

## FOSTERING POSITIVE CORPORATE CULTURE IN THE POST-ENRON ERA

STEPHANY WATSON\*

Have you considered the meaning of that word “worthy”? Weigh it well. . . . I had rather you should be worthy possessors of one thousand pounds honestly acquired by your own labor and industry, than of ten millions by banks and tricks. I should rather you be worthy shoemakers than secretaries of states or treasury acquired by libels in newspapers. I had rather you should be worthy makers of brooms and baskets than unworthy presidents of the United States procured by intrigue, factious slander and corruption.<sup>1</sup>

### I. INTRODUCTION

Discussions about business ethics are in. While corporate scandals are not new, the communication age and modern mega-corporations have made them bigger and more spectacular than ever before. The frequent photographs of teeth-gritting, handcuffed executives, illustrating the fast and steep fall of Enron, Arthur Andersen, WorldCom, Tyco, and other firms, are chilling.<sup>2</sup> How could they do it? How could the stewards of corporate America break the law, lose their shareholders’ investments, and cause the collapse of trust in the financial markets?

At least one possible answer is that corporate ethics have been abandoned, and greed is now king. Even if we disagree about the importance of ethics to healthy businesses, few would argue against an ethics refresher. This article outlines ways to

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\* Stephany Watson is a partner of Krogh & Leonard, in Portland, Oregon, where she has practiced law since 1985. Ms. Watson has a B.A. from Reed College, and a J.D. and LL.M. from Lewis and Clark Law School. Her practice is focused on energy and environmental law, corporate compliance, and ethics.

<sup>1</sup> DAVID MCCULLOUGH, JOHN ADAMS 608-09 (2001). President John Adams offered his opinion on the importance of ethics to his grandchildren. *Id.*

<sup>2</sup> Kurt Eichenwald, *After a Boom, There Will Be Scandal. Count on It.*, N.Y. TIMES, Dec. 16, 2002, at C3. Mr. Eichenwald’s article includes photographs of Andrew S. Fastow of Enron, L. Dennis Kozlowski of Tyco International, John Rigas of Adelphia Communications, Samuel D. Waksal of ImClone, and Scott D. Sullivan of WorldCom. Some of the executives pictured are handcuffed. *Id.* See also George Soros, *Why the Markets Can’t Fix Themselves*, THE NEW REPUBLIC ONLINE (Sept. 2, 2002), at <http://www.tnr.com/docprint.mhtml?i=20020902&cs=soros090202> (last visited Sept. 11, 2002).

create an effective corporate compliance program and develop positive corporate culture in the post-Enron era.

## II. BACKGROUND: CORPORATE COMPLIANCE & CORPORATE ETHICS

Narrowly defined, corporate *compliance* programs are those that encourage compliance with the laws, regulations, and policies that affect a particular company. These programs vary from company to company, and often from one work unit to another. They can include training regarding the state and federal laws governing unfair trade practices, discrimination, harassment, and environmental compliance, as well as regulations and policies that affect a particular industry.<sup>3</sup> The primary reason for establishing corporate compliance programs is to prevent employees from violating any of the laws, regulations, or policies that employees may encounter while performing their jobs. However, even in the unfortunate event that a violation does occur, having the right kind of program in place may also lessen a corporation's potential civil and criminal liability.<sup>4</sup>

By contrast, the term corporate *ethics* addresses the more philosophical notions of honesty, fairness, responsibility, respect, and compassion.<sup>5</sup> Most commentators agree that good corporate compliance programs—the ones that work—incorporate training both in legal compliance and in ethics.<sup>6</sup> In fact, one theme that runs consistently throughout the corporate compliance and ethics

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<sup>3</sup> For example, in the energy industry, a corporate compliance program could include training in the Federal Energy Regulatory Commission's standards of conduct for companies that both market electricity and own high-voltage transmission lines. *See generally* 889 F.E.R.C. STATS. & REGS. ¶ 31,035, at 31,594 (1996).

<sup>4</sup> *See infra* pp. 9–19, discussing the United States Sentencing Guidelines and *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996).

<sup>5</sup> This list is illustrative. One of the possible components of a corporate compliance and ethics program is leading the participants through a values identification exercise. Research indicates that the list included here appears after almost every such exercise, regardless of the age, nationality, or occupation of the participants. RUSHWORTH KIDDER, READINGS IN ETHICS 25-60 (2001).

<sup>6</sup> The Chair of the United States Sentencing Commission wrote that “[c]ompliance is more than looking to the letter of the law,” and questions whether “a compliance program can be truly effective if it does not have an ethics component.” She also stated that “[a]n ethical organization will develop ways in which ethical dilemmas are to be resolved by management and employees. An ethical organization will also foster and protect reporting mechanisms and reward ethical conduct.” Diana E. Murphy, *The Federal Sentencing Guidelines for Organizations: A Decade of Promoting Compliance and Ethics*, 87 IOWA L. REV. 697, 715–16 (2002).

commentary is that mere compliance training, without an examination of ethics, can often backfire with rank-and-file employees by portraying the firm as being concerned only with avoiding legal problems for executives and maintaining big profits for shareholders. In such cases, employees often perceive the training as inapplicable to themselves, and they therefore ignore it. Yet rank-and-file employees, as well as managers and executives, often have the capacity to cause great harm to companies, which demonstrates the need for positive corporate culture to permeate deeply throughout all personnel levels.<sup>7</sup>

A variety of legal commentaries, statutes, and cases have spurred most Fortune 500 companies to adopt codes of conduct outlining legal requirements, business ethics, and other aspects of business conduct.<sup>8</sup> Companies may combine these elements into a corporate compliance office (often with an executive corporate compliance officer), assign the legal compliance aspect to the firm's office of general

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<sup>7</sup> Note, too, that corporate downsizing increases the individual employee's importance and decreases managerial supervision:

The phenomenon of downsizing usually causes a severe reduction in the number of personnel performing many business processes. This trend further increases the importance of an ethical corporate culture to mainstream business operations. Traditional control procedures like direct supervision, segregation of duties, and approval of transactions are no longer feasible. This greatly increases the need for better 'soft controls.' These include an open, interdependent, and cohesive atmosphere of loyal teamwork exemplified by an ethical culture where individual and corporate goals are congruent.

Dr. Curtis C. Verschoor, *Corporate Performance is Closely Linked to a Strong Ethical Commitment*, STAKEHOLDER POWER (June 2001) at [http://www.stakeholderpower.com/story.cfm?article\\_id=49](http://www.stakeholderpower.com/story.cfm?article_id=49) (last visited Nov. 3, 2003). See also *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 968 (Del. Ch. 1996). ("[O]rdinary business decisions that are made by officers and employees deeper in the interior of the organization can, however, vitally affect the welfare of the corporation and its ability to achieve its various strategic and financial goals.")

<sup>8</sup> See *infra* pp. 9–19, discussing the United States Sentencing Guidelines and *In re Caremark*. Some commentators draw a bright line at 1991, the year in which the United States Sentencing Guidelines, which made codes of conduct a mitigating factor in sentencing for federal crimes, were adopted and applied to organizations. Others point out that there was a significant, high-level academic movement urging the adoption of codes many years earlier. See, e.g., Brown, *infra* note 47. Mr. Brown observes that the Securities and Exchange Commission and the American Law Institute concluded that corporate codes of conduct and compliance training were an important part of good corporate governance well before the Federal Sentencing Guidelines were passed. See Brown, *infra* note 47, at pp. 47–71.

counsel, or may have dedicated ethics officers. This article explores some model programs as part of the “how to” section near the end.

## II. HISTORY OF CORPORATE COMPLIANCE PROGRAMS: ETHICS LAPSES AND RESPONSES TO THEM

From an oddly comforting perspective, corporate scandals have long been a part of American business. Examples throughout history show that as bust follows boom, scandal follows bust.<sup>9</sup> One chronicler of corporate scandals writes: “[a]fter bubbles collapse and interfere with economic growth, the resulting loss of income stimulates efforts to maintain and increase income, both honestly and in corrupt ways.”<sup>10</sup> Furthermore, “[o]nce there are pressures put on profits, the obvious incentive for management to maintain their lifestyle or their stock prices is to fiddle with the books.”<sup>11</sup> There is also the pragmatic point that so long as the economy is doing well, no one knows or cares that the engine is powered by corrupt means. One commentator describes this condition quite colorfully: “you never know who’s swimming naked till the tide goes out.”<sup>12</sup>

American corporate ethics scandals date back at least as far as Charles Ponzi’s famous “pyramid scheme.” In 1920, Mr. Ponzi’s company promised investors a 50 to 100 percent return on their investments in “international postal reply coupons,” which were purported to be postage stamps that could be sold again and again.<sup>13</sup> However, Mr. Ponzi did not invest the funds in anything; he merely

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<sup>9</sup> Eichenwald, *supra* note 2, at C3.

<sup>10</sup> Charles P. Kindleberger, *Corruption, Crime, Chicanery: Business Through the Ages*, N.Y. TIMES, Dec. 16, 2002, at C3.

<sup>11</sup> Eichenwald, *supra* note 2, at C3.

<sup>12</sup> Remarks of Carol Loomis, ONLINE NEWSHOUR (Public Broadcasting Service, June 27, 2002), at [http://www.pbs.org/newshour/bb/business/jan-june02/ethics\\_6-27.html](http://www.pbs.org/newshour/bb/business/jan-june02/ethics_6-27.html) (last visited Nov. 3, 2004).

<sup>13</sup> Eichenwald, *supra* note 2, at C3.

repaid earlier investors with the funds he obtained from later ones.<sup>14</sup> Mr. Ponzi went to prison for defrauding some 40,000 people of at least \$15 million.<sup>15</sup>

Not surprisingly, the 1929 stock market crash and the Great Depression also produced some enormous corporate frauds. In 1929, Albert Wiggin, the head of Chase National Bank, short-sold 42,000 shares of his company's stock. While this maneuver was technically legal, the sales were detrimental to the interests of his shareholders and led to the passage of laws prohibiting executives from short-selling their own company's stock.<sup>16</sup> Another example is Ivar Krueger, the "Match King," who was the head of several companies that collectively made two-thirds of the world's matches. To stay afloat during the Depression, Krueger used hundreds of Byzantine off-the-books ventures to hide his losses. The business ultimately collapsed when he had a stroke and was unable to perpetuate the scheme, thus exposing the fraud.<sup>17</sup> Finally, Richard Whitney was the only high-level executive sent to prison for fraud stemming from the 1929 stock market collapse.<sup>18</sup> Mr. Whitney was the president of the New York Stock Exchange in 1929, and after the crash he gave powerful testimony before the Senate defending the Exchange's ability to regulate itself.<sup>19</sup> Yet Mr. Whitney himself had lost large sums of money in the crash, and he had attempted to cover his losses by stealing cash from his customers and from a fund that was established to aid widows and orphans of stockbrokers.<sup>20</sup>

Next came the notorious "Teapot Dome Scandal," which brought down President Warren G. Harding's Secretary of the Interior, and also revealed the

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<sup>14</sup> *Id.*

<sup>15</sup> Ellen Florian, *Schemers and Scams: A Brief History of Bad Business*, FORTUNE MAGAZINE (Mar. 3, 2002), available at <http://www.fortune.com/fortune/articles/0,15114,371011,00.html> (last visited Nov. 3, 2003).

<sup>16</sup> *Id.*

<sup>17</sup> *Id.* Part of Enron's demise stemmed from off-the-books partnerships, thus illustrating the timelessness of at least some fraudulent schemes. Heesun Wee, *Corporate Ethics: Right Makes Might*, BUSINESSWEEK ONLINE (Apr. 11, 2002), at [http://www.businessweek.com/bwdaily/dnflash/apr2002/nf20020411\\_6350.htm](http://www.businessweek.com/bwdaily/dnflash/apr2002/nf20020411_6350.htm) (last visited Nov. 3, 2004).

<sup>18</sup> Eichenwald, *supra* note 2, at C3.

<sup>19</sup> *Id.*

<sup>20</sup> *Id.*

corruption of a number of prominent oil executives.<sup>21</sup> During the presidencies of Theodore Roosevelt, William Howard Taft, and Woodrow Wilson, federal conservation laws established several oil reserves in Wyoming and California. These public land assets were set aside for the Navy's future use. President Harding's Secretary of the Interior, Albert Fall, leased Teapot Dome—a Wyoming oil reserve located on land with a teapot-shaped natural formation—to the Mammoth Oil Company while receiving substantial cash “gifts” from Mammoth and other lessees. Mr. Fall was found guilty of bribery in 1929 and sentenced to one year in prison.<sup>22</sup>

In the late 1950s and early 1960s, Anthony DeAngelis perpetrated the great “salad oil swindle.”<sup>23</sup> Mr. DeAngelis sold government surplus salad oil overseas, and then began to speculate in salad oil futures while simultaneously amassing huge loans. Mr. DeAngelis said the loans were secured by his stored salad oil. He was able to attract investors despite the fact that the American Bureau of Statistics reported that the volume of salad oil purportedly held in storage by DeAngelis' company exceeded the entire country's salad oil production.<sup>24</sup> As it turned out, many of the company's oil tanks contained nothing but water.<sup>25</sup>

One commentator argues that modern corporate compliance programs began after the electricity industry's antitrust scandal in the early 1960s.<sup>26</sup> During the 1950s, heavy electrical equipment manufacturers engaged in widespread market-sharing, bid-rigging, and price-fixing.<sup>27</sup> When the dust settled, twenty-nine corporations and forty-five individuals had pleaded guilty or no contest to criminal antitrust charges. Seven executives ultimately served prison sentences—among the

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<sup>21</sup> Leslie E. Bennett, *One Lesson From History: Appointment of Special Counsel and the Investigation of the Teapot Dome Scandal*, THE BROOKINGS INSTITUTION (1999), available at <http://academic.brooklyn.cuny.edu/history/johnson/teapotdome.htm> (last visited Nov. 3, 2004).

<sup>22</sup> *Id.*

<sup>23</sup> Eichenwald, *supra* note 2, at C3.

<sup>24</sup> *Id.*

<sup>25</sup> *Id.*

<sup>26</sup> John D. Copeland, *The Tyson Story: Building an Effective Ethics and Compliance Program*, 5 DRAKE J. AGRIC. L. 305, 311 (Winter 2000); see also Florian, *supra* note 15, *passim*.

<sup>27</sup> Copeland, *supra* note 26, at 311.

first imprisonments in the 70-year history of the Sherman Antitrust Act.<sup>28</sup> After the scandal subsided, antitrust compliance codes became commonplace.<sup>29</sup>

In 1975, a number of prominent U.S. companies made questionable payments to foreign officials.<sup>30</sup> Lockheed, Exxon, Mobil, and Gulf were involved in a scandal that damaged U.S. relations with NATO and brought down governments in Japan, Bolivia, and Honduras.<sup>31</sup> In 1977, Congress responded with the Foreign Corrupt Practices Act,<sup>32</sup> which caused many businesses to re-examine and revise their corporate codes of conduct.<sup>33</sup>

In the early 1980s, the Washington Post reported on a number of questionable defense contracts. The articles reported outrageous prices that the Pentagon had paid for ordinary objects, including \$9600 for a twelve-cent Allen wrench, and \$7400 for a coffee maker.<sup>34</sup> In response, President Reagan established the Blue Ribbon Commission on Defense Management, known popularly by its chair's name – the Packard Commission.<sup>35</sup> The Packard Commission made numerous ethics recommendations for defense contractors to follow, and some courts and the United States Department of Justice also applied these recommendations to other industries.<sup>36</sup> The recommendations included “distribut[ing] copies of the code of ethics to all employees and new hires,” and “mak[ing] business conduct standards and typical business situations a regular part of the employees' experiences and performance evaluations.”<sup>37</sup>

Before the current wave of accounting scandals and outright fraud involving Enron, Tyco, ImClone, WorldCom, and Arthur Andersen, the mid-1980s brought

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<sup>28</sup> *Id.* at 312; Florian, *supra* note 15, *passim*.

<sup>29</sup> Copeland, *supra* note 26, at 312.

<sup>30</sup> *Id.* at 312–13.

<sup>31</sup> *Id.*

<sup>32</sup> 15 U.S.C. § 78(a) (1977) (amending Title of original Act).

<sup>33</sup> Copeland, *supra* note 26, at 314.

<sup>34</sup> *Id.*

<sup>35</sup> *Id.*

<sup>36</sup> *Id.* at 315.

<sup>37</sup> *Id.*

the insider-trading and junk bond scandals involving Dennis B. Levine, Ivan Boesky, and Michael R. Milken.<sup>38</sup> As a result of insider trading and other illegal activities, all three prominent executives went to prison, and the powerful Wall Street firm of Drexel Burnham Lambert went bankrupt.<sup>39</sup> In 1989, Charles Keating was convicted of fraudulently marketing junk bonds and engaging in sham transactions.<sup>40</sup> His firm, Lincoln Savings and Loan, ultimately collapsed, costing taxpayers some \$3.4 billion.<sup>41</sup> In 1991, the Bank of Credit & Commerce International (“BCCI”) collapsed in a money-laundering scandal.<sup>42</sup> In 1995, a 28-year-old trader brought down the 233-year-old Barings Bank by hiding losses he could no longer cover.<sup>43</sup> In 2000, the venerable auction houses Sotheby’s and Christie’s were involved in a price-fixing scandal, resulting in prison terms and a combined payment of \$524 million to their customers.<sup>44</sup>

So what’s new? Business scandals certainly are not. However, the capacity to do great harm in a short period of time has increased as the world has grown smaller through globalization, improved communications, and increased market share by fewer firms.<sup>45</sup> For example, Enron’s collapse virtually dried up the capital markets for energy generating projects that were not at all related to Enron or its corrupt executives. In other generations, one firm’s bankruptcy would not have affected an entire industry, but due to Enron’s size and its enormous financial losses, investors have become leery of the entire energy business. Enron’s collapse may help cause a retreat from electricity industry restructuring, something the federal

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<sup>38</sup> Eichenwald, *supra* note 2, at C3.

<sup>39</sup> *Id.* See also Dennis B. Levine, *The Inside Story Of an Inside Trader*, PERSPECTIVES IN BUSINESS ETHICS 612 (Laura P. Hartman ed., 2002).

<sup>40</sup> Florian, *supra* note 15, at 2.

<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

<sup>44</sup> John Goldman, *Sotheby’s Former Chairman Jailed*, THE AGE, Apr. 24, 2002, available at <http://www.theage.com.au/articles/2002/04/23/1019441243127.html> (last visited Nov. 3, 2004).

<sup>45</sup> In “How Good People Make Tough Choices,” Rushworth Kidder cites the examples of the Chernobyl nuclear reactor explosion, the Exxon Valdez oil spill, and the Keating Five savings and loan collapse, to illustrate the modern ability of a few ordinary people to do great harm in a short time. The scale and power of modern scientific, technological, financial, governmental, and educational systems “amplify small whispers of wrongdoing into vast bellows of amorality.” RUSHWORTH KIDDER, HOW GOOD PEOPLE MAKE TOUGH CHOICES 34–35 (1995).



government has advocated for over a decade. So while scandals are not new, their ability to cause widespread damage has substantially increased.

#### IV. LEGAL REASONS FOR HAVING A COMPLIANCE PROGRAM

##### A. *In re Caremark International, Inc. Derivative Litigation*

Training programs for corporate employees regarding the legal implications of their conduct gained new importance after the 1996 case of *In re Caremark International, Inc. Derivative Litigation*.<sup>46</sup> In early corporate law, the question of whether a corporation itself could be found criminally liable remained unsettled. Because a *mens rea*, or criminal state of mind, is a necessary element of criminal conduct, the argument was that a “soul-less” corporation could not form a *mens rea* and therefore could not commit a crime.<sup>47</sup> Yet in 1909 the United States Supreme Court affirmed the criminal conviction of a railroad for violation of the Elkins Act stemming from illegal payments by one of the railroad’s employees.<sup>48</sup> The Court used the tort law principle of *respondeat superior* to impute the employee’s knowledge to the corporation.<sup>49</sup>

In contrast, some courts have found that corporate criminal liability does not arise from *respondeat superior*, but from the corporate director’s non-delegable duty to ensure that those who conduct the corporation’s business do so lawfully.<sup>50</sup> These older cases settled the question as to the corporate entity’s potential liability, but not

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<sup>46</sup> *In re Caremark Int’l Inc. Derivative Litigation*, 698 A.2d 959 (Del. Ch. 1996).

<sup>47</sup> Case of Sutton’s Hosp., 77 Eng. Rep. 960, 973 (K.B. 1612). Professor Kathleen F. Brickey writes,

The corporation was recognized in law not as a natural person, but as an artificial entity. As an abstraction, it lacked physical, mental and moral capacity to engage in wrongful conduct, or to suffer punishment. It could neither commit criminal acts, entertain criminal intent, nor suffer imprisonment. It had no soul and so could not be blamed.

Kathleen F. Brickey, *Corporate Criminal Accountability: A Brief History and Observation*, 60 WASH. U. L.Q. 393, 396 (1982), quoted in H. Lowell Brown, *The Corporate Director’s Compliance Oversight Responsibility in the Post Caremark Era*, 26 DEL. J. CORP. L. 1, 72 (2001).

<sup>48</sup> *New York Central & Hudson River R.R. Co. v. United States*, 212 U.S. 481, 496 (1909).

<sup>49</sup> *Id.* at 493.

<sup>50</sup> *United States v. Armour & Co.*, 168 F.2d 342, 344 (3d Cir. 1948); *United States v. Uniroyal, Inc.*, 300 F. Supp. 84, 95 (S.D.N.Y. 1969) (quoted in Brown, *supra* note 47, at 78).

as to the liability of individual directors and officers. That question had to wait until the *Caremark* decision.

Before *Caremark*, a corporate director's duty of care was widely interpreted as having been fulfilled so long as the director did not engage in outlandish acts of neglect.<sup>51</sup> A director's actions were clothed with the legal presumption of due care, and that presumption was rarely overcome. Indeed, before *Caremark*, a corporate director could behave more like an honored guest than an active steward of the business. "In the past, being a member of a board of directors was an honor. Now, it's also a job carrying with it some substantial personal and professional risks."<sup>52</sup> The *Caremark* case established that corporate directors *can* be held personally liable for a corporation's wrongdoing, and that personal liability is easier to prove in the absence of an effective corporate compliance program.<sup>53</sup>

In *Caremark*, a managed-care healthcare provider received substantial revenues from Medicare and Medicaid reimbursements. These reimbursements were subject to the Anti-Referral Payments Law ("ARPL"), which prohibits healthcare

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<sup>51</sup> Directors were never meant to micromanage companies; indeed, the corporate form itself depends on considerable distance between a board of directors and day-to-day operations.

Courts are reluctant to subject directors – particularly outside directors – to due care liability. A number of factors explain this reluctance. First, courts realize that no person is obligated to serve as a corporate director, especially an outside director. If corporate law threatened directors who failed to perform at the level of the law's aspirations with liability, "no men [or women] of sense would take the office . . . ." Second, shareholders, as equity investors, can be viewed as having assumed the risk that managers will make some bad judgments resulting in business losses. Third, fact finders viewing situations retrospectively too often may be inclined to determine that a bad result was due to bad judgment rather than bad luck. Finally, the threat of liability may lead directors or managers to avoid potentially profitable but risky business opportunities or to focus on safeguarding corporate resources.

Elliott J. Weiss, *Economic Analysis, Corporate Law, and the ALI Corporate Governance Project*, 70 CORNELL L. REV. 1, 14 (1984).

<sup>52</sup> Victoria M. Wessler, *Corporate Board Membership: Risky Business*, ETHICS & COMPLIANCE STRATEGIES, at <http://www.ethicscompliance.com/news.html> (last visited Nov. 3, 2004). Ms. Wessler quotes John Nash, the immediate past president and CEO of the National Association of Corporate Directors.

<sup>53</sup> *In re Caremark*, 698 A.2d at 970.

companies from making payments to doctors in exchange for Medicare and Medicaid patient referrals.<sup>54</sup>

In 1991, the Inspector General for the Department of Health and Human Services began investigating Caremark for possible ARPL violations.<sup>55</sup> Contracts between Caremark and doctors indicated that Caremark was paying doctors for monitoring patients under Caremark's care, including Medicare and Medicaid patients. In turn, some of those doctors were referring patients to Caremark. The United States Department of Justice and other federal and state agencies joined in the investigation.<sup>56</sup>

Shortly before the investigations commenced, and then during the investigations, Caremark undertook a number of actions in response to the ARPL indictment. These included providing greater supervision of its 7000 employees and several revisions of its "Guide to Contractual Relationships," an internal compliance manual.<sup>57</sup> Caremark's outside auditor reported that there were no material weaknesses in Caremark's conflict control structure.<sup>58</sup> The company also appointed a compliance officer.<sup>59</sup> All of these actions, as well as the minutes from meetings of the board of directors, suggested that Caremark's board was aware of various efforts to assure compliance with the ARPL and other anti-kickback laws.

Despite these efforts, a federal grand jury indicted Caremark, two of its officers, and two other employees, accusing them of violating the ARPL.<sup>60</sup> Shortly afterwards, five stockholder derivative actions were filed in Delaware Chancery Court, which were later consolidated. Those cases alleged that Caremark's directors had breached their duty of care by failing to adequately supervise the conduct of

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<sup>54</sup> *Id.* at 961–62.

<sup>55</sup> *Id.* at 962.

<sup>56</sup> *Id.*

<sup>57</sup> *Id.* at 963.

<sup>58</sup> *Id.* Despite the auditor's finding, Caremark's Audit & Ethics Committee decided to comprehensively review the company's compliance policies and compile an employee ethics handbook.

<sup>59</sup> *Id.*

<sup>60</sup> *Id.* at 963–64.

Caremark employees or institute sufficient corrective measures, thereby exposing the company to substantial fines and other liabilities.<sup>61</sup>

Caremark began settlement discussions with federal and state prosecutors. In exchange for Caremark's agreement to plead guilty to mail fraud and substantial payments, federal authorities committed to an agreement that allowed Caremark to continue participating in Medicare and Medicaid reimbursement programs.<sup>62</sup> Caremark then executed a proposed settlement agreement in the shareholder derivative suits, which required the Delaware Chancery Court's approval.

In evaluating the settlement agreement, the Chancery Court asked whether Caremark's board of directors had breached its duty of care to the corporation by failing to adequately oversee Caremark's affairs, so that violations of the ARPL could have been detected earlier, thus preventing the company's losses.<sup>63</sup> Caremark's shareholders argued that the directors allowed a situation to develop which exposed the corporation to enormous legal liability, and that in so doing they had violated their duty to actively monitor Caremark's corporate performance. In describing the corporate director's duty of care, the court stated:

What should be understood . . . is that compliance with a director's duty of care can never appropriately be judicially determined by reference to the content of the board decision that leads to a corporate loss, apart from consideration of the good faith or rationality of the process employed. That is, whether a judge or jury considering the matter after the fact, believes a decision substantively wrong, or degrees of wrong extending through "stupid" to "egregious" or "irrational," provides no ground for director liability, so long as the court determines that the process employed was either rational or employed in a good faith effort to advance corporate interests.<sup>64</sup>

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<sup>61</sup> *Id.* at 964.

<sup>62</sup> The payments totaled at least \$250 million. *Id.* at 961.

<sup>63</sup> *Id.* Procedurally, the court pointed out that its evaluation was limited to the claims and defenses on the discovery record. Its inquiry was whether or not the proposed settlement appeared fair to the corporation and its absent shareholders. *Id.*

<sup>64</sup> *Id.* at 967.

The court further stated that the touchstone of any corporate law duty of care inquiry is whether there was a “good faith effort to be informed and to exercise appropriate judgment.”<sup>65</sup>

A breach of the duty of care may be active or passive. In the case of an active breach, liability follows from an ill-advised or negligent board decision that results in a loss; in a passive breach, a loss results from the board’s inaction. Allegations of a passive breach formed the basis of the *Caremark* shareholders’ suit, which caused the court to inquire, “[w]hat is the board’s responsibility with respect to the organization and monitoring of the enterprise to assure that the corporation functions within the law to achieve its purposes?”<sup>66</sup>

The court reviewed an earlier Delaware decision alleging a corporate director’s breach of the duty of care. In that 1963 decision, the court stated that “there is no duty upon the directors to install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists.”<sup>67</sup> The *Caremark* court declined to interpret that holding broadly, finding that a modern corporate board must make certain that management establishes appropriate information and reporting systems.<sup>68</sup> In support of this interpretation, the *Caremark* court cited the potential impact of the U.S. Sentencing Guidelines for Organizations and their mitigation factors. The court found that failure to take the Guidelines into account in responsibly governing an organization is not rational.<sup>69</sup>

Ultimately, the court held:

that a director’s obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate, exists, and that failure to do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards.<sup>70</sup>

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<sup>65</sup> *Id.* at 968.

<sup>66</sup> *Id.* at 968–69.

<sup>67</sup> *Id.* at 969 (*citing* *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125, 130 (Del. Ch. 1963)).

<sup>68</sup> *Id.* at 969–70.

<sup>69</sup> *Id.* at 970.

<sup>70</sup> *Id.*

While this holding contains a degree of ambiguity and reticence, the court also offered some guidance for the real world. With regard to an “adequate” information and reporting system, the court said that this system should be “reasonably designed to provide to senior management and the board itself timely, accurate information sufficient to allow management and the board, each within its scope, to reach informed judgments concerning both the corporation’s compliance with law and its business performance.”<sup>71</sup> In addition, the court stated that:

it is important that the board exercise a good faith judgment that the corporation’s information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations, so that it may satisfy its responsibility.<sup>72</sup>

Thus, the reporting system must be timely and accurate, it must contain legal compliance and business performance information, and the information must flow to the board in the ordinary course of business. Moreover, given the *Caremark* court’s frequent references to the U.S. Sentencing Guidelines, most commentators believe that the “floor” for a corporate compliance reporting system must contain the elements necessary for sentence mitigation under the Guidelines.<sup>73</sup>

The *Caremark* court held that the settlement offered in the motion was fair and reasonable. It stated that, in order to show that the *Caremark* directors had breached their duty of care, the plaintiffs would have to show that the directors knew or should have known that legal violations were occurring, that the directors took no action to prevent or remedy the violations, and that such failure caused the corporation’s loss.<sup>74</sup> The court offered the following additional insights into its holding: First, the duty to act in good faith to be informed does not require that a director have detailed information about all aspects of the corporation’s enterprise.<sup>75</sup> Second, only a sustained or systematic failure of the board to exercise oversight, such as having no reasonable reporting system, will establish the lack of good faith necessary for liability. In acknowledging its intent to establish a high threshold for corporate director liability, the court noted that such a high threshold benefits shareholders as a class because it

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<sup>71</sup> *Id.*

<sup>72</sup> *Id.*

<sup>73</sup> See, e.g., Copeland, *supra* note 26, at 348.

<sup>74</sup> *In re Caremark*, 698 A.2d at 971.

<sup>75</sup> *Id.*

creates an environment in which qualified people will still agree to sit on corporate boards after *Caremark*.<sup>76</sup>

Subsequent litigation in Delaware indicates that the courts, on behalf of corporate shareholders, are becoming increasingly willing to examine complaints alleging breach of a director's fiduciary duties. While deference to the business judgment rule might have meant an almost automatic dismissal of this kind of complaint before the most recent wave of corporate scandals, some are seeing a trend towards greater scrutiny of shareholders' allegations.<sup>77</sup> As the federal government increases its role in regulating corporate law—an area of law historically regulated largely by the states—state courts may increase their corporate law activism. Greater state court attention to shareholders' complaints may be one way for states to show federal regulators that they are capable of enforcing corporate law without further federal involvement.<sup>78</sup>

### B. United States Sentencing Guidelines

The *Caremark* case also introduced the U.S. Sentencing Guidelines mitigation measures into the realm of civil corporate law. As the court explained, and as commentators and other cases have shown, a corporate compliance program must, at a minimum, contain the compliance and reporting measures outlined in the U.S. Sentencing Guidelines for Organizations.<sup>79</sup> Many corporate lawyers and personnel may have had little interest in the U.S. Sentencing Guidelines before *Caremark*, but in the aftermath of that case there is no doubt that the Guidelines contain the core elements of a legally sufficient compliance program.<sup>80</sup>

First, some background about the Sentencing Guidelines is necessary. The Sentencing Reform Act of 1984 was enacted to eliminate inconsistent sentencing for

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<sup>76</sup> *Id.*

<sup>77</sup> The essence of the business judgment rule is that in the absence of fraud, other egregious conduct, or neglect, judges may defer to corporate directors' decisions. John Gibeaut, *Stock Responses*, 89 A.B.A. J. 38 (2003).

<sup>78</sup> *Id.* at 41.

<sup>79</sup> Wessler, *supra* note 52.

<sup>80</sup> Copeland, *supra* note 26, at 326. See also Murphy, *supra* note 6 at 714, citing cases after *Caremark* holding that corporate directors can avoid liability in shareholder derivative suits by implementing an effective corporate compliance program. See also *Dellastatious v. Williams*, 242 F.3d 191 (4th Cir. 2001) and *McCall v. Scott*, 239 F.3d 808 (6th Cir. 2001).

federal crimes.<sup>81</sup> The Act created the U.S. Sentencing Commission, an independent agency within the judicial branch, which was charged with developing consistent sentencing guidelines for the federal courts.<sup>82</sup> Guidelines for sentencing organizations became effective on November 11, 1991.<sup>83</sup> Of greatest interest at present is the provision in the Guidelines for the mitigation of sentences for corporate offenders where the corporation has an appropriate corporate compliance program in place.<sup>84</sup>

The Guidelines state that “[t]he hallmark of an effective program to prevent and detect violations of law is that the organization exercised due diligence in seeking to prevent and detect criminal conduct by its employees and other agents.”<sup>85</sup> At a minimum, an effective program will:

(1) Establish compliance standards and procedures for its employees and other agents that are reasonably capable of reducing improper conduct;

(2) Assign responsibility to specific, high-level personnel within the organization to oversee compliance with the standards described above;

(3) Use “due care not to delegate substantial discretionary authority”<sup>86</sup> to people whom the organization knows or should know engaged in illegal activities;

(4) Take “steps to communicate effectively its standards and procedures to all employees and other agents,”<sup>87</sup> through training programs and publications;

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<sup>81</sup> 18 U.S.C. §§ 3551-3742 (1998); 28 U.S.C. §§ 991-998 (2003).

<sup>82</sup> 28 U.S.C. § 991 (2003).

<sup>83</sup> Since nationwide implementation of the sentencing guidelines, federal courts have sentenced approximately 600,000 defendants under them. News Release, *U.S. Sentencing Comm’n* (Apr. 18, 2003), available at <http://www.ussc.gov/PRESS/rel0403.htm> (last visited Nov. 3, 2004).

<sup>84</sup> While the guidelines promulgated for individuals center on punishment and incapacitation, the guidelines for organizations focus on deterrence. In developing the organizational guidelines, the Commission was cautioned that fines, even enormous ones, had done little to deter organizational wrongdoing. Murphy, *supra* note 6, at 701.

<sup>85</sup> 18 U.S.C.S. App. § 8A1.2, cmt. 3(k) (2004).

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*



(5) Take “reasonable steps to achieve compliance with its standards,”<sup>88</sup> for example, by using monitoring and auditing systems to detect improper conduct and by having in place and publicizing a reporting system that allows employees and other agents to report improper conduct without fear of retribution;

(6) Enforce company standards through appropriate disciplinary mechanisms; and

(7) Take all reasonable steps to respond to an offense and to prevent further similar offenses.<sup>89</sup>

The Sentencing Guidelines also state that the precise elements of an effective compliance program will depend upon a number of factors, including the size of the organization, the type of business it operates, and its prior history of misconduct.<sup>90</sup> Industry practice and any applicable government regulations are also part of an effective compliance program.<sup>91</sup> Thus, the seven elements noted above form the basis for a corporate compliance program, but a company committed to preventing and curing ethical lapses will tailor its program to the unique circumstances of its own industry and workforce.

Of course, once a corporation has been accused of a crime and convicted, mitigation may be too little, too late.<sup>92</sup> Thus, the incentive for a corporation to

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<sup>88</sup> *Id.*

<sup>89</sup> *Id.* See also discussion, *infra*, pp. 32–37, regarding “How to Establish a Corporate Compliance Program” for more discussion of how to implement the seven elements set forth in the U.S. Sentencing Guidelines.

<sup>90</sup> 18 U.S.C.S. App. § 8A1.2, cmt. 3(k) (2004).

<sup>91</sup> *Id.*

<sup>92</sup> Obviously, companies want to avoid criminal convictions, even with lessened penalties:

[E]ven for the organization that is able to reduce substantially its criminal fine through the Guidelines’ culpability factors, a criminal conviction carries high costs. There are out-of-pocket expenses in defending the prosecution, such as attorneys’ fees and travel and investigative expenses. There are also indirect costs such as the loss of time and attention to business matters by corporate executives and corporate counsel who must involve themselves in the criminal investigation and defense. Other devastating costs may follow a conviction. Even if the sentencing court reduces the criminal fine by applying the culpability factors, collateral consequences may arise which the Guidelines cannot reduce . . . [C]onsequences such as suspension or elimination from governmental programs, loss of professional licenses necessary to continue in business, imposition of substantial

develop and implement a compliance program that actually prevents corporate employees from committing crimes remains the most important feature of the mitigation program.<sup>93</sup> After all, the focus of any corporate compliance program should be prevention, not damage control.<sup>94</sup>

### C. Administrative Debarment

Corporate compliance programs may also help reduce a company's chances of being banned or "debarred" from contracting opportunities with federal agencies. Historically, agencies began exercising administrative discretion to debar federal contractors in the late 1920s.<sup>95</sup> These discretionary decisions were often inconsistent, giving rise to Constitutional due process concerns. In 1982, the Office of Federal Procurement Policy issued a letter setting forth rules for standardized government-wide debarment, which were codified as part of the Federal Acquisition Regulations ("FAR").<sup>96</sup> Under the FAR, government contractors must have a

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administration and civil fines, termination of insurance, and denial of applications for expansion may effectively ruin a corporation. In addition to these collateral consequences, the convicted corporation may face adverse publicity. In some instances, adverse publicity alone can cause corporate devastation, as when depositors flock to withdraw deposits from a convicted, or even indicted, financial institution.

Brown, *supra* note 47 at 90, quoting Pamela H. Bucy, *Organizational Sentencing Guidelines: The Cart Before the Horse*, 71 WASH. U. L.Q. 329, 352-53 (1993).

<sup>93</sup> Murphy, *supra* note 6, at 703.

<sup>94</sup> Pursuant to emergency authority granted to the U.S. Sentencing Commission under the Public Company Accounting Reform and Investor Protection Act of 2002 ("Sarbanes-Oxley Act"), *infra* pp. 20-24, the Commission increased penalties significantly for corporate and other serious white-collar frauds on April 18, 2003. Sentencing enhancements now apply to registered brokers, dealers and investment advisors who defraud investors or employers. Sentencing is enhanced for white-collar offenses affecting large numbers of victims. The amendment also increases penalties for those who obstruct justice by destroying documents and records. News Release, *U.S. Sentencing Commission* (Apr. 18, 2003), available at <http://www.usc.gov/PRESS/rel0403.htm> (last visited Nov. 3, 2004). Note also that on October 7, 2003, the Ad Hoc Advisory Group on the Organizational Sentencing Guidelines delivered its final report to the U.S. Sentencing Commission. The 138-page report makes 10 recommendations for revising the 1991 Guidelines. Report of the Ad Hoc Advisory Group on the Organizational Sentencing Guidelines (Oct. 7, 2003) available at <http://www.usc.gov/corp/advgrp.htm> (last visited Nov. 3, 2004). See also Stephany Watson, *Scandals May Result in More Corporate Compliance & Ethics Program Changes: Summary of the Report of the Ad Hoc Advisory Group on the Organizational Sentencing Guidelines*, 22 PREVENTIVE L. RPTR. 1 (Fall 2003).

<sup>95</sup> Brown, *supra* note 47, at 96.

<sup>96</sup> 48 C.F.R. § 1.000 (2003); Brown, *supra* note 47, at 96-97.

satisfactory ethical record including no history of bid-rigging, fraud, or other related behavior.<sup>97</sup> If a contractor is debarred, it can be prevented not only from receiving government contracts, but also from receiving grants, scholarships, loans, loan guarantees, and insurance.<sup>98</sup>

Debarment or suspension is not automatic. The debarment rules state that:

[b]efore arriving at any debarment decision, the debarring official should consider . . . [w]hether the contractor had effective standards of conduct and internal control systems in place at the time of the activity which constitutes cause for debarment or had adopted such procedures prior to any Government investigation of the activity cited as a cause for debarment.<sup>99</sup>

A debarring official may consider a variety of mitigating factors in addition to effective standards of conduct.<sup>100</sup>

As with the Sentencing Guidelines, arguing for mitigation in the face of a company's loss of federal contracts may be too little, too late. But also like the Sentencing Guidelines, the debarment rules provide a company with government contracts—or one that aspires to have government contracts—strong incentives to adopt a preventive compliance program.

#### D. The “Sarbanes-Oxley Act” of 2002

As on earlier occasions when scandals gave rise to increased regulation and penalties, the recent scandals involving Enron, Arthur Andersen, WorldCom, and others, gave rise to the Public Company Accounting Reform and Investor Protection Act of 2002 (“Sarbanes-Oxley”).<sup>101</sup> Sarbanes-Oxley is the most expansive federal corporate governance legislation since the Great Depression. It addresses corporate structure, accounting, auditing, fraud, liability, and reporting. For well-run companies already practicing much of what it requires, the Act's most significant

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<sup>97</sup> 48 C.F.R. § 9.104-1(d) (2003).

<sup>98</sup> 48 C.F.R. § 9.405(c) (2003).

<sup>99</sup> Brown, *supra* note 47, at 101 note 484.

<sup>100</sup> 48 C.F.R. § 9.406-1(a)(1) (2003).

<sup>101</sup> Public Company Accounting Reform and Investor Protection Act of 2002 (“Sarbanes-Oxley Act”), Pub. L. No. 107-204, 116 Stat. 145 (2002).

feature may be the new requirement for “rolling disclosures” of material changes in a company’s financial condition or operation. These disclosures will prevent companies from quietly engaging in corporate restructuring, refinancing, mergers, and other significant business activities. However, Sarbanes-Oxley is new and has not yet been completed. The Act charges the Securities and Exchange Commission (“SEC”) with promulgating rules to implement the Act’s reporting requirements; however, all of the rules have not yet been finalized.<sup>102</sup> Sarbanes-Oxley is addressed in this article because many of its requirements relate to ethical lapses and regulate ethical matters.

It is important to note that Sarbanes-Oxley applies only to public companies and auditors of public companies.<sup>103</sup> Specifically, the Act applies to any company that (1) is registered under Section 12 of the Securities and Exchange Act of 1934, as amended, (the “Exchange Act”); (2) is required to file reports under Section 15(d) of the Exchange Act; or (3) files, or has filed, a registration statement under the Securities Act of 1933, as amended. The SEC is charged with implementing most of the Act’s provisions, which includes issuing substantial regulations to flesh out the Act.<sup>104</sup> SEC Commissioner Paul S. Atkins has explained that because Congress gave the SEC a relatively short timeline to issue the regulations, many of them are general and may undergo further changes.<sup>105</sup>

Sarbanes-Oxley also established the Public Company Accounting Oversight Board. The Board is responsible for registering accounting firms, establishing auditing standards, investigating and disciplining accounting firms, and enforcing

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<sup>102</sup> Dan Bailey, et al., *The Sarbanes-Oxley Act of 2002: The Government’s Latest Fix* (Aug. 26, 2002), available at <http://www.artherhadden.com/publications/clientalert/alert082602b.asp> (last visited Mar. 27, 2003). See also Stephen Labaton, *Praise Runs Into Politics at S.E.C.*, N.Y. TIMES, Jul. 25, 2003, at C6, stating that on the one-year anniversary of Sarbanes-Oxley’s passage, the Commission has not yet finished issuing new rules related to the Act.

<sup>103</sup> S. REP. NO. 107-205 ¶ 5001 (2002). “The statutory intent is that state regulatory authorities should make independent determinations of the proper standards for small and medium-sized accounting firms that do not audit public companies; state authorities should not presume that the standards applied under the bill should apply to those companies under state regulatory schemes.” *Id.* Non-public companies may choose to substantially comply with Sarbanes-Oxley for public image, financing, altruistic, or other reasons, however. Some of the Act’s provisions may indeed become the standard of care for reasonable corporations.

<sup>104</sup> 15 U.S.C. § 77s (2002).

<sup>105</sup> Commissioner Paul S. Atkins, United States Securities & Exchange Commission, remarks at the University of Cologne, Germany (Feb. 5, 2003), at <http://www.sec.gov/news/speech/spch020503psa.htm> (last visited Nov. 3, 2004).

compliance with the Act.<sup>106</sup> The establishment of the Board signals the end of self-regulation for the accounting industry.

Sarbanes-Oxley also amends the Exchange Act to prevent accounting firms from performing auditing for companies that also receive non-audit services, such as consulting, investment banking, and bookkeeping from the same accounting firm.<sup>107</sup> Furthermore, accounting firms auditing public companies must rotate their partner-in-charge every five years, and if the accounting firm performing an audit employed the audited company's CEO, CFO, controller or Chief Accounting Officer in the year before the audit, that firm may not perform the audit.<sup>108</sup> Companies must also have an independent audit committee responsible for overseeing audits, including choosing the accounting firm, determining its compensation, and reviewing its work. The audit committee members must be independent of the company, which can pay them only for their services on the committee. In other words, audit committee members cannot also be salaried officers or directors.<sup>109</sup>

Sarbanes-Oxley also obligates the SEC to adopt rules requiring the principal executive officer and principal financial officer to certify in each annual and quarterly report that they have reviewed the reports and that the reports do not contain material misstatements or omissions of fact.<sup>110</sup> The essence of the certification

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<sup>106</sup> Dan A. Bailey, et al., *Summary of The Sarbanes-Oxley Act of 2002* (Aug. 26, 2002), at <http://www.artherhadden.com/publications/clientalert/alert082602a.asp> (last visited Mar. 27, 2003).

<sup>107</sup> *Id.*

<sup>108</sup> *Id.*

<sup>109</sup> *Id.*

<sup>110</sup> Under the Act, an issuer's principal executive officer or officers and the principal financial officer or officers must certify in each annual or quarterly financial report filed under section 13(a) or 15(d) of the Exchange Act (forms 10-K, 10-KSB, 20-F, and 40-F, 10-Q, 10-QSB) that:

the officer has reviewed the report; based on the officer's knowledge, the report does not contain any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which such statements were made, not misleading; based on such officer's knowledge, the financial statements, and other financial information included in the report, fairly present in all material respects the financial condition and results of operations of the issuer as of, and for, the periods presented in the report; the signing officers are responsible for internal controls, have designed controls to ensure that material information is made known to the officers on a timely basis, have evaluated the effectiveness of those controls within 90 days prior to the report, and have reported on their evaluation of the controls; the signing officers have disclosed to the auditors and the audit committee all significant internal

requirement is that CEOs and CFOs must ensure that financial statements are materially correct to avoid false certification.<sup>111</sup> In addition, CEOs and CFOs must certify each periodic report that the SEC requires. The certification must state that the report fully complies with the requirements of Section 13(a) or 15(d) of the Exchange Act and that the information contained in the report fairly presents, in all material respects, the financial condition and results of the company's operations.<sup>112</sup>

Sarbanes-Oxley also outlaws most corporate loans to directors and officers.<sup>113</sup> Additionally, corporations subject to regulation under the Act must develop and publish a corporate code of ethics, which must include a code of ethics for senior financial officers.<sup>114</sup>

One of the Act's more controversial features is its requirement that the SEC issue rules governing legal counsel's reporting on improper activity.<sup>115</sup> Section 307 of the Act requires lawyers to report evidence of a material violation of federal securities law or a breach of fiduciary duty to a client company's general counsel or chief executive officer. If this first approach fails to generate an appropriate response, the lawyer must report the matter to the company's independent audit board or board of directors.<sup>116</sup> Before Sarbanes-Oxley, Congress had not attempted

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control problems and any fraud involving employees who have significant internal control responsibilities; and the signing officers have indicated on the report whether there are any significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of their evaluation, including actions correcting weakness in control.

DAVID E. HARDESTY, CORPORATE GOVERNANCE AND ACCOUNTING UNDER THE SARBANES-OXLEY ACT OF 2002 305-06 (2002).

<sup>111</sup> Sarbanes-Oxley Act, *supra* note 101, at § 302. See generally Hardesty, *supra* note 110, at 1301–06.

<sup>112</sup> Sarbanes-Oxley Act, *supra* note 101, at § 906.

<sup>113</sup> Exceptions are home loans, consumer credit, credit cards and margin accounts in brokerage firms, but they must be on the same terms as the corporation makes loans to all consumers. See Bailey, et al., *supra* note 102.

<sup>114</sup> Gordon S. Kaiser, *Corporate Governance: Sarbanes-Oxley – A Play in One Act*, 41 INFRASTRUCTURE No. 4 at 10 (2003), available at [http://www.abanet.org/pubutil/summer\\_fall\\_2003.pdf](http://www.abanet.org/pubutil/summer_fall_2003.pdf) (last visited Mar. 6, 2003).

<sup>115</sup> Jenny B. Davis, *Sorting Out Sarbanes-Oxley*, 89 A.B.A. J. 44, 48–49 (2003).

<sup>116</sup> *Id.* at 48.

to regulate lawyer conduct, as this had been considered a traditional province of the states.<sup>117</sup>

Finally, Sarbanes-Oxley enhances a number of white-collar criminal penalties throughout the United States Code, including penalties for spoliation of evidence.<sup>118</sup> The Act makes it a federal crime, punishable by up to twenty years in prison, for any person knowingly to alter, destroy, mutilate, conceal, cover up, falsify, or make a false entry in any record, document, or tangible object with the intent to impede, obstruct, or influence the investigation or proper administration of any matter by an agency of the U.S. government.<sup>119</sup>

### E. New York Stock Exchange Corporate Governance Rule Proposals

The New York Stock Exchange (“NYSE”) has required companies to comply with certain listing standards for 150 years.<sup>120</sup> In 2001, “in the aftermath of the meltdown of significant companies due to failures of diligence, ethics[,] and controls,” the Chairman of the SEC asked the NYSE to review its corporate governance listing standards.<sup>121</sup> On April 4, 2003, the NYSE sent a corporate governance rule filing to the SEC.<sup>122</sup> The SEC has yet to approve the filing, which would require all companies listed on the NYSE to meet specific corporate governance standards.

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<sup>117</sup> The SEC dropped an additional lawyer disclosure proposal: that corporate counsel who did not receive an appropriate response from the list of company executives in Section 307 be required to “make a noisy withdrawal” from representing the corporation and report the incident to the SEC. *Id.* At least one state has warned lawyers that its ethics rules regarding non-disclosure of client confidences trump the permissive authority to disclose them contained in Sarbanes-Oxley. Mark Hansen, *State Fights the SEC*, ABA JOURNAL AND REPORT (Aug. 29, 2003), at <http://www.abanet.org/journal/ereport/au29sec.html> (last visited Sept. 2, 2003).

<sup>118</sup> See Bailey, et al., *supra* note 102.

<sup>119</sup> *Id.* at 94.

<sup>120</sup> *Id.*

<sup>121</sup> *Id.*

<sup>122</sup> Amendment No. 1 to the NYSE’s Corporate Governance Proposals, *available at* <http://www.nyse.com/pdfs/amend1-04-09-03.pdf> (last visited Nov. 3, 2004). The filing amended and restated the NYSE’s original corporate governance proposals filed with the SEC on August 16, 2002, which reflected the recommendations of the NYSE’s Corporate Accountability and Listing Standards Committee. *Id.*

The SEC puts forward the following proposed standard as Section 10: “Listed companies must adopt and disclose a code of business conduct and ethics for directors, officers[,] and employees, and promptly disclose any waivers of the code for directors or executive officers.”<sup>123</sup> The proposal states that the SEC’s choice of the words “must” and “should” is both intentional and specific.<sup>124</sup> The commentary to this section adds that:

no code . . . can replace . . . an ethical director, officer, or employee. However, such a code can focus the board and management on areas of ethical risk, provide guidance to personnel to help them recognize and deal with ethical issues, provide mechanisms to report unethical conduct, and help to foster a culture of honesty and accountability.<sup>125</sup>

Furthermore, “[e]ach listed company’s website must include its code of business conduct and ethics.”<sup>126</sup> While companies may adopt their own policies, the rule states that all listed companies should address the “most important” topics, including: conflicts of interest; taking personal advantage of corporate opportunities learned of while in the corporation’s service; confidentiality; fair dealing with competitors, suppliers and employees; protection and proper use of company assets; compliance with laws, rules and regulations (including insider trading laws); and the reporting of illegal or unethical behavior.<sup>127</sup> Every year, each listed company’s CEO must certify to the NYSE that the CEO is not aware of any company violations of NYSE corporate governance listing standards.<sup>128</sup>

## F. NASDAQ Rule Proposals

As of September 10, 2003, the National Association of Securities Dealers (“NASD”) had adopted a number of corporate governance reforms, including a requirement that all companies listed on the NASDAQ have a publicly available code

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<sup>123</sup> *Id.* at § 10.

<sup>124</sup> “The use of the word “must” indicates a standard or practice with which companies are required to comply. The use of the word “should” indicates a standard or practice that the Exchange believes is appropriate for most if not all companies, but failure to employ or comply with such standard or practice will not constitute a violation of NYSE standards.” *Id.* at note 2.

<sup>125</sup> *Id.* at § 10.

<sup>126</sup> *Id.*

<sup>127</sup> *Id.*

<sup>128</sup> *Id.* at § 12.



of conduct for all directors and employees.<sup>129</sup> The codes must include the elements of Section 406(c) of the Sarbanes-Oxley Act.<sup>130</sup> The NASD also proposes heightened requirements for independent directors, auditors, and nominating committees that exceed both the requirements of Sarbanes-Oxley and those proposed for the NYSE.<sup>131</sup> The major U.S. securities exchanges and the SEC continue to work together on corporate governance reform, and further refinement is likely.<sup>132</sup> SEC rules and those of the exchanges should be considered living documents.

## V. BUSINESS REASONS FOR HAVING A COMPLIANCE PROGRAM

Despite seemingly persuasive and contemporary real-world reasons to implement or update a corporate compliance and ethics program—remember the handcuffed executives described in the introduction to this article—companies may be somewhat hesitant to add a non-revenue producing layer to their structures. Yet who can ignore the obvious example of the stock performance of Enron, WorldCom, HealthSouth, and so many others? These companies were brought down because of bad ethics.<sup>133</sup>

Some of the quantifiable benefits of a corporate compliance program that may not be immediately visible include:

- (1) meeting compliance expectations of government and private customers;
- (2) facilitating the financing of business transactions through documented compliance performance;
- (3) obtaining liability insurance at a reasonable cost based on documented adherence to legal and safety standards;
- (4) improving shareholder relations;
- (5) enhancing community relations;
- (6) improving relationships with

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<sup>129</sup> NASD, *Summary of NASDAQ Corporate Governance Proposals* 14 (Sept. 10, 2003), available at [http://www.nasdaq.com/about/Corp\\_Gov\\_Summary.pdf](http://www.nasdaq.com/about/Corp_Gov_Summary.pdf) (last visited Nov. 3, 2004).

<sup>130</sup> Self-Regulatory Organizations: NASD Notice of Filing of Proposed Rule Change and Amendment No. 1, 68 Fed. Reg. 41,194 (Jul. 10, 2003).

<sup>131</sup> See NASD, *supra* note 129, *passim*.

<sup>132</sup> See, e.g., Letter from Hardwick Simmons, Chairman and CEO, NASDAQ, to the Honorable Harvey L. Pitt, Chairman, United States Securities & Exchange Comm'n (Apr. 11, 2002), available at <http://www.nasdaqnews.com/newsroom/news/pr2002/Corporate%20Governance.pdf> (last visited Nov. 3, 2004).

<sup>133</sup> Tom Taulli, *Why Corporate America's New Asset is Ethics, and Enforcement of the Sarbanes-Oxley Act Ought to Help the Stock Market*, FINDLAW (Jan. 14, 2003), available at [http://writ.findlaw.com/commentary/20030114\\_tauli.html](http://writ.findlaw.com/commentary/20030114_tauli.html) (last visited Nov. 3, 2004).

regulatory authorities; (7) satisfying penalty mitigation criteria under sentencing guidelines and other penalty standards; and (8) regularly compiling information necessary to comply with reporting requirements of the Securities and Exchange Commission and other authorities.<sup>134</sup>

Ample evidence suggests that ethical corporations are profitable corporations. With ethical measures in place and an ethical corporate culture, employees see that their employer is trustworthy.<sup>135</sup> Thus, employees are more loyal, have better morale, and are more likely to be innovative and cost-conscious.<sup>136</sup> Moreover, companies with good reputations are better able to attract suppliers, clients, and investment capital.<sup>137</sup> Employees of organizations with formal ethics programs are also more apt to report instances of misconduct, are more satisfied with their employer's response to any such misbehavior, and are more content with their jobs.

Some studies have attempted to show a direct correlation between a company's ethics and its business performance. The results support the premise that a values-based corporate culture is connected to superior corporate performance:

[T]here is clear evidence of a very strong connection between superior corporate performance and a public statement by corporate management of a strategic reliance on ethics as an element of internal control and corporate governance. The link exists for both financial and non-financial criteria. However, the mere presence of an ethics code or even a well-executed ethics program does not itself cause superior performance. The most critical factors appear to be both the nature of the values upon which the corporate culture is based as well as the strength of the top management commitment to ethical

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<sup>134</sup> Richard S. Gruner, *General Counsel in an Era of Compliance Programs and Corporate Self-Policing*, 46 EMORY L.J. 1113, 1168 (1997).

<sup>135</sup> See Taulli, *supra* note 133.

<sup>136</sup> Two fairly recent surveys show that ethical companies are better able to attract and retain employees and that an ethical culture discourages misbehavior. *Business Ethics Movement has Come Far, but Long Road Lies Ahead, Surveys Reveal*, 8 PREVENTION OF CORPORATE LIABILITY No. 5 at 41–44 (June 19, 2000). Interestingly, financial services and health care companies received the highest marks for having effective ethics and compliance systems. The utility industry performed worst on this score, “probably due to ongoing deregulation.” *Id.* at 44.

<sup>137</sup> *Id.*

treatment of stakeholders, which is expressed in actions and not just in words.<sup>138</sup>

Ethics programs themselves have been shown to enhance a company's financial performance, improve sales, improve brand image and reputation, strengthen employee loyalty and commitment, limit vulnerability to activist pressure and boycotts, avoid fines, court-imposed remedies and criminal charges, avoid loss of business, and give greater access to capital.<sup>139</sup> The effect seems to be circular: if a firm has a strong ethics program, it develops a reputation for ethical business practices, and lenders, suppliers, employees and others view it favorably *because* of that reputation. Of course, the company must not merely “talk the talk” – it must also “walk the walk.” Remember, Enron also had a corporate ethics and compliance manual.

## VI. ELEMENTS OF POSITIVE CORPORATE CULTURE

H. Lowell Brown notes that while government pronouncements regarding the minimum elements of a corporate compliance program are important, a program addressing *only* those elements is not sufficient to inspire a positive corporate culture. “[C]orporate compliance programs should not only foster a culture of compliance within the corporation, but also instill employee awareness of standards of conduct.”<sup>140</sup> Brown writes:

Each element of a compliance program should foster, in one way or another, a culture of compliance. Although the issue of whether compliance should be rule-based or value-based has been a topic of debate, there must be formal policies that clearly articulate both the company's commitment to compliance and the standards to which the conduct of employees will be held. Procedures must be established for employees to follow in order to ensure compliance with those standards. Employees must also be made aware of the standards of conduct and the company's implementing procedures. Finally, the company must be vigilant in preventing possible

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<sup>138</sup> Dr. Curtis Verschoor, *Corporate Performance is Closely Linked to a Strong Ethical Commitment*, STAKEHOLDER POWER, ¶ 28, June 2001, at [http://www.stakeholderpower.com/story.cfm?article\\_id=49](http://www.stakeholderpower.com/story.cfm?article_id=49) (last visited Mar. 11, 2003).

<sup>139</sup> Business for Social Responsibility White Paper, BUSINESS ETHICS, 2001-2002, at 2-3, at <http://www.bsr.org/CSRResources/IssueBriefDetail.cfm?DocumentID=48809> (last visited Nov. 3, 2004).

<sup>140</sup> Brown, *supra* note 47, at 107.

violations and in responding to violations that occur by taking appropriate remedial measures and disciplinary action.<sup>141</sup>

Finding an effective way to open a dialogue about ethics and positive corporate culture depends somewhat upon the message and the audience. Yet most ethics educators agree that the object is not to lecture pedantically about what it means to “be good” or to “do right,” but to engage the audience in stating its own values. A variety of materials, such as cartoons, fiction excerpts, poems and real-life stories, may be help stimulate discussion. It is also helpful to have program participants share their own ethical dilemmas and work together to *analyze*, rather than simply *decide* them.

The need for top management and CEO-level buy-in is repeatedly stressed as a critical element of an effective corporate compliance program. The ethics program must be seen as a serious corporate value for all who run the company, rather than a nicety such as retirement planning or stress management classes. Employees must perceive the program as more than a way to help top-earners in the company hold onto those earnings. Part of the employee buy-in is demonstrating the risks of unethical behavior to all firm employees:

Shareholders and creditors obviously can lose their money. However, managers and employees may also place themselves at risk if they invest in firm-specific skills and knowledge or if they rely on implicit promises of future compensation or job security. The risk of loss due to other participants’ misbehavior is separate from and in addition to ordinary business risks and risk of “bad luck.”<sup>142</sup>

Indeed, when major firms go bankrupt and disappear, *all* of the employees lose their jobs, and in the modern mega-corporation era, devalued corporate stock can wipe out employee retirement accounts.

An additional element in a successful compliance program is repetition. Handing out an ethics manual to new employees, or even accompanying it with an

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<sup>141</sup> *Id.* at 130–131. Rule-based compliance programs place primary emphasis on complying with laws and regulations. Value-based compliance programs lead participants to the right choices by examining and enhancing their ethics. The term “approach” means that rules and values are not taught exclusively in either format, but rather identifies which approach is the focus or starting point of the program.

<sup>142</sup> Blair & Stout, *infra* note 145, at 1737 n.1.

ethics training program as part of new-employee orientation, is not enough.<sup>143</sup> The best programs permeate the workplace. Training is frequently refreshed to emphasize the importance of ethics to the company, and also to incorporate new law into the program.<sup>144</sup>

What makes people act ethically? Some commentators have challenged the traditional belief that, within a firm, legal and market incentives are most important in encouraging cooperation and discouraging opportunistic behavior.<sup>145</sup> Applying social scientific principles, they argue that internal constraints of trust and trustworthiness govern behavior as much as external financial and legal carrots and sticks.<sup>146</sup> And when conditions are right, the non-selfish aspects of personalities emerge.<sup>147</sup> Blair and Stout compiled data from the incidence of trust in social dilemma games. They propose four findings:

- (1) [T]rust is an empirical reality; individuals in social dilemma experiments exhibit far more cooperative behavior than can possibly be explained by external incentives;
- (2) [D]ifferent individuals manifest different levels of willingness to cooperate in social dilemma experiments;
- (3) [T]hese individual variations to some degree reflect differences in individuals' past experiences, suggesting that trust may be a learned behavior; and
- (4) [T]rust appears to depend significantly on individuals' perceptions of *others'* expectations, likely behaviors, and social relationships to themselves; in some social situations

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<sup>143</sup> Presentation, discussion and re-visitation are essential to developing a culture of truthfulness and safety in which employees can and will discuss and report ethics dilemmas. See Kidder, *supra* note 45, at 99.

<sup>144</sup> "Communication of the ethics message may be the single most important element of an ethics and compliance program. The ethics message must be repeatedly communicated through a multi-media approach." Copeland, *supra* note 26, at 339.

<sup>145</sup> Margaret M. Blair & Lynn A. Stout, *Trust, Trustworthiness, and the Behavioral Foundations of Corporate Law*, 149 U. PA. L. REV. 1735, 1735 (2001).

<sup>146</sup> "[O]ne of the most important lessons of trust is that cooperation is not always best promoted by promising rewards and threatening punishments. To the contrary, attempts to employ external incentives can often reduce levels of trust and trustworthiness within the firm by eroding corporate participants' internal motivations." *Id.* at 1739.

<sup>147</sup> *Id.* at 1743.

people predictably display trust, while in others they predictably do not.<sup>148</sup>

“[E]conomic payoffs are not irrelevant. Although people cooperate in social dilemmas even when they must incur a personal cost, the levels of cooperation observed begin to decline as the cost of cooperating increases.”<sup>149</sup>

[T]he typical individual manifests at least two distinct personalities. One might be described as a “competitive” or “self-regarding” personality. When the competitive personality is dominant, an individual will choose options that maximize [his or] her personal payoffs without regard for effects on others, implying a preference function indifferent to others’ welfare. The second self is a “cooperative” or “other-regarding” personality. When the cooperative personality governs, an individual will choose options that maximize group welfare over options that maximize [his or] her own individual welfare, implying an other-regarding preference function. Social context, tempered by considerations of personal cost, determines when the cooperative personality emerges.<sup>150</sup>

The objective of compliance programs is to create a social context that encourages cooperation.

Interestingly, merely instructing game players to cooperate induced a great deal of cooperation.<sup>151</sup> “People seem inclined to do what they are told to do, especially when instructions come from someone who is perceived as something of an authority.”<sup>152</sup> This confirms the need to adopt a code of ethics and deliver it with training and a visibly high level of management and CEO buy-in. A second phenomenon is that group members cooperate more when they perceive a group identity, such as when they feel that they are part of an “in group.”<sup>153</sup> This suggests that creating an identifiable workplace culture and getting employee buy-in may help

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<sup>148</sup> *Id.* at 1761 (emphasis added).

<sup>149</sup> *Id.*

<sup>150</sup> *Id.* at 1761–62.

<sup>151</sup> Blair & Stout, *supra* note 145, at 1764.

<sup>152</sup> *Id.* at 1770.

<sup>153</sup> *Id.* at 1770–71.

to create an ethical culture. Also instructive is that individuals tend to cooperate more (whether they are low or high trusters) when they view a social dilemma as cooperative rather than competitive. If the task is viewed as competitive, even high trusters will pursue self-interest and defect.<sup>154</sup> Finally, when people view others in their group as trustworthy, they tend to cooperate more. In the game experiments, if participants were afforded some time to talk and get to know each other, they were more likely to cooperate.<sup>155</sup> This finding suggests that feeling like part of a group and having some identity with a firm may foster a more ethical workplace.

## VII. HOW TO IMPLEMENT A COMPLIANCE PROGRAM

A precise roadmap for creating or improving a corporate compliance program depends on the size of company, its type of business, and whether a compliance program is already in place.<sup>156</sup> All successful programs, however, contain important common elements.

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<sup>154</sup> This finding suggests that hyper-competitive workplace practices, such as Enron's "legendary" six-month interval evaluations and "rank and yank" system, could be counterproductive to employee honesty. Jodie Morse & Amanda Bower, *The Party Crasher*, TIME MAGAZINE, Dec. 30, 2002 at 55 (describing Sherron Watkins's role in de-frocking Enron). See also Judy Olian, *The Force in Performance Reviews*, PENN STATE SMEAL NEWS, at <http://www.smeal.psu.edu/news/releases/oct02/force.html> (last visited Nov. 3, 2004):

Others claim that such systems [such as "rank and yank"] breed internal competitiveness and discourage collaboration and teamwork. They may foster a "me against them" mentality since all performance judgments are relative, and each employee clamors to make it into the higher performance categories. There are also instances of significant deal-making among managers of work units that have been pooled for purposes of review, each bargaining over employees who will be "sacrificed" into the lowest category. Some managers deliberately carry employees to the end of the performance year so that they have expendable employees to insert into the lowest category.

*Id.* Rank and yank yields a paranoid work environment, in which employees are afraid to speak their minds, innovate and report unethical behavior for fear of being labeled troublemakers. PETER C. FUSARO & ROSS M. MILLER, WHAT WENT WRONG AT ENRON 52 (2002).

<sup>155</sup> Blair & Stout, *supra* note 145, at 1771-72.

<sup>156</sup> Company size is an interesting element. While small companies have the smallest staff and resources available to create additional company programs, they may also be particularly at risk. With fewer employees, there is likely greater responsibility and discretion in each position and less time for busy managers to supervise workers. In a small firm, it may be more difficult for owners and managers to argue that they were unaware of what a particular person was doing. Dana H. Freyer & Benjamin B. Klubes, *A Practical Approach to Implementing a Corporate Compliance Program for Smaller Companies*, 13 PREVENTIVE L. REP. 33, 34 (Winter 1994).

### A. Obtain Senior Management's Commitment and Support

The first critical element is senior management commitment and support.<sup>157</sup> “Compliance programs are not ends in themselves; they are risk management tools to help the company achieve its broader goals of enhancing shareholder value and profitability by being a responsible corporate citizen.”<sup>158</sup> The *Caremark* case, the U.S. Sentencing Guidelines, and other matters discussed in this article should convince managers that corporate compliance and ethics programs are not luxuries. Indeed, the President, Congress, and various regulatory agencies recently have made their zeal for prosecuting corporate wrongdoers very clear.<sup>159</sup> Ideally, a company's CEO or other high-ranking officer should lead the creation or revision of the firm's ethics and corporate compliance manual. Upper management's high profile involvement strongly conveys the company's commitment to ethics and compliance. Similarly, unethical CEO conduct strongly conveys the notion that ethics training programs and messages are merely fig leaves. For example, the CEO who asks his assistant to pick up his dry-cleaning or baby-sit on company time does little to discourage other employees from running their own personal errands on company time, using company equipment for personal matters or engaging in other minor rule-bending that leads to a degeneration of high corporate ethics and morale. Upper-level managers should also serve as role models for other employees.

### B. Form a Compliance Committee

Once CEO buy-in is obtained, the company should form a compliance committee consisting of as many of the following personnel as possible: CEO, CFO, business line managers, general counsel, and corporate communications

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<sup>157</sup> *Id.* at 33.

<sup>158</sup> *Id.*

<sup>159</sup> President George W. Bush, Remarks at Signing of H.R. 3763, the Sarbanes-Oxley Act of 2002 (Jul. 30, 2002), available at <http://www.whitehouse.gov/news/releases/2002/07/20020730-1.html> (last visited Nov. 3, 2004). Two practitioners representing officers and directors charged with securities violations note that as of July 2003, the Securities and Exchange Commission has brought a record number of cases against alleged securities law violators, yet the corporate scandals show no signs of abating. Linda S. Stein, *Annual Spring Meeting: Industries On the Edge*, 42 INFRASTRUCTURE No. 3 at 7 (2003), available at [http://www.abanet.org/pubutil/infra\\_sp03.pdf](http://www.abanet.org/pubutil/infra_sp03.pdf) (last visited Jul. 1, 2003). See also Alex Berenson, *A U.S. Push on Accounting Fraud*, N.Y. TIMES, Apr. 9, 2003, available at <http://www.nytimes.com/2003/04/09/business/09FEDS.html?pagewanted=print&position=top> (last visited Apr. 9, 2003).



representatives.<sup>160</sup> Companies should also include a few rank-and-file employees, perhaps from a volunteer call, to provide a view from the trenches and provide credibility with the employees who ultimately must follow the company's policy. If the company is unionized, the committee must include a union representative.

The compliance committee should also perform all of the usual organizational tasks (e.g., deciding on a chairperson, note-taker, timelines, and so on). The note-taker is especially important because a company should document how it went about creating and implementing a compliance policy. As an additional precaution, the note-taker should document this process in the presence of counsel under conditions in which the attorney-client privilege will attach as appropriate.<sup>161</sup>

The U.S. Sentencing Guidelines state that "high-level personnel" must be responsible for implementing and administering the compliance program. The company's compliance office may be headed by a dedicated compliance officer, the company's general counsel, a compliance committee, or a committee of managers.

The initial compliance committee may be responsible only for creating the company's compliance policy, but it may also serve as the initial standing committee responsible for ongoing compliance monitoring. There are pluses and minuses to having the initial committee morph into the standing committee. The initial committee will be most familiar with its own processes and the reasoning behind the compliance program's features, and its members may have a lot of enthusiasm for seeing their theoretical work put into practice. However, a long-term commitment may make it more difficult to obtain officers' and managers' time, and it may blind some committee members to flaws in the program's structure. The initial compliance committee must also decide how to transition from creation to implementation, and it must make a recommendation concerning that process to the company's board when it presents all the other aspects of the proposed program.

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<sup>160</sup> The CFO is needed to assess the compliance code's effect on internal and external audit functions. Harvey L. Pitt & Karl A. Groskaufmanis, *Minimizing Corporate Civil and Criminal Liability: A Second Look at Corporate Codes of Conduct*, 78 GEO. L.J. 1559, 1638 (1990).

<sup>161</sup> Too many lawyers and clients seem to believe that sitting in a meeting with a member of a bar makes discussions privileged. Likewise, simply exchanging e-mail or drafts with counsel does not convert non-privileged communications into privileged ones. Corporate counsel should thoroughly acquaint themselves with state and federal law before assuming that communications are privileged. See Ronald J. Allen & Cynthia M. Hazelwood, *Preserving the Confidentiality of Internal Corporate Investigations*, 12 J. CORP. L. 355, 377 (1987).

### C. Perform a Compliance Audit

The company should perform a compliance audit to determine which of its activities pose improper risks. Legal counsel (for confidentiality reasons) or counsel's agent, such as a consultant, should interview the heads of all of the business lines and frankly inquire into all of the company's functions, identifying areas of legal risk, especially for antitrust, environmental, employment, securities, and regulated areas unique to the business. These interviews will be the basis for a report to the board identifying the matters to be addressed in the corporate code and in compliance training.<sup>162</sup>

The compliance audit may be the most important part of creating a corporate compliance program. The audit will be used to identify weaknesses and vulnerabilities in the company's structure—the places that pose criminal or significant civil exposure, where important responsibilities lie with very few employees, and where direct reporting is limited.

### D. Draft a Corporate Compliance Code

The compliance committee should then draft a corporate code, which amounts to establishing compliance standards and procedures for employees and other agents who are reasonably capable of reducing improper conduct, as required by the U.S. Sentencing Guidelines.<sup>163</sup> The code should:

- (1) State the company's commitment to ethical and legal conduct;
- (2) Summarize the legal and ethical matters most relevant to the company's business, with a reference to other publications for specific legal requirements not relevant to all business lines;
- (3) Identify corporate compliance officers, how to reach them, how to ask questions, and how to report ethics or compliance concerns confidentially;
- (4) Explain how questions about ethics and compliance matters will be answered; and

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<sup>162</sup> Freyer & Klubes, *supra* note 156, at 34.

<sup>163</sup> UNITED STATES SENTENCING GUIDELINES MANUAL § 8A1.2, cmt. 3(k).

(5) Describe disciplinary measures that may be used to enforce the code as well as to protect whistleblowers.<sup>164</sup>

The code must also be written plainly and concisely, or employees will not read it. It must not contain incomprehensible “legalese,” or future litigation opponents will argue that the code is meaningless. A representative from corporate communications on the compliance committee could help ensure that the appropriate tone and content are achieved.

### **E. Adopt the Compliance Code**

The company’s board of directors should formally adopt and endorse the code to set a “true tone from the top.”<sup>165</sup> The code of conduct and company adoption of the compliance program should be “rolled out” in a memorable way, with a company-wide event, distribution of the code, and some mementos to substantially connect the program with everyday work, such as computer screen savers, notepads or calendars. Training programs should follow that are thorough, brief, and lively.

### **F. Training and Enforcement**

Mandatory training is an essential component of an effective program. New hires should receive a copy of the code, and they should be required to certify that they have received, read, and understand its terms.<sup>166</sup> Training must be repeated periodically, however, to ensure that the program penetrates the workforce as much as possible. Part of managers’ compensation review should include evaluating their compliance code implementation strategies. For example, the managers at Tyson Foods created a cartoon campaign to draw attention to various aspects of its compliance code, and they posted the cartoons throughout the workplace.<sup>167</sup> There are probably one hundred such ways to help bake ethics and compliance into the corporate culture.

Ethics and compliance programs must be enforced, both to be effective and to comply with *Caremark* and the U.S. Sentencing Guidelines. Most programs

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<sup>164</sup> Freyer & Klubes, *supra* note 156, at 34.

<sup>165</sup> Pitt & Groskaufmanis, *supra* note 160, at 1642.

<sup>166</sup> *Id.*

<sup>167</sup> Tyson Foods received a Certificate of Excellence from the American Advertising Federation for its ethics posters. Copeland, *supra* note 26, at 340-41.

contain an anonymous reporting hotline, and all programs should have procedures to evaluate complaints in a particular amount of time, specify recommended actions, provide guidelines for reporting to the complainant, and so on. The less discretion involved in investigation and action, the better.

### G. Drawbacks of Corporate Compliance Programs

The benefits derived from an effective compliance program are significant. In a well-designed and well-maintained program, corporate ethical culture improves, problems diminish, and employees report questionable practices before significant harm is done. There can be downsides, however, to a pervasive, company-wide program designed to ferret out problems, and measures must be taken to minimize them.

First, the corporate compliance program will generate materials that will establish an arguable standard of care for employee conduct that may be higher than that of local tort law. While this argument may not be a winner, but it may well survive summary judgment. It emphasizes the need for the corporation consistently to enforce its ethics code to show that an employee who acts outside its boundaries is acting without authority. Second, the corporate compliance program will generate material showing its weaknesses, especially in complaint investigations and ethics audits. Corporations must involve counsel in these activities, who must be well-versed in the limits of the attorney-client privilege and attorney work-product rule.<sup>168</sup> Although it is beyond the scope of this article, corporations should also have an effective document retention (and destruction) policy. Companies should pay serious attention to voice and e-mail records because they are voluminous, and they also tend to produce the most glib and dangerous evidence.

Companies should also assume that entire compliance manuals are discoverable. In fact, they may choose to publish them on the company's website as part of their campaign to "establish compliance standards and procedures" as required by the U. S. Sentencing Guidelines. Again, creating and enforcing the compliance policy should involve legal counsel and it should be done, if possible, in a way to keep sensitive information privileged. This advice is not meant merely as company CYA—rather, effective corporate compliance programs must address difficult matters and rectify them. The purpose of the privilege is not to keep

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<sup>168</sup> See generally Edward S. Rapier, Jr., *The Federal Sentencing Guidelines for Organizations: How They Affect a Civil Practice*, 46 LA. B.J. 20, No. 1 (June 1998). See also *supra* note 144, regarding the nuances and limitations of the attorney-client privilege.

evidence out of court, but to encourage candor in adopting and enforcing a meaningful program.

### H. Enforcement

*Enforcement* is the final, obvious, and most difficult step following implementation. Once a company has decided how to sanction bad behavior, it must enforce those sanctions. Otherwise, not only is the entire compliance program toothless, but the U.S. Sentencing Guidelines are also automatically violated.<sup>169</sup> A corporation must be willing to carry out the punishment it adopts, even against top-performers, managers, loyal long-time employees, and so on. For some companies, this is the most difficult part of a compliance program, but it is essential.<sup>170</sup> Having a structurally independent corporate compliance committee that is responsible for investigating and recommending sanctions to the board may keep enforcement more at arm's-length and therefore easier to implement. In addition to consistently enforcing procedures with appropriate sanctions, companies must monitor their compliance programs and modify them if necessary to prevent recurrent violations.

## VIII. CONCLUSION

If further serious corporate scandals are to be avoided, or at least minimized, companies must recognize that corporate culture plays a role in employee behavior. Although people often have different views of what is ethical, corporate culture nourishes and shapes those views. Corporate culture also may initially attract people with similar views and, conversely, repel people with different views. The current wave of business and accounting scandals, together with the devastating effects of September 11, are in large measure responsible for the stock market jitters that

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<sup>169</sup> UNITED STATES SENTENCING GUIDELINES MANUAL, § 8A1.2, cmt. 3(k)(7) (2002).

<sup>170</sup> Sometimes enforcement is the most difficult part of the U.S. Sentencing Guidelines for a company to meet:

Once a program is implemented and standards of conduct established, they must be met. Often, this effort requires a level of corporate determination and dedication that is difficult to sustain under the pressures of daily commercial activity. In some instances, the establishment of standards of conduct that are then ignored could be the worst of all possible worlds. The government will use the standards to try to prove bad intent—after all, government counsel will argue, corporate officials knew what to do and merely chose not to do it—and private plaintiffs will argue that the program set the standard of care that was breached.

Steven M. Kowal, *Corporate Compliance Programs: A Shield Against Criminal Liability*, 53 FOOD & DRUG L.J. 517, 523 (1998).

plague the U.S. economy. The importance of restoring ethics to business should be clear.

In the end, however, each corporation must find its own way. Legal compliance must be seamlessly integrated into the corporate culture and must become an integral part of the product and not a *post hoc* response to a problem. It is only when the directors, managers, and employees create a culture of compliance that there can be any reasonable assurance that the law will be obeyed and that corporate liability, civil and criminal, will be avoided.<sup>171</sup>

In general, companies should put Wall Street in the proper perspective. Feeding the market's appetite for growth can make a company lose sight of other business goals and demonstrates to employees that company returns are more important than anything else—including being ethical and law-abiding.<sup>172</sup>

Companies should reward real performance. In addition to those measurable in dollars, many other behaviors deserve recognition. Companies can reward intense project work, commitment to training, community service, low industrial accident rates, staff retention, and other achievements.<sup>173</sup>

Executives should also acknowledge poor performance. For example, Warren Buffett is frequently cited for his honesty and candor, and his company has been better off for it. In his 1999 letter to his company's shareholders, Mr. Buffet acknowledged the worst performance of his tenure without resorting to euphemisms.<sup>174</sup>

Companies should also avoid unnecessary predictions. Nothing destroys morale like unending, overly optimistic goals that can never be met. On the other hand, companies can evaluate annual company performance at the end of the year, when its achievement can be measured against the previous year's real record.<sup>175</sup>

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<sup>171</sup> Brown, *supra* note 47, at 144.

<sup>172</sup> James Lardner, *Why Should Anyone Believe You?*, BUSINESS 2.0 (Mar. 2002), at <http://www.business2.com:80/articles/mag/0,1640,37748,FF.html> (last visited Nov. 27, 2002).

<sup>173</sup> *Id.*

<sup>174</sup> *Id.*

<sup>175</sup> *Id.*

Finally, and perhaps most importantly, companies should remember that a fish rots from the head.<sup>176</sup> The straightforward, plain-talking CEO who makes it clear that ethics really matter, sets the tone for the entire firm. CEOs should tell the truth, adopt a serious ethics and compliance program, and get their own coffee.

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<sup>176</sup> ROBERT BRYCE, PIPE DREAMS: GREED, EGO, AND THE DEATH OF ENRON 12 (2002). Bryce's thesis is that Enron failed for a single reason: its corporate culture.