

Carrots, and Criminal

Arizona Incentives for Corporate Compliance Planning

Governor Jane Hull recently signed into law legislation that changes the way criminal penalties will be imposed on businesses in Arizona. House Bill 2660 requires the court to reduce by 25 percent the presumptive \$500,000 fine imposed against businesses found guilty of a felony if the company had an “effective program to prevent and detect violations of law” in place at the time of the offense—a compliance program.² Thus, having an effective compliance program can save a company \$125,000 per felony offense. The failure to prevent or detect a

In the 2000 legislative session, Arizona enacted new laws that recognize and give value to the efforts of business to reduce the risks associated with unlawful employee behavior,¹ with a focus on corporate compliance plans. Arizona joins the U.S. Congress, administrative agencies and the courts in creating incentives for companies to implement compliance programs and in treating more harshly companies that lack such programs.

This article discusses (1) how Arizona’s new legislation and established federal law enable a company to minimize its exposure by having an effective compliance program, (2) how a rogue employee’s illegal acts can expose an entire company to criminal liability and (3) how to implement an effective compliance program that will minimize that risk and produce positive benefits for a company.

violation of law, by itself, does not mean that a program is not effective if the court finds the company exercised due diligence in establishing its program.³

Given the risk that a single rogue employee could render a company liable for numerous felony offenses, this legislation offers powerful incentives for companies to maintain effective compliance programs.

H.B. 2660 also greatly enhances penalties for companies that fall into the category of “dangerous and repeat enterprise offenders.”⁴ A sentencing court may increase the fine against a business to \$5 million per felony if it finds certain aggravating factors. Maintaining an effective

compliance program should preclude the possibility of such a finding and the imposition of the enhanced fines.

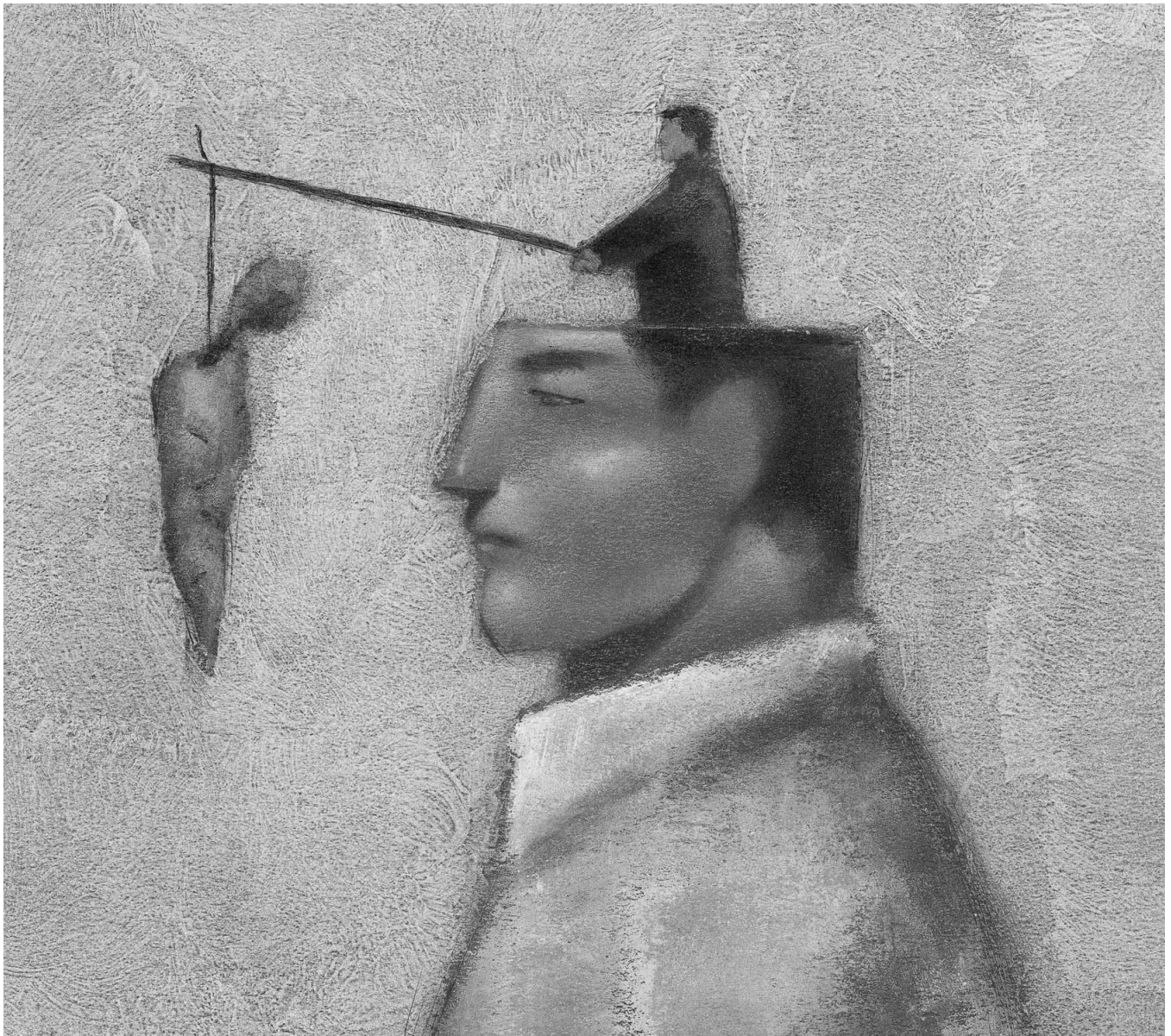
Arizona’s legislation is modeled after the Federal Sentencing Guidelines, which the United States Sentencing Commission adopted in 1991. If a company is found guilty of a federal crime, it will be sentenced under those Guidelines. The Guidelines provide for fines that often massively exceed those previously imposed on companies and significantly reduce fines for a company that had “an effective program to prevent and detect violations of law.”⁵

One court has observed, “The Guidelines offer powerful incentives for

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corporations today to have in place compliance programs to detect violations of law, promptly to report violations to appropriate public officials when discovered, and to take prompt, voluntary remedial efforts.⁶ The same observation is true for Arizona's new corporate sentencing provisions.

A Rogue Employee Can Expose a Company to Criminal Liability

Criminal prosecution is a serious and real threat to a company. Under federal law, a corporation may be held criminally liable for the illegal acts of a single employee, regardless of the employee's position within the corporation, if the employee's actions (1) were within the scope of his duties and (2) were intended, at least in part, to benefit the corporation.⁷ Under Arizona law, a corporation may be held criminally liable for conduct undertaken on its behalf if the offense was "engaged in, authorized ... or recklessly tolerated by the directors of the enterprise in any manner or by a high managerial agent acting within the scope of employment."⁸

The illegal knowledge or intent necessary for many felony violations can be inferred from the collective conduct of the company's executives and employees.⁹ The corporation need not profit from its employee's illegal conduct to be held liable.¹⁰ Even though an employee was acting primarily to benefit himself, the corporation may be criminally liable if any part of his motivation was to benefit the corporation.¹¹

The government is continually expanding its use of criminal sanctions to ensure that businesses comply with applicable laws and regulations and to impose heavy fines and penalties on businesses that do not comply. The U.S. Department of Justice recently stated that the vigorous prosecution of businesses results in great benefits to law enforcement and the public:

Prosecutors should be aware of the important public benefits that may flow from indicting a corporation For instance, corporations are likely to take immediate remedial steps when one is indicted for criminal conduct that is pervasive throughout a particular industry, and thus an

indictment often provides a unique opportunity for deterrence on a massive scale.¹²

The existence or nonexistence of a compliance program at a company will be a significant factor in whether the government investigates and criminally prosecutes that company.¹³ Businesses that fail to implement effective compliance programs are subjecting themselves to an unnecessary risk of criminal prosecution and penalties, as well as civil liability.

The Nature of a Compliance Program and its Benefits

A compliance program may be a company's best investment to reduce criminal and civil liability. In the language of the new Arizona legislation and the Federal Sentencing Guidelines, a compliance program is "an effective program to prevent and detect violations of law."¹⁴ A compliance program informs management and employees of the standard of legal and ethical conduct that the company requires of them, and it creates mechanisms and incentives to maximize compliance with those standards. Such a program will help foster a corporate culture that emphasizes ethical behavior and minimizes the risk of potential violations of the law.

A Compliance Program Minimizes Exposure

The principal benefit of a compliance program arises when the program works: A successful program prevents violations from occurring in the first place. The company and its officers are never faced with a government investigation, criminal prosecution or civil litigation.

If an offense occurs despite the company's best efforts, a compliance program will enhance the opportunities for the company to detect the violation and remedy it before the government investigates or before the victim initiates legal action. Perhaps most important, an effective compliance program can dissuade the government from criminally prosecuting a company or taking civil enforcement action.

The savings a company achieves by avoiding negative exposure, litigation costs and disruption will provide a valuable return on its investment in a compli-

ance program. If the government prosecutes or the victim sues, the existence of an effective compliance program will mitigate the assessment of criminal and administrative penalties¹⁵ and reduce or eliminate any punitive damage claims based on willful misconduct.¹⁶

A Compliance Program Increases the Value of a Business

Compliance programs generate real value for businesses even apart from reducing civil and criminal exposure. A compliance program reflects the effort of a business to achieve a reputation for honesty and fair dealing. Such a reputation pays disproportionate dividends in many arenas.

For instance, an effective compliance program may mean fewer inspection visits from government regulators.¹⁷ Prospective suppliers and customers may be more inclined to do business with a company that has a plan dedicated to preventing unethical business conduct. Regular audits that are part of an effective compliance program also may save money by uncovering lawful practices that are wasteful or inefficient.¹⁸

In today's legal climate, a company that lacks an effective compliance program is exposing itself to unnecessary risks of expanded criminal and civil liability. The failure of a company's officers and directors to institute a compliance program in certain situations may result in claims of breach of fiduciary obligation seeking to impose individual liability.¹⁹

Creating an Effective Compliance Program

Under Arizona's new legislation and the Federal Sentencing Guidelines, there are seven steps to implementing an effective compliance program. Experienced counsel can guide a company through this process.

1. Establish Compliance Standards Through a Code of Conduct

A code of conduct is the core of most compliance programs. The code must describe the particular compliance issues that employees may confront in conducting the company's business and guide employees on how to handle those issues. The company should craft its code of conduct in light of the

company's unique compliance needs and corporate culture. Copying another company's code of conduct or purchasing a generic document that purports to be a compliance plan will not provide an effective plan.

To properly tailor a code of conduct to its needs and culture, a company should establish a team of in-house or outside counsel and senior management to conduct a due diligence investigation to identify significant compliance issues. These issues may be identified either because the company has had problems with them in the past or because they are areas of risk for the industry. The due diligence effort should include the compilation of an inventory or survey of the laws, regulations and other obligations that apply to the company.²⁰

Due diligence also should include interviews with the company's officers, department heads and managers about past problems the company has had and any perceived vulnerabilities within the company that might generate future problems.²¹ The due diligence should result in a compliance program that is tailored to the company given its regulatory environment, past experience and corporate culture. The code of conduct should educate employees about how to avoid violations that may occur because of the nature of the company's business.

Generally, a company's code of conduct should provide enough information so that employees will be able to recognize potential problems. For example, a company's code of conduct might include the following hypothetical to illustrate the prohibition on insider trading:

Q: While I was in our accounting department yesterday, I saw an internal memo from our Chief Financial Officer that said that our company is going to announce higher than expected earnings for the quarter. I mentioned this to my brother, and we agreed that this would be an excellent time to buy our company's stock. Can I buy the stock before the earnings announcement?

A: No. It is a violation of state and federal securities laws to trade on the basis of material nonpublic information. In addition, giving your brother

this inside information about company earnings violated company policy and may violate state and federal securities laws if he buys stock based on that information.

The code should direct employees where they can obtain further guidance if they are concerned about how to handle a particular issue or how to avoid a potential violation. The code of conduct should emphasize that employees have a duty to report any questionable conduct, that such reporting will be kept in confidence to the extent possible and that employees will not suffer any detriment or retaliation for reporting a potential violation in good faith.

2. Make Senior Management Responsible for Compliance

The company must select specific senior managers who will be responsible for the day-to-day running of the compliance program and enforcement of the code of conduct. Some businesses may designate only one compliance officer, whereas others may divide these responsibilities among a team of executives such as the chief operating officer, in-house counsel and the chief financial officer.

The "right" person(s) for a company likely will depend on a variety of factors, including who among senior management has the proper training and experience and the time and resources to do a good job. The organizational and personal factors will vary from company to company and from person to person, but the ultimate objective should remain constant—for senior management to implement an effective compliance program.²² Finally, the company should establish a subcommittee of the board of directors to whom the compliance officer or team regularly reports.

3. Ensure That the Company Does Not Delegate Authority to Individuals who Have a Propensity To Engage in Illegal Activities

It may seem obvious that a company that seeks to comply with the law should not employ individuals whom it believes are likely to engage in criminal conduct. Nonetheless, Arizona's new legislation and federal guidelines expressly state that to have an effective compliance

program, a company must take appropriate steps to ensure that it does not delegate authority to individuals whom it knows or should know have a propensity to break the law.²³

4. Communicate Compliance Standards Effectively

Producing a code of conduct is of little value unless employees understand what conduct is required of them. The company must train all employees in what the standards mean. The training program should use examples to illustrate how the standards apply to specific workplace situations. The goal should be to train each employee to identify ethical and compliance problems and to seek appropriate assistance in resolving such issues.

Usually a company will conduct mandatory compliance training when it rolls out its compliance program and distributes the code of conduct. That should not be the end of compliance training, however. The company should supplement its initial training with regular communications on compliance issues through the company newsletter, intranet or even payroll envelopes. The company should remind its employees periodically of the applicable compliance standards and apprise employees of pertinent new laws or regulations.

5. Establish Procedures To Achieve Compliance, Including Monitoring and Regular Audits

An effective compliance program requires that a company establish (1) avenues by which employees can report potential compliance problems, (2) procedures for the company to investigate reports of potential violations, and if necessary, take remedial action and (3) procedures by which the company will regularly monitor and test its compliance program to make sure it is working as it should.

Reporting Mechanisms. A company should establish and explain alternative avenues for employees to report questionable conduct. It is important that an employee have more than one way to report his or her concerns in case the person to whom the employee would normally report—the employee's supervisor—is responsible for the perceived misconduct.

Investigation and Remedial Measures. If a company receives a report of a potential compliance violation or otherwise suspects an employee of illegal activity, it should investigate. If the investigation reveals illegal activity, the company must discipline, terminate and perhaps report the employee to the authorities, no matter how productive or otherwise valuable he or she is to the business.

Monitoring and Auditing Procedures. Companies must make an ongoing effort to monitor and test their compliance procedures to ensure that they are working effectively. The scope of a company's monitoring effort will depend on the size of the company, the particular risks its business presents and the existence of other internal controls. A company may use employee surveys, interviews, and audits to monitor the effectiveness of its compliance program.

At the conclusion of the initial compliance training and on an annual basis thereafter, employees should be asked to sign a certification stating that (1) they have read the company's code of conduct and they understand what conduct the company expects of them, (2) they understand that they have an obligation to report potential compliance violations and (3) they understand how they can report potential violations. The certification should ask whether the employee is aware of any potential violations. Any identified problems will require appropriate follow-up, such as interviews, an investigation or an audit.

Periodically, a company should conduct audits of specific compliance areas. An audit should include a thorough review of applicable documents and employee interviews. Auditors should question employees about any vulnerabilities the employees perceive in their own department and elsewhere in the company. (Employees usually will provide information about potential problems in other departments more readily than they will acknowledge problems within their own areas of responsibility.) Auditors also should test employees' knowledge of laws, regula-

tions and code of conduct standards that apply to the employees' work.

For example, to detect potential antitrust violations, a company's compliance officer or team should monitor price changes, discount practices and bidding decisions. Front-line purchasing and sales personnel should be tested for their understanding of bidding standards and proper pricing practices.

6. Enforce Standards With Appropriate Discipline for Violations

When a company finds that an employee has violated the law or its code of conduct, the company must discipline the employee. What discipline is appropriate will depend on the violation, but no leniency should be given based on the offender's position within the company. If anything, the more the offender—such as a corporate officer or senior manager—was entrusted with significant responsibilities, the more harsh should be the discipline. If the unlawful conduct was perpetrated over a lengthy period because other employees failed to detect or report it, they should be disciplined, too.


Fear of discipline will not be the best incentive for employees to avoid violations, however. A recent study of 2,800 employees in six major companies found that programs employees believe are designed to guide positive behavior and establish a shared set of company values are considerably more successful than are programs that are viewed primarily as a means to detect and punish illegal behavior.²⁴ Companies can motivate their employees to achieve compliance by emphasizing the positive benefits of ethical conduct and by tying it to job performance reviews, raises and promotions.

7. After a Violation Is Detected, Take All Reasonable Steps To Respond Appropriately and Prevent Future Violations

If a company discovers unlawful conduct, it must take all reasonable steps to remedy the violation. In addition to disciplining the employees involved, the company may need to make restitution to anyone injured by the unlawful conduct, report

the conduct to law enforcement or other government agencies and modify its compliance program to prevent similar recurrences in the future.

Conclusion

Arizona's new legislation provides even greater incentives than already existed under federal law for businesses to have effective compliance programs. Today's legal climate demands that businesses establish programs to prevent unlawful conduct from occurring in the first instance and to detect and remedy unlawful conduct if it occurs despite a company's good-faith efforts. An effective compliance program serves these functions and is a company's best investment to protect against criminal and civil liability. 

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ENDNOTES

- 2000 Ariz. Sess. Laws, Ch. 172, H.B. 2660 (amending A.R.S. § 13-803, and adding §§ 13-822 and 822.01, relating to effective compliance programs).
- A.R.S. § 13-822(A).
- A.R.S. § 13-822(E).
- The factors that could lead a court to find that a company is a dangerous and repeat offender are (1) in committing the offense, the company "violated a judicial or administrative order or injunction," (2) the offense involved conduct that was malicious or wanton or (3) "the offense involved conduct that posed [or resulted in] an imminent and substantial hazard to human health or to the environment. . . ." A.R.S. § 13-822.01(A)(1)-(3).
- United States Sentencing Commission, FEDERAL SENTENCING GUIDELINES MANUAL § 8C2.5 (West 1999).
- In Re Caremark Int'l Inc. Derivative Litigation*, 698 A.2d 959, 969 (Del. Ch. 1996).
- Zero v. United States*, 459 U.S. 991 (1982) (agent's knowledge of illegal act may be imputed to corporation if agent was "acting as authorized and motivated at least in part by an intent to benefit the corporation"); *New York Cent. & Hudson River R.R. Co. v. United States*, 212 U.S. 481, 491-495 (1909); *United States v. Route 2, Box 472, 136 Acres More or Less*, 60 F.3d 1523, 1527 (11th Cir. 1995) (holding corporation liable for acts of one of its agents committed in scope of employment); *United States v. Bank of New England, N.A.*, 821 F.2d 844, 856 (11th Cir. 1987) (same), *cert. denied*, 484 U.S. 943 (1987); *United States v. 7326 Hwy. 45 North*, 965 F.2d 311, 316 (7th Cir. 1992).
- A.R.S. § 13-305(A)(2).
- Bank of New England*, 821 F.2d at 855 (imputing to corporation various employees' collective knowledge obtained within the scope of their employment).
- United States v. Automated Medical Laboratories*, 770 F.2d 399, 407 (4th Cir. 1985).
- Automated Medical Laboratories*, 770 F.2d at 407 (affirming corporation's conviction for actions of subsidiary's employee despite claim that employee was acting for his own benefit, namely his desire to ascend the corporate ladder: "Partucci was clearly acting in part to benefit AML since his advancement within the corporation depended on AML's well-being and its lack of difficulties with the FDA").
- Memorandum from Eric H. Holder, Jr., Deputy Attorney General to Heads of Department Components and All United States Attorneys Re: Bringing Criminal Charges Against Corporations (June 16, 1999).
- "In conducting an investigation, determining whether to bring charges, and negotiating plea agreements, prosecutors should consider the following factors in reaching a decision as to the proper treatment of a corporate target: . . . (5) The existence and adequacy of the corporation's compliance program." Memorandum from Eric H. Holder, Jr., Deputy Attorney General to Heads of Department Components and All United States Attorneys Re: Bringing Criminal Charges Against Corporations (June 16, 1999).
- A.R.S. § 13-822(B); United States Sentencing Commission, FEDERAL SENTENCING GUIDELINES MANUAL § 8A1.2, comment 3(k).
- United States Sentencing Commission, FEDERAL SENTENCING GUIDELINES MANUAL § 8C2.5 (providing for significantly reduced criminal fines if corporate defendant had "an effective program to prevent and detect violations of law," that is, a compliance plan); A.R.S. § 13-822 (providing for a 25 percent reduction in criminal fines if corporate defendant had an effective compliance plan).
- Kolstad v. American Dental Ass'n*, 527 U.S. 526 (1999) (employer may not be vicariously liable in punitive damages for discriminatory employment decisions of managers when those decisions are contrary to employer's good-faith efforts to comply with antidiscrimination laws).
- Note that the Arizona legislature passed another bill that was signed into law in the 2000 legislative session that creates a Voluntary Environmental Performance Program for businesses that implement compliance programs approved by the Arizona Department of Environmental Quality. See 2000 Ariz. Sess. Laws, Ch. 263, S.B. 1321.
- John Gibeaut, *Getting Your House in Order*, ABA JOURNAL, June 1999, at 65.
- See *Caremark*, 698 A.2d at 970 ("I note the potential impact of the federal organizational sentencing guidelines on any business organization. Any rational person attempting in good faith to meet an organizational governance responsibility would be bound to take into account this development and the enhanced penalties and the opportunities for reduced sanctions that [an effective compliance plan] offers").
- See A.R.S. § 13-822(D) ("The failure of an enterprise to incorporate and follow applicable industry practice or the standards called for by any applicable governmental rule weighs against a finding of an effective program to prevent and detect violations of law").
- United States Sentencing Commission, FEDERAL SENTENCING GUIDELINES MANUAL § 8A1.2, comment 3(k) ("An organization's prior history may indicate types of offenses that it should have taken actions to prevent. Recurrence of misconduct similar to that which a corporation has previously committed casts doubt on whether it took all reasonable steps to prevent such misconduct"); see also A.R.S. § 13-822(C) (relevant factors in establishing an effective compliance plan include the prior history of the enterprise and "the likelihood that certain violations may occur because of the nature of the enterprise's business").
- Jay N. Fastow, *Step Two of the Sentencing Guidelines: Assign Overall Responsibility To Oversee Compliance to "High Level Personnel,"* in CORPORATE COMPLIANCE: CAREMARK AND THE GLOBALIZATION OF GOOD CORPORATE CONDUCT, at 301, 305 (Practicing Law Institute, June-July 1998).
- United States Sentencing Commission, FEDERAL SENTENCING GUIDELINES MANUAL § 8A1.2, comment 3(k)(3); see also A.R.S. § 13-822(B)(3).
- Linda Kleve Trevino et al., *Managing Ethics and Legal Compliance: What Works and What Hurts*, 41 CAL. MGMT. REV. 131 (1999).