

## Compliance Programs Redefined: Elevating Contractual Responsibilities to Their Proper Place

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**M**ost attention in respect of corporate compliance centers on laws and government regulation. This should surprise no one since compliance programs arose in the context of government investigations of antitrust violations, the bribery of foreign officials to secure lucrative sales and contracts and similar societal offenses. Moreover, the development of compliance programs has followed the path laid out by the U.S. Sentencing Commission in its Sentencing Guidelines for Organizational Defendants, giving those programs a distinct criminal-law orientation. In 2003, the Commission established a working group to review the then-extant Guidelines with a view to amending them in light of the ten-plus years of experience since they were first adopted. One recommendation by that group that the Commission did not accept was to broaden the mandate of an effective compliance program in that “an effective compliance program should be aimed at preventing not just criminal activities within organizations, but rather all ‘violations of law.’” (Advisory Group Report, p. 54.) Instead, in the changes to the Guidelines that it adopted in 2004, the Commission only directed that an ethics and compliance program be

designed “to prevent and detect criminal conduct.” (See §8B2.1(a)(1) of the Guidelines.) Further guidance on the set up and operation of compliance programs emanates from the prosecutorial guidance distributed to the offices of United States Attorneys around the country by the federal Department of Justice interpreting the Guidelines. The limited focus of the Guidelines on criminal conduct thus influenced the development and discussion of compliance programs generally.

That perspective does not, however, serve as the proper basis on which private enterprise should consider a compliance program. Looking at such programs through that prism constitutes a missed opportunity. Such a narrow view of compliance could lead one to overlook some of the greatest benefits that a compliance program offers a company—and perhaps one of the few that represents a truly positive benefit, rather than one that consists solely of preventing bad things from happening or responding to the occurrence of violations of law.

The lifeblood of a company consists of its revenues and cash flow. A successful company takes steps to assure its continued receipt of payments due it under its contracts and to minimize amounts that it must pay or credit to others on account of failures to honor any of its obligations under those agreements. Signing agreements for its services and products will be for naught if the company fails to honor its responsibilities and thereby forfeits its right to payments thereunder or incurs obligations that outweigh the benefits to which it is entitled under those agreements.

Those benefits would follow the application of a compliance perspective to a company’s contracting process.

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Assuring compliance with its obligations under private agreements thus occupies (or, more properly, should occupy) a more central position in a company's compliance interests than many realize. Non-compliance with government mandates can lead to government orders that equate with a "death sentence" if carried to an extreme. Non-compliance with responsibilities to customers and other counter-parties in a company's agreements, however, could lead to death by starvation if the company's cash flow dries up or dissipates due to penalties or other contractual results of its defaults.

In addition, a company that fails to honor its contractual obligations (or is seen to do so) will find it difficult to enter into agreements with other organizations. As a rule, businesses need to believe that their contractual counterparties can be relied upon to live up to their commitments. Otherwise, their ability to plan their affairs based on their entered-into agreements will be compromised.

Two general forms of compliance with contracting issues relevant to this analysis come to mind: process compliance and substantive compliance. The first encompasses the process leading up to the commencement of a contract-based relationship. The second comes into play once a contract takes effect as the contracting parties are then obligated to honor their respective commitments to the others.

Compliance with the contracting process entails assuring that all of the policies and steps set out by a company's internal procedures for entering into an agreement with another party (as well as any requirements of applicable law) have been addressed and met. Failure to do so could set up a default in the later, post-contract environment or even a contract that the party cannot enforce against its contracting partners. Consider a company that has entered into a corporate lending agreement with its primary source of financing that limits the company's ability to encumber its assets for the benefit of others. Were that company's representatives to fail to confirm their au-

thority to commit certain assets to the satisfaction of its obligations under a potential agreement with a joint venture partner, they might come to an agreement with the potential partner that by their very terms violate the lending agreement. In another situation, an agreement by a franchisor to grant certain territorial exclusivity to a franchisee of its business model could conflict with the geographic scope of a previous grant of franchise rights. A law regulating an industry might prohibit certain types of commitments by regulated companies; an agreement violative of that prohibition would not be enforceable.

One common "boilerplate" provision calls for a party to represent that it has entered into the contract in accordance with its internal procedures and external law, and that the person executing the contract on the company's behalf has authority to do so. A compliance program could include procedures to ensure satisfaction of the requirements precedent to entering into an enforceable contract and satisfaction of that boilerplate representation.

Compliance with the terms of the various and varied agreements to which a firm has become a party constitutes a subset of its obligations to those outside the corporate entity, including government authorities, lenders and the company's owners (whether shareholders or some other category). Each holds its own expectations vis-a-vis the organization's future behavior pursuant to their relationship. The firm's contractual obligations, however, may be among the more specific and the more relevant on a day-to-day basis. Moreover, those obligations, and the organization's adherence to such obligations, can have a more immediate impact on its financial fortune than many of the other obligations that it faces.

Accordingly, every organization faces a considerable, and critical, challenge: assuring that it satisfies the requirements of its contracts and other agreements. This requires attention to a number of issues, including these: meeting the substantive requirements (e.g., completing work according to enumerated project milestones, giving the other party notice of certain events spelled out in the contract, providing the other party the opportunity to exercise certain negotiated rights, such as a

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right of first refusal, and satisfying the contract's itemized success goals, like sales targets); honoring deadlines; and meeting any other "tests" contained in the agreement for measuring that company's performance.

A key factor in ensuring proper performance under an agreement is that individuals within the organization understand their respective responsibilities pursuant to the contracts, but also ensuring that they contribute to achievement of the contractual goals in a timely manner. This calls for a system to ensure that each person understands his or her role and the time in which his or her action is necessary. Even the steps precedent to entering into valid contracts (the "process compliance" outlined above) require that certain actions occur in the proper sequence. Having the law department review a proposed agreement before it has been deemed to meet the company's business goals, for example, likely will result in wasted effort in at least some instances. This is true even taking into account that earlier involvement by attorneys can help the company avoid entering into arrangements that present problematic obligations that conflict with other commitments or applicable requirements.

Timely action by a company's employees can be critical to creating enforceable contracts. Late action after a contract exists may constitute a default, and could in some instances reduce the contract's value to the parties even if enforceable. An appropriate "tickler" mechanism to alert employees when their involvement in certain types of matters (e.g., proposed contracts, post-contract obligations, legal matters involving other parties, etc.) is necessary should be among the tools that an effective compliance department deploys as part of its responsibilities.

Does all this mean that the firm's business groups must report to or depend on its compliance officer? How broad is the role of the compliance officer and does it eclipse or co-opt the roles of other corporate officers who have traditionally overseen the contracting and related processes?

While compliance does encompass many elements of an organization's operations (consider, as one example, that compliance with manufacturing standards comes into play on the factory floor and touches, in many cases, on technical issues and union rules), the compliance function should serve in a coordinating role more than anything else. Assuring the appropriate corporate functional unit addresses its unique and singular compliance responsibilities, enables the corporate compliance department to enforce the various compliance-related activities that occur throughout the organization. Take the example cited above: the compliance department can assist the sales group to adopt a "tickler" system that increases the efficiency and effectiveness of that sales group, including plotting the appropriate sequence of "alerts" for the sales team, without taking over the sales group's responsibilities of selling the company's products and services.

An effective compliance department does not replicate other corporate functions; rather, it creates mechanisms that track the performance of those other units in respect of those activities that relate to the company's compliance with the various behavioral expectations that apply to its operations. Some of those expectations arise externally and others are created internally.

External expectations come from the government, owners of the enterprise, lenders, customers, joint venture partners, stock exchanges and other sources. The significance of those expectations for a firm's compliance-related efforts, of course, varies. For example, the stock exchanges have adopted rules that implement the mandates of the Sarbanes-Oxley Act passed in 2002. A failure to satisfy those requirements can lead to de-listing. Failure to satisfy some requirements in a corporate loan document, on the other hand, might lead to default remedies for the lender, but likely will not trigger a catastrophic event for the borrower. Failure to satisfy shareholders' expectations could lead to a shareholder election for seats on the board of directors.

Nonetheless, no organization should ignore the need to comply with expectations of every party with a legitimate interest in its affairs. In the context of contractual compliance, this will entail the expectations of its contracting partner and even those who, while

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not privy to the contract in question, would react negatively to a demonstration by the company of indifference to its contractual obligations.

Assuring that the other units of the company develop policies that address legal and contractual compliance constitutes the compliance department's responsibility in respect of that issue. Responsibility for drafting the policies should lie with the groups that possess the necessary knowledge of the business processes involved.

By assisting the various units in the company (e.g., sales, marketing, customer service, legal, etc.) to create ongoing compliance-assurance mechanisms, a compliance department will accomplish the following:

- Strengthen the company's competitive posture
- Improve the reliability of its cash flow
- Improve customer relations
- Reduce the likelihood of disputes and litigation, both of which drain resources from more productive uses
- Improve the ethical culture of the organization

Finally, those benefits for the company will serve the interests of the compliance department itself as its role will be seen as more than just preventing the occurrence of bad things; the department's assistance to other units of the company will enable them better to realize the company's business objectives and assure the continued revenue stream that constitutes its lifeblood. A firmer base of support within the company, particularly among senior management, should result from those efforts. ♦