a networking and cybersecurity solutions company that uses third-party intermediaries, known as "channel partners," to sell to end-user customers. Between 2008 and 2013, sales employees of Juniper's Russia subsidiary convinced senior management that the company needed to offer additional discounts on its products to meet competitive demands. However, these sales employees had made secret agreements with various channel partners whereby the increased discounts were not offered to the customers. Instead, these additional discounts were retained by the channel partners and eventually routed into accounts that were off Juniper's books.

These off-book accounts were subsequently used by company employees and channel partners to fund leisure trips for customers, including government officials, without obtaining proper internal Juniper approvals. These trips included visits to Italy, Portugal and the United States and involved sightseeing tours, amusement parks and tours of national parks. In some instances, the customers' family members were also invited on the trips. These trips were not to Juniper facilities or to attend industry conferences. The trips had no legitimate business purpose but were designed specifically to improperly influence customers to obtain more business.

In 2009, senior management learned about these off-book accounts and the improper discounts offered, both of which violated company policy. However, Juniper's remedial attempts were ineffective and failed. For example, employees simply resorted to using personal communication devices instead of work email to evade detection by the company. Ultimately, the misconduct continued until 2013.

The SEC alleged that Juniper "failed to accurately record the incremental discounts and travel . . . in its books and records" and did not "devise and maintain a system of internal accounting controls sufficient to prevent and detect off-book accounts, unauthorized customer trips, falsified travel agendas and after-the-fact travel approvals."

The SEC also detailed Juniper's remedial actions – such as establishing an independent and expert investigations function. SEC enforcement actions typically include remedial efforts, some more detailed than others. For example, they vary from vague remedial efforts (implement new compliance and accounting procedures) to more specific (ceasing business operations at the foreign subsidiary until the parent company was satisfied it could operate compliantly). The SEC's reference to an "independent and expert investigations function" reflects the nature of the allegations that gave rise to the violations. It also indicates that the SEC approves of an independent and expert investigations function. Independence and expertise are important because they lend credibility to investigations that will withstand regulator scrutiny, should it come to that.

See "Juniper Networks Resolves SEC Charges for $11.7M After Allowing Subsidiary Misconduct to Continue for Years" (Oct. 2, 2019).

Sanofi (2018)

Sanofi is a pharmaceutical company operating in over 100 countries with approximately 107,000 employees worldwide. The SEC's investigation focused on three non-U.S. Sanofi subsidiaries that allegedly used fake expenses for purportedly legitimate travel and entertainment expenses, distributor discounts and credit notes to distributors. Specifically, Sanofi senior managers paid funds to foreign officials derived from discounts (typically 20 to 30%) and credit notes on Sanofi products. In the scheme, the distributor kicked back funds to Sanofi employees who then delivered the illicit proceeds to government officials. The SEC noted that at the time, Sanofi had no standardized commercial policy for distributor discounts and did not review the discounts provided by local management. Moreover, tender sales increased 200 percent and included Sanofi's top-selling products.

The SEC settled its case against the Paris-based company for violations of the FCPA's books and records and internal accounting control provisions for $25.2 million (disgorgement, penalty and prejudgment interest).

See "Sanofi SEC Settlement Offers Lessons on Pharma Discounts, Samples and Receipts" (Sep. 19, 2018).

Smith & Nephew (2012)

Looking further back, the SEC and DOJ resolved its FCPA enforcement action against Smith & Nephew in 2012. In the scheme, a distributor made illicit payments to public doctors employed by government hospitals or agencies in Greece. For years, Smith & Nephew sold orthopedic products to its Greek distributor at a discounted list price and the distributor re-sold to Greek public hospitals for full list price. For reference, the discounts in a typical arrangement were 25-40 percent.

Smith & Nephew also paid marketing expenses for the distributor, up to 10 percent of sales. In 1997, Smith & Nephew started to charge the full list price and then paid for marketing services to shell companies that were never provided. Smith & Nephew inaccurately recorded the bribes as legitimate marketing expenses in their books and records.

Importantly, the DPA did not suggest (as the SEC noted in Sanofi) that Smith & Nephew implement a commercial policy for distributor discounts.

Eli Lilly (2012)

Eli Lilly is a pharmaceutical manufacturer that hired distributors in Brazil to sell its products to both private and government customers. Generally, the company sold its products to its distributors at a discount, ranging between 6.5% and 15% with most receiving a 10% discount. These distributors' compensation was the difference between the price at resale and the discounted price negotiated with Eli Lilly. In 2007, Eli Lilly approved two unusual discounts of 17% and 19% to a nationwide distributor. The company did not question this higher discount. Ultimately, the distributor resold the product to a government entity and used a portion of the purchase price to bribe government officials in order to obtain/retain a business benefit such as the government continuing to purchase the Eli Lilly product.

The SEC concluded that Eli Lilly did not conduct sufficient analysis to verify the facts surrounding the requests for additional discounts nor did it have an adequate internal accounting system to detect possible FCPA violations in its transactions. Accordingly, Eli Lilly was required to pay disgorgement of $13.9 million, prejudgment interest of $6.7 million and a penalty of $8.7 million.

See "Pharma Giant Eli Lilly Agrees to $29.4 Million Consent Judgment to Settle SEC Charges of FCPA Violations Arising Out of Its Operations in Russia, China, Brazil and Poland" (Jan. 9, 2013).

Compliance Measures to Mitigate Risk

The compliance measures used to mitigate risk when engaging distributors and giving discounts will depend on the company's business and the corruption risk in the region, among other factors.

Company Policy on Discounts to Third Parties

As the SEC intimated in the Sanofi enforcement action, companies that engage high-risk third parties should consider implementing a standardized commercial policy for distributor discounts. One that includes a process that analyzes the factors surrounding the discount and that ensures the approved discount is properly used with respect to the end customer is advisable.

Consistent with the above enforcement actions and U.S. government expectations, the existence of a standardized commercial policy for distributor discounts is not enough – a company's commercial policy should create a process for evaluating the reasonableness of a discount. The commercial policy should identify the parameters of permissible commercial discounts, which should specify the types of eligible end customers, volume discounts, and permitted standard discounts, if any. The policy should also define distributors that the company uses, if there's more than one.

If the company permits non-standard discounts, the commercial policy should also specify a process for reviewing and approving non-standard discounts (and marketing expenses if applicable) before executing a third-party agreement that includes discounts on selling company items or services. For high-risk transactions, this analysis should include more than just a local business confirmation of the need for the additional discount. For example, general explanations such as competition in the market, end customer budget or potential gain from future contracts should be substantiated with actual market research.

Additionally, companies should consider implementing a process that requires various levels of local business unit approvals for non-standard discounts before final review and decision from companies' management/headquarters. Ultimately, the commercial policy on discounts should have sufficient controls to verify the legitimacy of requests for any type of additional discount.

Further, it may make sense to require the customer's formal confirmation of the discount. Companies should ensure transparency around discounts for government customers. That is, if a non-standard discount is requested where the end customer is a government entity, companies should not only verify the legitimacy of the request but also consider obtaining a formal confirmation from the end customer that they are aware of the discount. This process would ensure that the approved discounts are passed on to the end customers and mitigates the risk that distributors use the inflated price difference for improper business advantages.

As with any company policy, it is important to train relevant company employees on the requirements of the commercial policy. In Juniper, the employees used personal devices to evade detection of their discount practices. Companies may wish to implement a policy to prohibit using personal email accounts for company business.

Considerations During Third Party Engagement Process and After Engagement

In addition to standard due diligence and engagement procedures for high-risk third parties, companies should include the following in contracts:

- anti-corruption clauses, including audit rights;
- the amount of discount offered and what process is followed to increase that discount, such as the addendum to a contract; and
- representations and warranties from distributors that no side funds or off-book accounts exist.

It is also important to review all forms of compensation, not just distributor discounts, to the third party. For example, Sanofi issued credit notes to vendors and in some cases, vendors exchanged the credit notes for cash from Sanofi.

After engagement, the company should follow a risk-based approach to auditing third parties that are given discounts. If the engagement permits marketing expenses, the company should request evidence like the online advertisement or signage. If the company negotiates a particular third-party discount based on sales volume, it should go back and review prior sales to determine if the third party achieved that sales volume. If the additional discount was approved based on the potential for future contracts, the company should follow up to determine status of said future contracts.

Finally, if a high-risk distributor requests changes to the compensation arrangement, either discounts or otherwise, the company should analyze the changes and the associated corruption risk. Any changes should be reflected in an addendum to the engagement agreement.

See "From Discounts to Slush Funds: Red Flags to Heed and Eight Steps to Take to Avoid SAP's $3.9 Million Mistakes" (Feb. 10, 2016).

Customizing Policies and Potentially Eliminating Distributors

It is important to design compliance mitigation measures that are embedded in the company's process that adequately address the company's risk. Not all of the above measures will make sense for a specific company. The reasonableness of a discount will vary based on many factors: what is reasonable for Smith & Nephew was not reasonable for Eli Lilly. In fact, companies are increasingly modifying their business strategy to go direct to consumer and eliminate use of distributors. Texas Instruments recently announced in October 2019 that it would do exactly that. The company indicated that direct relationships with customers allows Texas Instruments "to provide better service and greater assurance of supply, among other benefits."

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