Compliance Programs: The First Step To Protect Against Employee Criminal Acts

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Introduction

In the wake of increasingly publicized corporate scandals and lawsuits, many corporations are justifiably concerned about the potential risk of corporate liability for the conduct of corporate officers, directors, and employees. Although the criminal prosecution of corporations has become the popular means of regulating corporate governance and compliance, there are significant civil and regulatory ramifications for the wrongdoing of corporate officers, directors, and employees, as well.

Thus, the prudent general counsel may ask, "What can I do to protect my corporation from vicarious corporate liability?" The most effective means of avoiding potential corporate liability for the wrongdoing of corporate agents and/or employees is the implementation of an effective corporate compliance program. In fact, some companies are required by law to do so.[1] Practically speaking, a compliance program will educate employees and promote lawful conduct in the workplace. If employees and executives are aware that certain conduct is illegal and may be discovered, they will be more likely to avoid the misconduct in the first place.

Furthermore, the federal government expects modern business organizations to become partners in combating misconduct and promoting corporate compliance and ethical behavior.[2] Having a formal program in place may help your corporation's image with a regulatory government entity, in the unfortunate event that alleged misconduct is being investigated or even prosecuted. For instance, in determining whether to criminally charge a corporation for its alleged misconduct, the U.S. Department of Justice considers whether meaningful compliance measures (such as employee discipline, implementation of an effective corporate compliance program, and improvement of an existing compliance program), have been taken.[3] Moreover, even if the risk of potential liability is not compelling enough to encourage corporations to establish compliance programs, corporations should consider the business' "bottom-line." Allegations of egregious misconduct, even if untrue, create negative publicity for the company. More importantly, fraud can cost the company large sums of money, not only in lost goods and services, but in the expenses associated with matters such as shareholder derivative suits and other costs that are a natural result.

Corporate compliance, at its core, is a commitment to engage in upright conduct in the workplace for the good of the company and public at large. As General Counsels or Corporate Compliance Officers throughout the country have learned, corporate compliance programs bring a unique set of challenges to the job. Following are five questions that concern many General Counsels and Corporate Compliance Officers. Consider though, that often the best offense is a great defense — setting up a compliance program that works.

I. Does our company really need a formal corporate compliance program?

I hate to break it to you, but your company cannot simply operate on an "honor system." No matter how large or how small your company is, you do need a corporate compliance program of some sort. Practically speaking, a compliance program will educate your employees and promote lawful conduct in the workplace. If employees or executives are aware that what they are doing is illegal and may be discovered, they are more likely to avoid the misconduct in the first place. Having a formal program set up may help your corporation's image with a regulatory government entity, in the unfortunate event that alleged misconduct is being investigated or even prosecuted.

Former Deputy Attorney General Larry D. Thompson's memo on the Principles of Federal Prosecution of Business Organizations, commonly referred to as the Thompson Memo, discusses factors considered in the *criminal* prosecution of corporations. It provides significant guidance on principles for avoiding corporate *civil* liability, as well. Both relevant case law and the Thompson memo indicate that the most effective means of avoiding criminal and civil liability for the illegal actions of corporate employees is the prevention of such wrongful acts, primarily through the establishment and maintenance of effective corporate compliance programs.

II. Senior Management acts as if our compliance program does not apply to them. How do I make our compliance program "have teeth"?

[1] The Public Company Accounting Reform and Investor Protection Act (commonly known as the Sarbanes-Oxley Act) was enacted in July 2002 in an effort to increase corporate accountability in publicly traded companies, registered public accounting firms and companies that are in the process of registering securities. *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204 (2002).

[2] Gabriel L. Imperato, *Corporate Crime And Compliance What Does The Government Expect?*, Federal Lawyer 25 (2005).

[3] Memorandum from former Deputy Attorney General Larry D. Thompson to United States Attorneys, Section VIII (January 20, 2003).

If the persons not taking the program seriously are those in upper management, make the "business case" for compliance. In other words, speak their language by showing how non-compliance affects the bottom line. Fraud can cost the company thousands of dollars:

a) The Association of Certified Fraud Examiners' 2004 Report to the Nation on Occupational Fraud and Abuse revealed that the typical U.S. corporation loses 6% of its annual revenues to fraud.[4]

b) The median loss for organizations with an anonymous reporting system was $56,500, while the median loss for those without such a reporting system was more than twice that amount.[5]

c) Frauds committed by an owner or executive caused a median loss of $900,000, which is six times higher than the losses caused by managers, and 14 times higher than losses caused by employees.[6]

Moreover, remind upper level management that the Sarbanes-Oxley Act of 2002 now holds them accountable for several representations made by the company. The Act requires CEOs and CFOs to certify that each periodic financial report "fairly represents, in all material respects, the financial condition and results of operations of the issuer."[7]

Now, if you find yourself with employees that do not take the program seriously, one of the best ways to show that the company is dedicated its stated corporate compliance program is to designate members of upper management to be involved in the supervision and updating of the program. Their involvement will demonstrate that the program is applicable to all employees and that compliance is expected and enforced, no matter what title is on their business card.[8]

III. I suspect that there are some major compliance issues going unaddressed in the company, but no one tells me anything because they are afraid of retaliation. How do I get them to talk to me?

Create a confidential, user-friendly method to report suspected or known violations of the company's compliance program. Section 301 of the Sarbanes-Oxley Act requires the establishment of a procedure for employees to anonymously report their concerns about these matters.[9] However, the Act does not specify what type of procedures to use.[10] Depending on the size of your company, procedures could include something as simple as placing a depository near your office, or as complicated as an anonymous telephone hotline reporting procedure created by an outside vendor. An Ernst & Young Survey indicates that people perceive anonymous hotlines as more "trustworthy" when they are maintained and monitored by a third-party, and therefore those hotlines receive more calls than internal hotlines.[11]

Not surprisingly, some employees fail to report questionable accounting methods or fraudulent activities because they are not sure that it is indeed happening or whether what they are observing is actually illegal. That is why it is imperative that you, as the General Counsel or Compliance Officer, make it clear that while employees do not have to be certain that wrongdoing is occurring or be well-versed in securities laws, their report must be made in good faith.[12] In fact, for companies that are governed by Sarbanes-Oxley, section 806 of the Act states that, in order to obtain the protection of the whistleblower statute, a whistleblower must only have a "reasonable belief" that there has been a violation of the federal securities laws. When counseling your upper management, you should remind them that publicly traded companies may not

[4] Association of Certified Fraud Examiners, *2004 Report to the Nation on Occupational Fraud and Abuse* (visited Sept. 22, 2005) http://www.acfe.com. The Association conducted a study covering 508 cases of occupational fraud personally investigated by certified fraud examiners. Those examiners included attorneys, security personnel, accountants, educator, private investigator or law enforcement. The agencies examined included government agencies, not-for-profit organizations, private companies, and public companies. Four-hundred eighty-seven of those organizations were able to specify the amount of losses suffered by the organization.

[5] *Id*.

[6] *Id*.

[7] Robert J. Sussman, *Practicing White Collar Criminal Defense in the Post-Enron Era: Some Changes in the System*, 43 HOUSTON LAWYER 25, 28 (2005).

[8] Richard S. Gruner, *Evaluating Compliance and Ethics Programs Under the New Sentencing Guideline Standards*, CORPORATE COMPLIANCE INSTITUTE 243, 266-67 (2005).

[9] Sarbanes-Oxley Act, Section 301.

[10] *See* Miriam A. Cherry, *Whistling in the Dark? Corporate Fraud, Whistleblowers, and the Implications of the Sarbanes-Oxley Act for Employment Law*, 79 WASHINGTON LAW REVIEW 1028, 1070 (2004).

[11] Cherry, at 1075.

[12] *See* Carol B. Johnson, *Make It Easy, They Will Come: U.S. Corporations Are Liable For The Criminal And Fraudulent Acts Of Their Employees. But They Can Mitigate The Risk By Demonstrating A Solid Internal Corporate Compliance Program For Employee Reporting* (visited Sept. 21, 2005) http://findarticles.com.

discharge, demote, suspend, threaten, or harass any employee in his terms or conditions of employment based on his good faith reporting of misconduct.[13]

Additionally, your state may have provided an avenue for you to report alleged misconduct without offending your role as counselor and advocate.[14] The ABA Model Rules of Professional Conduct[15] allow a lawyer to reveal information relating to the representation of an organization to the extent the lawyer reasonably believes necessary to prevent substantial injury to the organization. Under Rule 1.13, if you are aware that a person associated with the organization is engaged in misconduct that reasonably might be imputed to the organization, and the highest authority that can act on behalf of the organization fails to address in a timely and appropriate manner the misconduct, you may report your discovery to the proper authorities without violating client confidentiality issues.[16]

Further, it may be encouraging to some to know that the Fifth Circuit[17] recently empowered corporate counsel, who believe that they have suffered an adverse employment action due to the exposure of misconduct, to use documents subject to attorney-client privilege in an offensive manner.[18] The court held that no case law or rule imposes a *per se* ban on the offensive use of documents subject to the attorney-client privilege in an in-house counsel's retaliatory discharge claim against his former employer under the federal whistleblower statutes.[19]

IV. I am pretty well-informed about the enforcement role of the Department of Justice, but are there other regulatory agencies or laws I should be aware of?

It would certainly be prudent of you to do some research, but here's a short list. Based on the nature of your organization, you may be subject to the Sarbanes-Oxley Act,[20] the USA Patriot Act's Anti-Money Laundering Compliance Standards for Financial Institutions,[21] NASDAQ Regulatory Requirements,[22] and NYSE Enforcement Division's regulatory requirements.[23] If you work for a state government agency, many states have ethics enforcement officers charged with investigating any alleged or actual misconduct committed by government agencies, its employees or vendors with those state agencies. Seeking appropriate counsel from someone familiar with enforcement of these statutes and regulatory requirements is advisable.

V. As the General Counsel/Compliance Officer, I have the daunting responsibility to develop or implement an effective compliance program and enforce its guidelines. Where do I begin?

The first advisable step for a General Counsel or Compliance Officer with no enforcement or prosecution background is to seek appropriate outside counsel for creation and enforcement advice. Outside counsel can offer their unique knowledge based on experience and will have the resources necessary to help create a credible corporate compliance program. From the perspective of those expected or required to report suspected misconduct, outside counsel may be viewed as a unbiased party, which may make your potential reporters more confident in the reporting process.

In preparation for your meeting with outside counsel, take a look at the United States Sentencing Commission's Guidelines Manual.[24] The manual offers seven foundational elements for a valuable compliance program:

1. The organization should establish standards and procedures to prevent and detect criminal conduct;

2. The program's governing authority, which should include high-level personnel, must be knowledgeable about the content of the program, with responsibility to oversee and operate the program;

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[13] Cherry, at 1065-66.

[14] *See* Craig Schneider, *The Attorney's Dilemma: Will The SEC's New And Proposed Rules To Turn Lawyers Into Whistle-Blowers Strain Relations Between Finance Executives And Corporate Counsel?* (visited Sept. 21, 2005) http://www.findarticles.com.

[15] ABA Model Rule of Professional Conduct 1.13.

[16] *Id*.

[17] *Willy v. U.S. Dep't of Labor*, 423 F.3d 483 (5th Cir. 2005).

[18] *See* John Council, *Attorney-Client Privilege Doesn't Shield Company in Suit* (visited Nov. 8, 2005) http://www.law.com.

[19] Willy, 423 F.3d at 501.

[20] Sarbanes-Oxley Act, Section 806.

[21] Title III of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (commonly known as the USA Patriot Act, (Pub. L. 107-56, Title III)) promulgates reporting and record-keeping procedures for financial and non-financial institutions.

[22] Companies listed on the NASDAQ Stock Market are subject to on-going regulatory and disclosure requirements. *See* http://www.nasdaq.com.

[23] The NYSE Enforcement Division investigates and prosecutes violations of NYSE rules and federal securities laws. *See* http://www.nyse.com.

[24] United States Sentencing Guidelines Manual §8B2.1 (2005).

3. Individuals who have demonstrated a work ethic consistent with an effective compliance or ethics program should be given supervisory authority over the program;

4. Those governing the program should periodically remind all employees of the compliance standards and procedures through training and proper dissemination of information;

5. The organization must have monitoring and auditing systems in place to test the effectiveness of the program and for reporting misconduct without fear of retaliation;

6. The compliance program should be enforced and promoted through appropriate incentives and disciplinary measures; and

7. The organization must respond appropriately to discovered misconduct and modify the program by implementing preventive measures.

Naturally, the required formality and extent of corporate efforts needed in each of these seven areas varies based on factors like company size and the types of offenses that are likely to be encountered by a firm given its business activities and legal environment.[25]

Conclusion

In today's "life after Enron" world, it is imperative that companies, including non-profit organizations and government agencies, take a serious look at their compliance and ethics measures. If you take the time to create a workable compliance program, not only can you save your company from significant corporate liability, you will set yourself up to be a part of a winning team!.

[25] Gruner, at 263.

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Patricia Brown Holmes is an Equity Partner in Schiff Hardin LLP. She is a former state trial judge who concentrates her practice in general commercial litigation and white collar criminal and corporate compliance matters.

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