Is Not Having a Compliance System Malpractice?

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2003 Institute for Corporate Counsel
Marriott Downtown
March 21, 2003
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January 31, 2003
Is Not Having a Compliance System Malpractice?

by

DANIEL S. BISHOP*

I. INTRODUCTION.

The short answer to the premise in the title is "Yes." Although the answer has probably remained in the affirmative for over a decade, today the conclusion is as easy as it is inescapable.

This paper will review the reasons for this conclusion as well as outline the basic framework of a corporate compliance system.

II. BACKGROUND.

A. United States Sentencing Guidelines.

On November 1, 1991, the course and scope of corporate compliance programs was forever changed. On that date the U.S. Sentencing Commission Guidelines ("U.S.S.G." or "Sentencing Guidelines") became effective and applicable to organizations. On that date "for the first time, corporations have been conscripted into the fight against crimes." On that date the benchmark against which effective corporate compliance programs are measured was established.

The Sentencing Guidelines identified seven specific areas that corporations should focus on to ensure the corporation has an effective program to prevent and detect fraud. The basic due diligence requirements of the Sentencing Guidelines basically require an ethics program that is supervised by high-level employees and that is taught and consistently enforced. Failure to comply with the basic requirements, including a failure to make a timely report to the appropriate governmental entity of a violation, will result in the corporation not being afforded the opportunity to take

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advantage of a reduced penalty. The compliance program described later in this paper will use the Sentencing Guidelines as its template.

The Sentencing Guidelines set forth the fundamental premises that unless a company has a written and enforced code of conduct and engages in self-reporting, the company will suffer an enhanced penalty if it is convicted of a crime. Since penalties for U.S. corporations are monetary, it is felt that most shareholders would concur in the sentiment that prudent corporate managers should engage in activity to reduce monetary exposure, which in this case is having a compliance program. The concept that prudent management requires a compliance program and a system of controls was continually reinforced on a wide variety of fronts over the next decade.

B. Treadway Commission.

In 1992 the Committee of Sponsoring Organizations ("COSO") of the Treadway Commission issued its report titled: "Internal Control Integrated Framework." In 1987, the Treadway Commission recognized the problems inherent in the lack of definition and the lack of standards relating to internal controls. The organizations sponsoring the Treadway Commission worked on this issue and retained Coopers & Lybrand to draft the 1992 report. The report basically charged an entity's directors with adopting a process of internal controls so that reasonably assurance could be obtained relating to:

(1) The effectiveness and efficiency of the entity's operations;

(2) The reliability and accuracy of financial reports; and

(3) The entity's compliance with applicable laws and regulations.

While not as sweeping in its scope as the U.S.S.G., the Treadway Commission Report did establish the baseline requirements for the process of internal control.

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C. Caremark.

The next basis for concluding that failure to advise a client to adopt a compliance system is tantamount to malpractice is the seminal decision of the Delaware Chancery Court, *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 956; (Del. Ch. 1996). This case redefined and updated the all-important business judgment rule, and is a case about which every general counsel should brief the board of directors.

The truncated fact situation in Caremark, a healthcare corporation, involved whether a certain type of billing practice engaged in by its doctors and hospitals was appropriate in light of the Anti-Referral Payments Law. While Caremark believed their existing practices had been appropriate, they agreed to change those practices in light of this new law. Caremark subsequently:

1. Issued a revised ethics guide;
2. Adopted additional contractual controls;
3. Had inside and outside counsel review the contracts;
4. Had a normal and special report on this matter conducted by its outside auditor;
5. Instituted an employee training program;
6. Appointed the CFO as the compliance officer;
7. Issued a letter from its president regarding the matter to all senior personnel; and
8. Briefed the board on a continual basis on all of the above.

In spite of all this, there was an allegation of a violation of the anti-referral statute and Caremark wished to enter into a settlement agreement.

The issue in this shareholders derivative action is whether the losses sustained by the company with regard to its subsequent violation of the anti-referral statute should
be recoverable from the directors because of their failure to exercise adequate oversight.

When analyzing the instant case, the court began its analysis with the 1963 Delaware Supreme Court case of Graham v. Allis-Chalmers Mfg. Co., 41 Del. Ch. 78, 188 A.2d 125 (1963). In that case, the Court held that, absent grounds for suspicion, directors cannot be charged with wrongdoing simply because they assumed the company's employees were dealing in an honest manner. Thus, absent some knowledge or motivation, the protections of the business judgment rule did not entail duty of inquiry in 1963.

The Caremark court clearly said that this is not the law today. To invoke the business judgment rule, not only must the directors act in good faith and make a rational decision, but the board must also assure itself that there is a system in place to ensure the board that it had adequate information and reporting. Thus, the business judgment rule is now a two part test:

1. Was the decision rational and made in good faith?

2. Did the board assure itself that there is a system in place to obtain sufficient corporate information so that it could make an informed decision?

What changed since the Graham case in 1963 so that the court added the second prong of the business judgment rule analysis? The court specifically identified the U.S.S.G. and its goals, requirements and substantial incentives to have in place compliance programs designed to detect, correct and report violations of the law to appropriate governmental agency. The Caremark court stated at p. 970, "Any rational person attempting in good faith to meet an organizational governance responsibility would be bound to take into account this development and the enhanced penalties and the opportunities for reduced sanctions it offers."

Thus, in 1996 we find the most influential court in the nation, in dealing with corporate issues, redefining the business rule and citing the need to have a compliance program in accord with the U.S.S.G.
D. **Holder Memo.**

On June 16, 1999, the Deputy Attorney General, Eric Holder, issued a memorandum entitled "Federal Prosecution of Corporations" ("Holder Memo"). This memorandum provided guidance to federal prosecutors when making a decision whether to charge a corporation. He lists eight factors. Of significance here are the items dealing with the corporation's prompt voluntary disclosure and the existence and adequacy of its compliance problem.

Under the U.S.S.G., the existence of a compliance program directly relates to the penalty determination. The Holder Memo goes one significant step further. Federal prosecutors are directed to take into account the effectiveness of a compliance program, including its voluntary disclosure portion, in deciding whether to charge a corporation in the first instance. At p. 8, he states:

> Prosecutors should therefore attempt to determine whether a corporation's compliance program is merely a 'paper program' or whether it was designed and implemented in an effective manner. . . . This will enable the prosecutor to make an informed decision as to whether the corporation has adopted and implemented a truly effective compliance program that, when consistent with other federal law enforcement policies, may result in a decision to charge only the corporation's employees and agents.

E. **The Securities and Exchange Commission ("SEC").**

The importance of an effective compliance program is strongly reflected on the civil enforcement side as well. In Securities and Exchange Commission Release No. 44969, the SEC took no action against the parent corporation where, upon discovering the improper accounting entries of its employee, the parent company conducted a full investigation, took the appropriate corrective action, and voluntarily disclosed the matter. In this Release, the SEC took the opportunity to articulate when it will take an enforcement action.
Among the 13 criteria listed, the SEC notes, at p. 2, the importance of an effective compliance program. Questions asked will be:

- What compliance procedures were in place to prevent the misconduct now uncovered?
- Why did these procedures fail to stop or inhibit the wrongful conduct?

Again, an enforcement has agreed that it will look to the corporation's design and implementation of an effective compliance program in deciding whether to bring an enforcement action against the corporation.

F. **New York Stock Exchange ("NYSE").**

Most recently in 2002 and into 2003, there has been a spate of new law and regulation arising out of corporate scandals that were broader in scope and conducted at a higher level than anyone could have anticipated. The scandals precipitated the hastily passed Sarbanes-Oxley Act, its mandatory regulations from the SEC, and new NYSE and Nasdaq listing requirements. Other papers have and will continue to delve into the intricacies of the law and regulation. The purpose of this article is only to note their requirements as part of a continuum in the need for an effective corporate compliance program.

The NYSE **Corporate Governance Rule Proposals** promulgated on August 1, 2002 proposed new listing requirements. At Proposal 10 of the Section 303A, the NYSE would require: "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 and executive officers."

This becomes yet another requirement for a code of conduct which is the linchpin of a compliance system.
G. Sarbanes-Oxley.

Sarbanes-Oxley contains a plethora of requirements that in one form or another relate what has now become a requirement for a compliance program. Basically, Sarbanes-Oxley legislated sound corporate governance of which the elements of a compliance system are part. The elements of a compliance system now required by Sarbanes-Oxley should look very familiar in that, for the most part (the "noisy withdrawal" requirement for buyers excepted), these requirements already exist by virtue of the U.S.S.G., the Treadway Commission, and Caremark.

A partial summary of the provisions of Sarbanes-Oxley that affect compliance programs is as follows:

1. Section 302—requires CEO and CFO certification that there is a system of internal controls that is effective and that this system is sufficient so that material information is made known to management in a timely fashion.

2. Section 404—requirement for internal control report and an assessment of its effectiveness.

3. Section 406—requires mandatory code of ethics for senior financial officers.

4. Section 903—dramatically increases the penalties for mail and wire fraud.

5. Sections 805, 905, and 1104—directs the U.S. Sentencing Commission to revise the U.S.S.G., increasing the penalties relating to destruction of documents, obstruction of justice, and securities and accounting fraud.

This last reference once again underscores the significance of the U.S.S.G. Sarbanes-Oxley is using it as a tool to require companies to actively implement U.S.S.G. compliance programs so that these companies may be eligible for sentencing relief.

The final area relating to compliance that is covered by Sarbanes-Oxley is found in Section 307, the controversial section dealing with Professional Responsibility for Attorneys. The November 21, 2002 SEC-proposed rules relating to Section 307 has
drawn considerable attention, if not criticism, most notably for its requirement for a "noisy withdrawal." The Final Rule, published on January 30, 2002, withdrew the "noisy withdrawal" requirement pending further review. However, from a corporate compliance viewpoint, although modified and narrowed from the proposed rule, the final role did retain certain provisions that effectively deputize in-house counsel to be one of the gatekeepers for the investing public.

A quick reading of the proposed regulations may lead one to believe that the regulations would require a securities lawyer practicing before the SEC to engage in "up the ladder" reporting upon becoming aware of a material violation of securities law, material breach of fiduciary duty, or other similar violation. However, the requirement is far broader than this, and the reporting obligations may apply to virtually all in-house counsel who have knowledge that what they are working on may be included in a company financial report.

Section 205.2(a) includes within the definition of appearing and practicing attorneys those who provide advice in the context of preparing a financial statement that will be filed with the SEC. (§205.2(a)(1)(iii).) The definition also includes any attorney that advises whether information or a statement or opinion should, or should not, be included in any filing with the SEC. (§205.2(a)(1)(iv).)

In the normal course of preparing a 10-K, it would be common to solicit opinions from attorneys within the company regarding potential or actual litigation, as well as any environmental matters that may arise. Material risks in these areas are disclosed in specific sections of these financial reports. Under the proposed rule, nontraditional securities lawyers such as litigation counsel or environmental counsel who are aware of the purpose for which their opinion is being solicited may be obligated to make reports to their supervisory lawyers of what they believe is a material violation of securities law. This, in turn, could trigger an "up the ladder" obligation on the part of the chief legal officer. Whether it will require or permit the chief legal officer's notification to the SEC, in some form or another, is a matter still under consideration by the SEC as of January 29, 2003.
Many companies have established a data review process as a precursor to the CEO and CFO certifications required by Sections 302 and 906 of Sarbanes-Oxley. In-house counsel, other than traditional securities lawyers, are often now part of the management team charged with ensuring that all material data has been disclosed to management, that the financial report does not contain untrue or omitted statements of material fact, and that it is not misleading. Further, the team must review the system of controls and procedures that are in place to assure compliance with the foregoing. The new Section 307 regulations would apply to the attorneys involved in this process. They are part of the team that assures the CEO and CFO that all material data is reflected in the financial reports and that these reports may be certified.

Thus, with this new regulation, a wide variety of in-house lawyers have now been enlisted along with the CEO, CFO, and independent auditors as gatekeepers to preserve the integrity of the marketplace and to protect the investing public.

III. FRAMEWORK FOR A COMPLIANCE PROGRAM.

The balance of this paper will review how the Sentencing Guidelines provide the basic framework of a corporate compliance program and provide examples of such a program.

The U.S.S.G. is the result of Congress's enactment of the Sentencing Reform Act of 1984. The primary purpose of the Act was to provide for "certainty and fairness in meeting the purposes of sentencing, avoiding unwarranted sentencing disparities. . ." while considering "the nature and circumstances of the offense and the history and characteristics of the defendant. . ." The Guidelines for individuals became effective in November 1987. The Guidelines for organizations, other than for an environmental offense, became effective in November 1988.

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The organizational Sentencing Guidelines are both complicated and complex. They are complicated due to the fact that one needs a degree in mathematics to apply them. For example, the basic fine is determined as follows:

- \[ F = OL \times \text{MinM or MaxM} \]
- Where
- \[ \text{MinM or MaxM} = CS \]
- And \[ CS = 5 + 5 \times \text{PH} + \text{VO} + \text{OJ} + \text{EP} + \text{SR} \]

\( F \) = Fine; \( OL \) = Offense Level; \( \text{MinM} \) = Minimum Multiplier; \( \text{MaxM} \) = Maximum Multiplier; \( CS \) = Culpability Score; \( S \) = Size; \( \text{PH} \) = Prior History; \( \text{VO} \) = Violation of an Order; \( \text{OJ} \) = Obstruction of Justice; \( \text{EP} \) = Effective Program to Prevent and Detect Violations of Law; and \( \text{SR} \) = Self-Reporting, Cooperation and Acceptance of Responsibility)

The Guidelines are complex due to the care and thought that has gone into them. While one might disagree as to the conclusions reached by the Sentencing Commission, one cannot dispute that virtually all issues and all sides to every issue were considered by the Commission.\(^7\)

The Sentencing Guidelines reach the issue of corporate compliance programs in the portion of their mathematical formulas whereby an effective program to prevent and detect violations of law can result in a substantial deduction from the culpability multiplier.\(^8\) It is in the U.S.S.G. commentary after Section 8A1.2 at paragraph 3(k) where the U.S.S.G. fully sets forth the framework for a corporate compliance program.

However, in spite of the clear impetus provided by the U.S.S.G., it apparently has not been enough. In a study performed by the Council of Ethical Organizations ("CEO"), which is comprised of 150 large U.S. corporations, 88% of the companies had some sort of an ethics code; nevertheless, 73% of the employees surveyed believed that their company's performance measures encouraged unethical conduct. Further, a

whopping 83% of the employees indicated they would not report improper conduct for fear of retaliation.9

Similarly, the Ethics Resource Center in Washington, D.C. surveyed 4,000 U.S. workers and found that one-third of the employees felt that they were pressured to violate company policy in order to achieve business objectives.10

IV. COMPLIANCE.

A. The Organization.

Before elements of an effective program are individually reviewed, it must be emphasized that no compliance program can be effective without the support and involvement of the most senior level people within an organization. A compliance administrator can only develop the mechanics of a compliance program. Essentially all compliance programs are dependent upon the voluntary efforts of individual employees. Most likely, an illegal act will be done by an individual employee when no one is watching or paying attention. Unless the individual employee has internalized the concept of compliance and understands that compliance with the law is expected as a normal part of the employee's job duties, then no program will ever be sufficient to prevent violations. The best way to reinforce the fact that compliance is part of the job requirements is to ensure that senior management is visibly involved in compliance activities.

People, whether consciously or unconsciously, tend to emulate their supervisors. The way to get ahead is to observe someone who is ahead. If that person is observed as being committed to legal compliance, then others are likely to follow.

The appropriate way to start a compliance program is at the board of directors level. Most boards have an audit committee (or shortly will have), whose primary job is to ensure that the company's financial statements and representations are accurate, correct, and can be relied upon by others. In the performance of this function, the audit

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9 492,000 Employees Can't Be Wrong About Ethics Lapses; Most Programs Don't Give Workers Confidence to Report on Bosses, Corporate Legal Times, 34 (May 1995).
committee relies upon reports from the company’s own internal audit staff as well as its outside auditors. Monitoring compliance with other aspects of the law is simply an extension of the traditional role played by the board's audit committee. Therefore, many boards have expanded the audit committee to be an audit and compliance committee.

To effectively manage the program, the company should create a formal compliance committee which actively monitors and provides guidance to a director of compliance. Individuals comprising the compliance committee may consist of the general counsel, the chief financial officer or controller, and the vice president of human resources. Note: the compliance committee is comprised of high-ranking corporate officers. It is this demonstration of corporate resources that will get the attention of employees when the program is implemented. Credibility is everything.

The general counsel is recommended since that person is responsible for the legal affairs of the corporation and, as such, will always be involved in its significant legal decisions. The general counsel’s role here is an adjunct to that person’s role as a preventative law advisor.

The chief financial officer or controller are suggested due to their traditional involvement in the operations of a corporation. The finance officer has a general obligation to understand the details of an organization so as to predict future results. This insight generally means the finance officer may also be able to predict where there are potential problem areas. Again, the skills needed in the compliance area are similar to those needed for the traditional audit function. Another reason to involve the finance officer in the area of compliance is—simply—"money." Compliance costs. It is a function that can be easily overlooked or ignored because it is a function and hence, cost, that is not demonstrably "value added" to the end item. Responsible managers are, and should be, loath to allow nonvalue-added costs to creep into the bottom line. The problem with this type of thinking is that compliance is a cost. Failure to comply with the law may result in a cost to society or may result in increased profit to the organization. In either case, the U.S.S.G. recognized these possibilities and made

\[ \text{Ibid. at 34.} \]
provisions that the base fine could be determined as a result of them.\textsuperscript{11} Thus, if the finance officer is a part of the compliance process, that person is more likely to understand the long-term view of the cost of noncompliance and understand that it is a cost of doing business.

Another member of the compliance committee should come from the human resources department. Portions of the compliance program deal with policies and procedures as well as disciplinary actions. Human resources department personnel are generally involved with the creation and dissemination of policies and procedures. Further, as the Sentencing Guidelines wish to establish uniformity among sentences, the organization should attempt to establish uniform disciplinary measures for similarly situated individuals. The human resources department can provide advice in these areas and help establish consistent and uniform disciplinary measures.

The director of corporate compliance would report to this compliance committee on a regular basis. The compliance committee would then similarly report action and issues to the audit committee of the board of directors. It is expected that this latter report would be on an annual or biannual basis.

B. The Program.

The discussion of the specific implementation of a corporate compliance program will follow the framework established in the Sentencing Guidelines themselves in paragraph 3(k) of the commentary following Section 8A1.2:


\textsuperscript{(k)} An ‘effective program to prevent and detect violations of law’ means a program that has been reasonably designed, implemented, and enforced so that it generally will be effective in preventing and detecting criminal conduct. Failure to prevent or detect the instant offense, by itself, does not mean that the program was not effective. The 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. Due diligence

requires at a minimum that the organization must have taken the following types of steps:

(1) The organization must have established compliance standards and procedures to be followed by its employees and other agents that are reasonably capable of reducing the prospect of criminal conduct.

U.S.S.G.

An organization should develop written guidelines concerning standards of conduct. The standards of conduct guidelines may begin with a general statement concerning the organization's commitment to ethics and integrity. The point should also be made that ethics and integrity are consistent with other sound business practices and consistent with the profit-making objectives of the corporation. Often, this introductory statement is made in the form of a letter to each employee from the CEO. This aspect reinforces the fact that compliance with the standards of conduct is a requirement of job performance and a condition precedent for continued employment.

The standards of conduct should be tailored to the needs and culture of each individual corporation. For example, publicly-held companies need to have a policy dealing with insider trading. Companies engaged in foreign operations need to have a policy dealing with Foreign Corrupt Practices Act ("FCPA") issues regarding bribery and influencing the actions of foreign officials and political parties. FCPA issues, in addition to SEC and U.S. Government contract accounting regulations, may require a policy on the need for accurate books and records. Antitrust, employee health and safety, quality assurance, environmental, doing business with the U.S. Government, and matters such as the prohibition of discrimination and harassment in the workplace are all likely candidates for standards of conduct.

In developing the standards of conduct, one may also wish to take this opportunity to inform employees that they have a responsibility to understand the standards of conduct as these standards apply to their job performance. Further, the employees have an affirmative duty to report instances of noncompliance.
2. Director of Compliance.

Specific individual(s) within high-level personnel of the organizations must have been assigned overall responsibility to oversee compliance with such standards and procedures.

An effective compliance program must be placed under the direction of someone with enough seniority to get things done. There is real work and real expense involved with a compliance program. Delegating the task of implementing the compliance program to one who does not have the necessary authority will likely result in failure for two reasons. First, the necessary work will not be carried out and, second, senior management has sent a message to the rest of management that compliance is not important enough to the organization to merit the attention of a senior level manager. It is this latter message which is the most dangerous to the organization.

Not only must the person selected to oversee the corporation compliance program be senior enough to get the job done, that person must also be able to enlist the support of senior line management. As the standards of conduct must be tailored to fit the needs of a particular organization, so must the personnel selected to implement those standards of conduct.

In a large corporation one would expect that the person selected to be head of the compliance program be at the corporate vice president or director level. What is equally as important as the "staff" person in charge of the program are the line managers who will ultimately implement the compliance program at the operating group and divisional levels of the organization.

As suggested earlier, it is important to get a senior finance person and human resources person on the compliance committee. This will make it easier to enlist the aid of the finance and human resources departments at the operating level. It is within these two departments where, in most organizations, the administrative and monitoring work of compliance will be done. Therefore, if one of these individuals at the operating level is to function as a compliance administrator, then the ability to implement the compliance program will be enhanced.
3. Proper Employees.

[k](3) The organization must have used due care not to delegate substantial discretionary authority to individuals whom the organization knew, or should have known through the exercise of due diligence, had a propensity to engage in illegal activities.

U.S.S.G.

This is perhaps the most vague, if not problematic, of the criteria set forth in the U.S.S.G. This criteria presupposes that one knows who has a propensity to engage in illegal activities. Further, this criteria presupposes an absence of privacy laws.

The most obvious method an organization has to detect such propensities exists in the pre-employment stage. It is a relatively simple matter to check on the references and background of new employees. There is a diminished duty regarding privacy issues involving someone who is not yet an employee. It is for this reason that a diligent background check of potential employees to be engaged in areas where problems may occur is encouraged at this pre-employment stage as part of a compliance program designed to meet this U.S.S.G. criteria.

This does not mean that a prospective employer may ignore privacy issues of potential employees during pre-employment checks. Not only are there potential constitutional issues and tort issues, but statutory ones as well. For example, the Employee Polygraph Protection Act of 1988\(^\text{12}\) all but eliminates the effective use of the polygraph as a pre-employment screening technique. In light of this tension between personal rights and a potential employer's obligations, it is felt there should be some balance between the degree and depth of the background check and the ability of the potential employee to commit a crime. That is, greater diligence is required involving the employment of individuals at more senior levels who have access to confidential company data. For example, people hired in sensitive financial positions may undergo more significant background checks than others. Other examples may be key personnel in purchasing, or in the sales and marketing department. This background check may involve the checking of references, criminal convictions, and even a credit check. Note that credit checks of applicants may impose certain duties on an employer.

pursuant to the Fair Credit Reporting Act\textsuperscript{13} and require notifying an applicant that an investigative report is to be undertaken,\textsuperscript{14} or notifying the applicant if the applicant is not hired as a result of information obtained from credit history.

4. **Employee Education.**

\textsuperscript{[k](4)} The organization must have taken steps to communicate effectively its standards and procedures to all employees and other agents, e.g., by requiring participation in training programs or by disseminating publications that explain in a practical manner what is required.

U.S.S.G.

It is the implementation of this section where the real expense of a compliance program occurs. It is relatively inexpensive for a small group of individuals to develop and create a compliance program. It also is relatively inexpensive to print the thousands of standards of conduct booklets that will be disseminated to all employees. What is expensive is diverting each employee's attention from their normal tasks in order to prove training regarding the company's standards of conduct. This is often the real cost of a compliance program and the company's need to commit to it.

At a minimum, it is recommended that the company's standards of conduct booklet be disseminated to each employee. The standards of conduct booklet should thereafter be provided to each newly-hired employee. It is further recommended that a record, perhaps in the form of a receipt or signed acknowledgment, be obtained from each employee who has received the standards of conduct booklet. In the application of the Sentencing Guidelines, it is not so much what an organization has done, but what an organization can prove that it has done. For this reason, documentary evidence must be maintained showing the company's compliance with each element of the Guidelines.

Once the standards of conduct have been disseminated, the next issue is to determine effective training techniques that will reinforce what is contained in the standards of conduct. One should evaluate the work place and determine which elements of the standards of conduct are most relevant to problems the employee is

most likely to encounter. For example, training in the area of antitrust may be beneficial to those involved in sales; the need for accurate books and records to those in finance; FCPA to those in business marketing; U.S. Government contract rules and regulations, such as accurate labor charging, to those in engineering; anti-kickback act and gratuities to those in purchasing; and environmental and employee health and safety training to facility managers.

Whatever the actual training, one recommended technique is to have the manager of the organization being trained be present at any organizational training courses given. For example, if international sales managers are being given a course concerning the FCPA, the sales director should be present for the entire class. It would be preferable if that director would make the introduction and indicate the director's support of the substance of the material being presented.

A theme that runs through the Sentencing Guidelines is senior level management involvement. It is necessary that senior management direct the program (see (k)(2) above) to obtain credit in the Culpability Score for having a compliance program\textsuperscript{15} and, conversely, the Culpability Score will be dramatically increased if "substantial authority personnel" participated in, were willfully ignorant of, or even tolerated the offense.\textsuperscript{16} It is the visible participation of senior management in training seminars that provides the organization with another opportunity to show compliance with the U.S.S.G. criteria.

One should also consider communication and training techniques other than the publication of the standards of conduct and formal classes. The standards of conduct principles could be implemented in specific policies and procedures of the operating entity. Articles can be published in the company newspaper or similar publications. Videos introducing the standards of conduct can be created and shown to all new employees as part of their initial company orientation. Some companies have created training modules using interactive videos. Others have produced videos by subject matter for employee viewing.

\textsuperscript{16} U.S.S.G. § 8C2.5(b) (1991).
Fundamentally, the important thing is to maintain a training program that continues after the initial training and distribution of standards of conduct booklets. Which employees receive training, what level of training, and with what frequency will depend on each company. The important thing is to keep doing it. It would be expected that some form of communication with employees concerning an aspect of the standards of conduct occur every year. It would also be expected that this communication or training take place primarily with members of the white-collar workforce, for the simple reason that these are the individuals whose actions are most likely to impute criminal liability to the corporation.

5. Audits and Hot Lines.

[U.S.S.G. 5(k)](5) The organization must have taken reasonable steps to achieve compliance with its standards, e.g., by utilizing monitoring and auditing systems reasonably designed to detect criminal conduct by its employees and other agents and by having in place and publicizing a reporting system whereby employees and other agents could report criminal conduct by others within the organization without fear of retribution.

Monitoring and auditing are probably second only to communicating in terms of the cost of a compliance program. This cost is found not only in the expense of an audit staff, but in the cost incurred in any necessary follow-up internal investigations as well.

The use of an organization’s internal audit staff is probably the most productive way to monitor and audit the compliance systems implemented by the company. An internal audit staff is already trained in the audit function and is familiar with the company and how it operates.

The most effective use of internal auditors is, of course, providing them something to audit. Borrowing a successful technique from quality assurance processes, a self-audit program can be developed for use at operating divisions. For example, checklists can be developed pertaining to environmental compliance that are to be completed by the facility’s manager at the operating division. The internal audit team then reviews whether the division has properly performed its self-audits. Similar reviews can be conducted in the areas of environmental compliance, procurement
integrity, antitrust, labor charging, FCPA, and the like. In this way the limited resources of the internal audit may be stretched to cover many of the substantive areas involved in the compliance program, while the responsibility of compliance remains with the operating managers.

If the internal audit does uncover areas requiring further investigation, legal counsel should be contacted to determine the appropriate course of action. Potential actions and some of the problems associated therewith will be discussed later in this paper.

Another important monitoring technique is the implementation of a company "hot line." In implementing a hot line, one should consider:

- Establishing a hot line at both the operating division and corporate headquarters.
- Using a toll-free "800" number for the hot line.
- Staffing the hot line for at least part of the day rather than relying upon an answering machine.
- Training the person who handles the hot line calls in basic interviewing and investigating techniques.
- Making sure there is feedback to the person who calls. If it is not known how to reach that person due to a request for anonymity, arrange for that person to call back at a pre-established time.
- Guaranteeing there will be no reprisal for using the hot line.
- Offering to maintain the anonymity of the hot line caller wherever possible.

The problem of maintaining anonymity has always been a thorny one. First, it is often difficult to conduct an investigation where one is constrained from telling those who are investigating the subject of the investigation. This is frequently a problem when investigating discrimination or harassment cases. In these cases, one may have to put the burden on the caller by informing the caller that the investigation has gone as far as it can without disclosing the identity of the caller. It can be explained that if the caller
wishes for more finality to what is, to this point, an inconclusive investigation, the company will need the caller's permission to provide the caller's identity in order to proceed. Most complainants understand this situation, and either give permission to provide their identity, or are satisfied that the company has done what it can to remedy the situation. Often the most important thing from the caller's standpoint is that something has been done.

Except as discussed below, a company should not, however, make an absolute guarantee of anonymity to all hot line callers. The organization's first responsibility is to itself. If the hot line call reveals something of a criminal nature occurring within the organization, or something affecting health and safety, the investigation must be concluded even if it means compromising the identity of the caller. While all attempts should be made to honor a request for anonymity, this request cannot be given greater precedence than investigating matters involving criminal activity or matters involving health and safety.

Anonymity will be required for employee complaints regarding questionable accounting on auditing matters. On January 8, 2003, the SEC promulgated its draft rules pertaining to Section 301 of Sarbanes-Oxley. This is the section that directs the national securities exchanges, i.e., NYSE or Nasdaq, to adopt rules prohibiting the listing of the securities of companies not in compliance with the SEC regulations. This section of the proposed rules deals with the obligations of audit committees. Specifically with regard to employee complaints:

Each audit committee must establish procedures for:

(1) The receipt, retention, and treatment of complaints received by the listed issuer regarding accounting, internal accounting controls, or auditing matters; and

(2) The confidential, anonymous submission by employees of the listed issuer of concerns regarding questionable accounting on auditing matters.17

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The proposed regulation does not specify any particular method by which the audit committee should administer this section. Each corporation is left to develop its own procedures consistent with this section. Since many corporations already have an ethics hot line, it is felt that the goals of this section can be met by modifying existing procedures. Employees need to be informed that the hot line should be used to report accounting irregularities and that such reports will remain anonymous and confidential. Further, a process must be established whereby the person receiving the hot line makes a report to the audit committee.


[k](6) The standards must have been consistently enforced through appropriate disciplinary mechanisms, including, as appropriate, discipline of individuals responsible for the failure to detect an offense. Adequate discipline of individuals responsible for an offense is a necessary component of enforcement; however, the form of discipline that will be appropriate will be case specific.

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As suggested earlier, it is important to involve the human resources department in corporate compliance programs. Eventually someone will violate the company's standards of conduct and disciplinary measures will have to be taken. Personnel from the human resources department will be the best source of advice on the level of adverse action to be taken. Advice will also be needed to assure the consistent treatment of people committing similar offenses in similar circumstances.

Disciplining an individual for failing to comply with written standards of conduct is a concept that is easily understood and accepted by most employees. The more difficult area raised by this U.S.S.G. criteria is the disciplining of management personnel for a failure to detect a violation of the standards of conduct.

In that dealing with the federal government generally, and DoD specifically, is a regulated activity, analogies to enforcement trends may be seen in another regulated business activity, namely, the SEC. In a highly-publicized action, the three senior managers at Salomon Brothers Inc. were disciplined by the SEC for the unauthorized
trading activity of someone under their supervision. This matter is significant due to the fact that liability was found both for a failure to take action once the trading violation was found, and also for the managers' failure to have in place a system capable of detecting the trading violation in the first instance.

The Cast of Characters:

John W. Gutfreund Chairman and CEO
Thomas W. Strauss President who reported to Gutfreund
John W. Meriwether Vice Chairman who reported to Strauss
Paul W. Mozer Managing Director and head of Government Trading Desk who reported to Meriwether
Donald N. Feurestein Chief Legal Officer. Head of Compliance Department reported directly to him

The issue involved the trading activities of Mozer in certain U.S. Treasury securities. The Treasury Department has limited the amount any one bidder can submit to a maximum of 35% of the auction amount. On February 21, 1991, Salomon submitted bids in its own name and in that of two other bidders who had not authorized the bid. At the conclusion of the bidding, Mozer then directed that the two client bids be transferred to Salomon. Thus, the two clients never knew their names had been used in the bidding process.

Unfortunately for Salomon, a related entity of one of the clients used for bidding purposes by Salomon had also submitted a bid that was deemed in excess of the 35% limit because of the unauthorized Salomon bid. Upon reviewing the situation, the Treasury Department informed this bidder in April 1991 that it was improper to submit bids for the securities in excess of the 35% limit using related entities. This came as

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somewhat of a surprise to the bidder since it did not know that Salomon had submitted a bid on its behalf. Salomon at that time explained away the bid as a mistake by one of its clerks. No further action was taken by the client.

Mozer then told Meriwether what had happened and that it was not a mistake. Salomon needed the securities for business purposes. Meriwether then told Strauss, who told Feurestein and Gutfreund. These individuals met and discussed this matter several times. Each time Feurestein told his clients that Mozer's activities were administratively wrong, if not criminal and, although not legally required given the nature of the business, something that should be disclosed to the government. The managers did not disagree with Feurestein. Gutfreund wanted to think over how and to whom the disclosures should be made.

In the meantime, Mozer, who had been told that his actions were wrong and possibly career-threatening, continued to trade as the head of the Government Trading Department. In fact, he proceeded to submit fictitious bids, putting Salomon over the 35% limit on two more occasions. The Salomon managers continued to talk about their problem and what to do about it. Each time lawyer Feurestein urged them to make a disclosure to the government. Still nothing happened, except that the government had apparently initiated its own investigation.

Eventually, Salomon undertook an internal investigation of the improper trading activity by Mozer's department, and as the government's own investigation began to become clear to Salomon, Salomon disclosed the improper trades to the government in August 1991. Salomon management had been agonizing from April 1991 to August 1991 about what to do regarding the improper trades. During this time an internal investigation was only belatedly initiated by Salomon. Mozer was allowed to continue as head of the Government Trading Department, and no controls were instituted to ensure that Mozer did not continue with his unauthorized trades.

At issue in the Salomon case, and of significance in analyzing this criteria's implicit requirement that management should be able to detect offenses, is Section 15(b) of the Securities and Exchange Act. This section states, in pertinent part:
Section 15(b), Securities and Exchange Act

The Act goes on to provide in Sections 15(b)(4)(E)(i) and (ii) an affirmative defense to the obligation to supervise in that this obligation will be deemed to have been met if the firm had established monitoring procedures which could reasonably be expected to detect violations.

In this case, the SEC felt there was clear failure on the part of the Salomon managers to supervise. The managers had knowledge of trading irregularities, yet they failed to do anything about it. They failed to replace Mozer; they failed to put in controls to prevent Mozer's activities from being repeated; and they failed to inform the government, who might have been able to do something about it. The fact that none of the individual managers participated in the improper trades, the fact that they all agreed that the trades were improper, and even the fact that each of them thought the other was doing more to correct the situation than was actually occurring was of no import.

The SEC noted in its opinion: "Even where the knowledge of supervisors is limited to 'red flags' or 'suggestions' of irregularity, they cannot discharge their supervisory obligations simply by relying on the unverified representations of employees." 19 What is clear from this decision is that the SEC expects people in a supervisory capacity to aggressively supervise. If an irregularity is observed or suspected, a supervisor must actively investigate the situation to ensure that no impropriety has occurred. Then, if there has been an offense, swift action must be taken to stop the offense if it is ongoing, action taken to prevent its recurrence, and prompt reporting made to appropriate government officials must occur.

19 Id. at ¶ 83,606.
Of further significance in the *Salomon* case is what happened to Feurestein. Feurestein was the General Counsel of Salomon and the head of the Compliance Department reported to him. Feurestein was not in the supervisory chain of Mozer. It was the three Salomon managers who were the subject of the SEC's Administrative Proceeding and its discipline; nevertheless, Donald Feurestein merited a special section in the Commission's Ruling.\(^{20}\)

The Commission, although not imposing a disciplinary action on Feurestein, did take this opportunity to reprimand him. Although Feurestein was not technically a "supervisor" of Mozer within the meaning of Section 15(b)(4)(E), Feurestein became a *de facto* supervisor due to his position within the firm and his history of substantial involvement in management decisions. As such, Feurestein's obligation was more than just to advise his client on the correct course of action. He further had a duty to ensure that the corrective action was implemented. If not implemented, he then had a duty to take additional appropriate steps even though the person he was advising was the chairman and CEO. The appropriate steps may have included disclosure to the board of directors or resignation.

While the Commission's report makes clear that this heavy burden was placed on Feurestein not just because he was a lawyer and responsible for the company's compliance program, but also because of his senior position within the company. It is, nevertheless, a heavy burden. In this case, the Commission's message to the senior lawyer was that it is not enough to provide the correct legal advice—one must also take affirmative steps to ensure that this advice has been followed.

James Doty, the former General Counsel to the SEC, analyzed the Commission's report as follows:

> Without converting the chief legal officer into an agent of the state, the Report contains a clear warning that the senior legal officers can be 'team players' only to a point—that at some point the inside lawyer, by virtue of his senior position, may need to seek advice on his own initiative outside the circle of senior management, and

\(^{20}\) *Id.* at ¶ 83,608.
may even need to pursue awkward questions or initiate actions that his superiors would want to avoid, or even view as disloyal. In effect, the inside lawyer for the regulated firm simply is expected in such circumstances to be more independent of other senior management—to be, in effect, more like outside counsel.  

Donald Feurestein resigned from Salomon Brothers on August 23, 1991.

The principles enunciated by the SEC in *Gutfreund* remain valid and relevant today. In supporting its controversial proposed regulations regarding Standards of Professional Conduct for Attorneys, the SEC cites *Gutfreund*, noting that:

> While the chief legal officer was not named as a respondent, the Commission issued the report to emphasize its views on the supervisory responsibilities of legal and compliance officers who learn of misconduct by their employer or by a co-worker. The Commission concluded that such individuals are 'obligated to take affirmative steps to ensure that appropriate action is taken to address the misconduct' including 'disclosure of the matter to the entity's board of directors, resignation from the firm, or disclosure to regulatory authorities.'

7. Prospective Actions.

[k](7) After an offense has been detected, the organization must have taken all reasonable steps to respond appropriately to the offense and to prevent further similar offenses—including any necessary modifications to its program to prevent and detect violations of law.

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The *Salomon* case would also be illustrative of this criteria as well. Once an offense has been detected, some action must be taken to stop it. If a lack of internal controls contributed to the likelihood of the offense occurring in the first instance, then the system of internal controls must be reviewed and changed.

From an organizational compliance viewpoint, one should periodically review one's compliance systems for adequacy and completeness. Changes in the law may require new compliance techniques. A compliance program is not static. It will always

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be changing, either in response to increased awareness of more effective monitoring and detection methods, changes in law or regulation, or changes in the business composition.

**C. Compliance Incentives.**

If one implements an organization that is in compliance with all of the above U.S.S.G. criteria, one will still not receive any credit for having an effective program under the Sentencing Guidelines unless one makes a voluntary disclosure of the discovered offense.\(^{23}\) Further, one can receive additional points off the Culpability Score if the self-reporting is combined with full cooperation and acceptance of responsibility.\(^{24}\)

The reasons to implement a compliance program are:

1. To prevent any misconduct from occurring.
2. To be able to detect the misconduct promptly if it does occur and remedy the underlying problem so that future occurrences may be prevented.
3. To limit liability to shareholder derivative and class action suits.
4. To obtain organizational sentencing relief when the organization is to be held liable for the acts of one of its employees.

If these reasons are not sufficient, the U.S.S.G. provides one more powerful incentive to implement a compliance program. If an organization has been found liable for a crime, and if that organization has no program to prevent future criminal misconduct, then the court will impose probation on the organization. The practical result of this probation is that people outside the organization will impose a compliance program on the organization as part of the organization's probation.\(^{25}\)

In short, there is no good reason for any organization not to have a formal compliance program.

V. **Prevention of Misconduct.**

Thus far, this paper has discussed the formation of a compliance program using the Sentencing Guidelines as a framework. This paper will now examine some of the fundamental philosophical underpinnings of the Sentencing Guidelines to see if the application of these principles leads to the right result in a compliance program.

The three fundamentals of the Sentencing Guidelines appear to be:

1. Do the right thing.
2. Voluntary disclosure. If one discovers any misconduct, disclose it to the proper government authorities.
3. Plead guilty.

Let us now review these fundamental principles and examine whether, as applied, they lead toward the most propitious results.

A. **Do the Right Thing.**

1. **Vicarious Liability.**

   The problem is what to do with a corporation that does the right thing. Should a corporation be held liable for misconduct of its mid-level managerial staff who probably has made no personal financial gain on the illegal act, where the corporation has, in fact, tried to prevent that type of misconduct and has instructed employees in the proper course of conduct? Corporations most certainly feel that, in the absence of some proof indicating the corporation’s intent to commit a crime, a corporation should not be held liable under the doctrine of vicarious liability. Criminal law requires an intent to commit a crime. In the absence of intent, perhaps manifest by a lack of due diligence in preventing a crime, a corporation should not be held guilty. In a case involving the theft of fur coats by an employee of the company where the prosecution was also attempting to hold the company liable for the offense, the court stated:

   While a corporation may be guilty of larceny, may be guilty of the intent to steal, the evidence must go further than in the cases
involving solely the violation of prohibitive statutes. The intent must be the intent of the corporation and not merely that of the agent.\textsuperscript{26}

Similarly, in \textit{Holland Furnace}, the corporation was not liable for the acts of an employee, where those acts occurred in spite of express warnings and direction from the employer not to engage in this proscribed conduct and where "there is a total lack of proof that any officer of the corporation was \textit{particeps criminis} with its salesman."\textsuperscript{27} A Louisiana court likewise held, in a case involving the theft by an employee, that "We hold that since this record reveals no evidence of complicity by the officers or the board of directors, explicit or tacit, that the actions of these managers and employees were insufficient to cause this corporate entity to be guilty of the offense of an unauthorized use of a movable."\textsuperscript{28}

The enlightened approach taken in these cases is reflected in the Model Penal Code at § 2.07, where corporate criminal liability is found only where the commission of the offense is authorized or recklessly tolerated by the board of directors or high managerial agents. The Model Penal Code also would allow for criminal liability on the part of the corporation where the offense was committed by an agent acting on behalf of the corporation, within the scope of the agent's authority, and where the agent's supervisor was not diligent in preventing the commission of the offense. Thus, under the Model Penal Code approach, a corporation that attempted to do the right thing would not be found guilty of the substantive criminal offense. This concept is consistent with the criminal law in most of the world.

In other than common law countries, it is generally held that a corporation will not be held liable for the criminal acts of its employees. As the Louisiana Supreme Court observed.

> It is important to point out that while some corporate criminal liability is recognized and applied in common law jurisdictions, the maxim that societas delinguere non potest (a corporation cannot do wrong) is still firmly recognized in the civil law. Only the natural

\textsuperscript{26} \textit{People v. Canadian Fur Trappers Corp.}, (N.Y. Ct. App.), 248 N.Y. 159, at 163, 161 N.E. 455, 456 (1928).
\textsuperscript{27} \textit{Holland Furnace Company v. United States}, 158 F.2d, 8 (6\textsuperscript{th} Cir. 1946).
\textsuperscript{28} \textit{State of Louisiana v. Chapman Dodge Center, Inc. and John Swindle}, 428 So. 2d 413, 420 (1983).
person acting for the corporation can incur criminal guilt. [I]n France, the jurisdiction recognized most often as our principal civilian ancestor, the courts reason that corporate criminal liability is irreconcilable with the principle of guilt. Corporate criminal liability is considered ineffective as a deterrent because it is deterrence addressed to no mind at all. The same line of thinking with no material difference is followed by virtually every other civil law country.  

Unfortunately, for corporations, while the cited cases have not been overturned, they have not been regularly followed either. Further, while the Model Penal Code has had an impact upon criminal codes throughout the country, this particular section is one that has not been adopted. In short, the law is other than expressed above. The law of criminal respondeat superior, that of imposing criminal liability upon corporations for the acts of its managers, was being settled in the late 19th century and was formally adopted in the New York Central case by the U.S. Supreme Court. In this case, the Supreme Court clearly held that a company may be liable for the acts of an agent acting within the scope of his employment. The court reasoned that a corporation should not be immune from being held criminally liable for its actions, since that would allow the corporation to reap the benefits of illegal conduct with impunity. The court further bolstered its opinion by stating that the imposition of corporate criminal liability is the only means of truly regulating interstate commerce.

More recently, the application of corporate criminal liability is best illustrated by the Hilton case. This was an antitrust case whereby vendors were required to contribute one per cent of their sales to local hotels to a special fund that was used to attract business to the City of Portland. At issue in the case was the jury instruction given by the trial court, wherein the court instructed: "A corporation is responsible for the acts and statements of its agents, done or made within the scope of their employment, even though their conduct may be contrary to the actual instructions or contrary to the corporation's stated policies." (Emphasis added.)

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29 Id. at 418, 419.  
32 Id. 1004.
The Ninth Circuit upheld this jury instruction as an accurate statement of the law. This is a case where the defendant, Hilton, tried to be a good corporate citizen. Not only did it have policy statements prohibiting this type of conduct, but it had specifically instructed the manager on this policy. The court was unmoved by this due diligence defense and stated: "Thus, the general policy statements of appellant's president were no defense. Nor was it enough that the appellant's manager told the purchasing agent that he was not to participate in the boycott."33

Thus, it is fairly well established that criminal liability will be imposed upon the corporation for the acts done by an employee, where that employee acts within the scope of his or her employment and for the benefit of the corporation, even though the acts in question were contrary to express corporate policy. The due diligence defense has not been expressly adopted by the vast majority of the courts.

The most a diligent corporation can hope for is a jury instruction that will permit the jury to consider the existence of corporate policies as a basis for determining that the agent did not act on behalf of the corporation. The jury instruction in this regard that was accepted in the Ninth Circuit reads:

You may, however, consider the corporate policies and instructions as one of the circumstances along with any other circumstances that you find to be significant in determining what the authority of the agent actually was and whether the agent was acting on behalf of the corporation.34

Similarly, in *Basic Construction*, the court approved the jury instruction that read: "However, the existence of such instructions and policies, if shown, may be considered by you in determining whether the agents, in fact were acting to benefit the corporation."35

Thus, while the due diligence defense has been rejected as an affirmative defense to corporate liability for the acts of the corporation's employees, the existence of a compliance program, along with sound policies and practices, may be introduced

33 *Id.* 1007.
34 *United States v. Beusch*, 596 F.2d 871, 878 (9th Cir. 1979).
at trial for the purpose of demonstrating that the agents were acting other than for the benefit of the corporation and, therefore, vicarious liability should not be imposed.

The Sentencing Commission also understood the dilemma of what to do with the diligent corporation. "Of all the conceptual issues, perhaps the greatest hurdle in developing corporate fine guidelines was how to deal with the principle of law that holds corporations vicariously liable for the criminal conduct of their employees."\(^{36}\) The Commission considered the argument that guidelines should not impose a fine unless senior management was implicated in the offense due to the inherent unfairness of the vicarious liability doctrine. While rejecting this argument, "The Commission acknowledged, however, that some justification may exist for distinguishing between companies at the sentencing phase based upon the level and extent of managerial involvement."\(^{37}\) The Commission feels that its Culpability Score takes into account the degree of corporate involvement. That is, for a corporation where there is no high-level involvement, where the corporation has actively been involved in a program to prevent a crime, and where after the offense the corporation has tried to remedy the situation, then the Commission believes that "fines can drop to a relatively nominal level."\(^{38}\) Whether the fines are at a relatively low level is in the eye of the corporate viewer; nevertheless, the Sentencing Guidelines did attempt to provide some relief to the imposition of corporate criminal liability for the acts of others.

2. Enforcement Discretion.

While a relief in the sentencing area may be of some help, it is essentially cold comfort to the diligent corporation. What is preferable, and what is felt would have a more significant deterrent effect on corporate behavior, is the ability for the diligent corporation to be able to work with government agencies so as to avoid the imposition of criminal liability in the first place. In this regard, the policy memo by the DOJ regarding environmental crimes is significant. In this policy statement, the DOJ stated:

> It is the policy of the Department of Justice to encourage self-auditing, self-policing, and voluntary disclosure of environmental


\(^{37}\) Id. at 238.

\(^{38}\) Id. at 239.
violations by the regulated community by indicating that these activities are viewed as mitigating factors in the Department's exercise of criminal environmental enforcement discretion. This document is intended to describe the factors the Department of Justice considers in deciding whether to bring a criminal prosecution for a violation of an environmental statute, so that such prosecutions do not create a disincentive to or undermine the goal of encouraging critical self-auditing, self-policing, an voluntary disclosure.

It is this type of enforcement policy that will have tremendous effect on corporate policy. Frequently, many types of behavior which are now characterized as criminal are, in fact, behaviors that are erroneous. One example of this is in the area of environmental crime. This area is so highly regulated and there is such a quantity of regulations extant that it is relatively easy to inadvertently run afoul of the regulations. In this new work of creating crimes without intent and creating corporate defendants who will be held criminally liable regardless of their best efforts to prevent an error in the administration of the massive quantity of government regulations, it is felt that the DOJ has taken a significant step in the area of environmental crimes by being willing to act as a government that does something other than put its citizens in jail. By adopting this policy, the DOJ is helping to create a government that will be viewed as an entity with which corporations can work, as opposed to defend against, in order to solve the underlying problem, which in this instant example relates to cleaning up the environment.

The DOJ has taken a similar policy in the antitrust area. In its Corporate Leniency Policy, which was most recently revised in 1993, the DOJ permits corporations to come forward with information pertaining to criminal antitrust activity. The DOJ will then grant amnesty to that corporation if the corporation meets the specific criteria. Not surprisingly, since this revised policy was announced in 1993, companies have been coming forward at a rate of one per month as opposed to the previous rate of one per year.

Of great significant is the Holder Memo, which now lists the effectiveness of a compliance system and voluntary disclosures as factors a prosecutor should review when deciding to prosecute a corporation. (See discussion on pp. 4-5.)

B. **Voluntary Disclosures.**

1. **Waiver of Privilege.**

The next area to be examined is the concept of voluntary disclosure and the privilege problems associated with it. Prompt reporting of an offense is essential to obtaining credit under the Sentencing Guidelines for having a compliance program.\(^{40}\) The problem is how one can disclose to the U.S. Government without disclosure to the world and every other adverse party.

On one hand, corporations believe they should be able to obtain the confidential advice of legal counsel so that they may determine the proper course of action. If this proper course of action is disclosure of certain events to the government, then such disclosure should not result in an effective concurrent disclosure to the world. Where the corporation has of its own volition undertaken an internal investigation and then, in order to properly remedy the situation, finds it necessary to disclose the results of its investigation to the government, the corporation should not be penalized for having done the right thing.

On the other hand, adverse parties would take the position that where the attorney-client privilege is to be asserted, then the communication between the attorney and client which was made for the purpose of obtaining legal advice, must be in confidence. These are the rules of the attorney-client privilege. If the confidence is broken, that is, by sharing with another party, namely, the U.S. Government, then the law surrounding the protection of attorney-client privilege is no longer effective.

It is felt that the strict interpretation of the rules concerning attorney-client privilege which would otherwise prohibit the selective disclosure of work created as part of a self-evaluation, where such disclosure is made for the purpose of remedying a problem, will prevent the creation of the work product in the first instance. This lack of
self-critical analysis and self-evaluation by an organization may be adverse to the goals of a society that may prefer a more reflective organization.

To say there is a split in the circuits on this issue is an understatement. There is a line of cases discussing the self-evaluation privilege which will involve the disclosure of attorney-client documents to the SEC for one purpose or another. In each case, another adverse party wished to have access to the confidential internal investigation conducted by the disclosing party. In the Diversified case, the court held that Diversified's disclosure of these documents to the SEC constituted only a limited waiver of privilege. "To hold otherwise may have the effect of thwarting the developing procedure of corporations to employ independent outside counsel to investigate and advise them in order to protect stockholders, potential stockholders, and customers." This case, however, was expressly not followed in two subsequent cases similarly involving third parties wishing access to a company's internal investigation after disclosure to the SEC.

In the Westinghouse Electric case, the court granted the adverse party access to the internal investigations prepared by Westinghouse. The court stated, "[W]e hold that Westinghouse's disclosures to the SEC and to the DOJ waived the protection of the work-product doctrine because they were not made to further the goal underlying the doctrine." In Steinhardt, the court again declined to preserve the privilege regarding material voluntarily disclosed to the SEC from third parties. As a matter of policy, the court believed that there were sufficient reasons for a company to make voluntary disclosures and that protecting such material is not necessary and will not encourage further voluntary disclosures. The court stated, "An allegation that a party facing a federal investigation and the prospect of a civil fraud suit must make difficult choices is insufficient justification for carving a substantial exception to the waiver doctrine."

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41 Diversified Indus., Inc. v. Meredith, 572 F.2d 596, 611, CA8 (8th Cir. 1977).
42 Id. at 611.
43 Westinghouse Electric Corp. v. Republic of the Philippines, 951 F.2d 1414 (3rd Cir. 1991).
44 Id. at 1429
45 In re Steinhardt Partners, LP, 9 F.3d 230 (2nd Cir. 1993).
46 Id. at 236.
This type of attitude on the part of the courts will do little to encourage disclosure. It fosters the perception that it is the job of the government to prosecute its citizens rather than to remedy underlying problems.

In reviewing these cases, it is felt that there is room for the self-evaluation privilege to exist and one may disclose such self-evaluation to government authorities without a waiver of privilege. Although ostensibly the same, i.e., each case involves the disclosure to the SEC and a subsequent claim for documents by a third party, there is a substantial difference in these three cases. Of significance, in the *Diversified* case, the court found that the law firm employed to perform the investigation by Diversified "was not employed to represent Diversified in any pending or potential litigation."47 The discussion in the *Diversified* case was a discussion of the attorney-client privilege, that is, Diversified hired the law firm in order to evaluate its own internal procedures and make certain decisions based upon that advice. In this case, one of those decisions was to disclose the results of the internal investigation to the SEC. This is in contrast to the *Westinghouse* case, where "the investigation was in response to an investigation by the Securities and Exchange Commission ('SEC') into allegations that Westinghouse had obtained contracts by bribing foreign officials."48 Similarly, in *Steinhardt*, "as part of this informal investigation, the SEC asked Steinhardt, among many others, to provide certain documents related to its trading activities."49

It is clear, at least in the *Westinghouse* case, that the court was rejecting the concept of the self-evaluation privilege in the context of the attorney-client privilege. In each case, however, where the privilege was found to have been waived, the reports in question were prepared in response to an ongoing investigation by a governmental entity. In *Diversified*, on the other hand, the investigation was made by the board of directors to review the business practices of the company in light of certain disclosures that had been made known to it in the course of other litigation. A governmental probe of some sort was not the cause of the company's internal investigation.

47 See note 38 at 600.  
48 See note 40 at 1417.  
49 See note 42 at 232.
Thus, where the internal investigation was done by the corporation for the purpose of reviewing its own practices to ensure compliance with the law in the absence of an ongoing investigation, it appears that the limited self-evaluation privilege should be extended. In reviewing the case where this has been the situation, there has been this common theme, that is, in each of these cases, the company was attempting to increase its awareness of a problem so it could take corrective action. In such cases, the courts seemed more likely to grant this limited privilege.

Support for the self-evaluation privilege has appeared most frequently in the employment area. In *Flynn v. Goldman Sachs*, Judge Kimba Wood upheld the self-evaluation privilege in this slip opinion.\(^{50}\) Goldman Sachs had hired a consultant to conduct an examination of its employment practices to determine, in part, whether there were any barriers preventing the advancement of women. The consultant conducted a series of interviews with people to determine the employee attitudes at Goldman, with the understanding that all such interviews would be held confidential. In this subsequent litigation, Flynn requested access to those documents. Judge Wood recognized the common law privilege for self-critical analysis where it will serve to advance desirable social policies. As applied in this case,

> The goal of eliminating any barriers to the full participation of women in the highest levels of corporate America is well served by encouraging such self-critical assessments, and that goal should not be undermined absent a compelling showing of need, which must be determined in light of the plaintiff's claims.\(^{51}\)


Most recently, in a terrific case (at least from this corporate lawyer's point of view), the Court of Chancery in Delaware squarely took on all the issues previously discussed in *Diversified, Westinghouse*, and *Steinhardt*. *Saito v. McKesson*\(^{52}\) was decided on October 25, 2002. The facts were fundamentally the same as all the


\(^{51}\) *Id.* at 5.

others. McKesson restated earnings, the SEC initiated an inquiry, McKesson retained an outside counsel and audit firm, outside counsel shared its work product with the SEC subject to a confidentiality agreement, and a shareholder plaintiff demanded the work product, claiming the work product privilege was waived because it was shared with an adverse party.

The court agreed that the work product privilege was waived because it was disclosed to an adverse party. However, in a very interesting decision laden with common sense, the court stated that the waiver to the SEC was a selective waiver and subject to the parties' confidentiality agreement and need not be disclosed to other adversaries.

In recognizing the widely divergent view of other courts, the Chancery Court stated, "Therefore, in light of conflicting but non-binding precedent, McKesson HBOC acted reasonably in expecting that its disclosures to the SEC under a confidentiality agreement would not reach the hands of its other adversaries."53

The court's decision was not premised on how selective waiver would benefit a corporation but, rather, perhaps helping the corporation enforcement action. The court articulated the strong public policy reason that selective disclosure, under these circumstances, was the most effective way to encourage corporations to comply with law enforcement agencies and to protect the investing public.

A selective waiver rule is such a rule that benefits law enforcement agencies, such as the SEC. Encouraging corporations to disclose their internal investigations confidentially allows the SEC to resolve its investigations expeditiously and efficiently. . . . Because of the SEC's savings and efficiency, great protection is afforded to the beneficiaries that it was designed to protect—investing shareholders. . . . The SEC is the 'agency principally responsible for the administration and enforcement of federal securities laws, which are designed to protect investors and the integrity of our capital markets.'54

In its analysis, the court goes on to describe the SEC as the first line of defense in the enforcement scheme. The court further notes that there really is no public policy

53 Id. at 25.
54 Id. at 30-31; also quoting BR of the U.S. SEC as Amicus Curiae at 1.
reason that would justify giving plaintiffs the requested attorney work product. In an adversarial system, giving only one party the work product of the other would permit litigating shareholders "to have their cake and eat it too."  

It is hoped that this well-reasoned decision in Saito becomes the standard. This is a court that, more than any other, understands and focuses on the need to protect the investing public. This decision accomplishes that goal. Further, this decision fits within the total scope of a compliance program that strongly encourages voluntary disclosure.

VI. CONCLUSION.

All of this brings us back to the basic question—Is not having a compliance program malpractice? The answer is "Yes" because:

1. U.S.S.G.—penalty relief
2. Caremark—informed judgment necessary to invoke business judgment rule
3. Holder Memo—may mitigate criminal prosecution
4. SEC Release No. 44969—may mitigate enforcement action
5. NYSE—Code of Conduct is a listing requirement
6. Sarbanes-Oxley—numerous legal and regulatory requirements.

The need for the protection of the equity markets, the investing public, and the corporation and its board of directors, all require a corporate compliance system. The question is no longer "whether" or even "if" to have a compliance program. The only question remaining today is the form and substance of the program.

55 Id. at 35.