

Chapter 7

Corporate Compliance Programs Under the Organizational Sentencing Guidelines

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§ 7:5 Caremark Liability

§ 7:1 Introduction

The Organizational Sentencing Guidelines (Guidelines) of the U.S. Sentencing Commission (USSC) are now more than twenty-five years old, having gone into effect November 1, 1991. One striking feature of the Guidelines is their attempt to modify the behavior of law-abiding organizations by recommending more lenient sentences for corporate offenders who, at the time of the offense, had implemented an “effective compliance and ethics program.”¹ The USSC’s apparent calculation is that organizations, fearing harsher fines as a result of possible criminal activities by employees in the unpredictable future, will adopt such programs as a precautionary measure.

Of course, all companies hope never to have to face the Guidelines at sentencing after a criminal conviction, and an effective compliance program may mean that they never have to. An effective compliance program will reduce the risk of unlawful conduct occurring in the first

1. U.S. SENTENCING COMMISSION, GUIDELINES MANUAL §§ 8B2.1, 8C2.5(f)(1) [Nov. 2016] [hereinafter GUIDELINES MANUAL], www.ussc.gov/guidelines/2016-guidelines-manual. This sentencing leniency for an effective compliance program does not apply to certain offenses, such as food, drug, cosmetic and agricultural product offenses, export control offenses, and environmental offenses, which are excluded from the sentencing calculation provisions of the organizational guidelines. *See* GUIDELINES MANUAL § 8C2.1 (listing offenses to which organizational fine guidelines apply).

place. Even where it occurs, however, the existence of an effective compliance program may qualify the company for lenient treatment by prosecutors in the exercise of prosecutorial discretion. The Principles of Federal Prosecution of Business Organizations² and government leniency programs, discussed in chapters 1 and 8, direct prosecutors to consider corporate compliance programs in making charging decisions. But a compliance program must be deemed effective in order to provide any such benefits.

The design, implementation, and enforcement of a compliance program considered “effective” for the purposes of the Guidelines may require companies to make non-trivial investments in both time and financial resources. For example, to ensure that it is promoting “an organizational culture that encourages ethical conduct and a commitment to compliance with the law,” a company may need to hire new staff or delegate to existing employees responsibility for the day-to-day operation of the compliance program. In addition, a company is expected to implement monitoring and auditing to detect unlawful conduct and to evaluate periodically the effectiveness of its compliance program as a whole.

Second, a company is likely to spend considerable time determining appropriate standards to incorporate into its compliance program’s policies and procedures. While the Guidelines prescribe general organizational directives, they do not provide specific standards or even outline the topic areas a company should address in its compliance program (for example, antitrust, anti-bribery, workplace conduct). Determining compliance policies and procedures, therefore, may require internal and external risk assessments, designing standards to minimize risks, benchmarking within an industry to determine best practices, and revising standards as the law changes.

Aside from leniency in the criminal context, other compelling reasons exist for implementing an effective compliance program. The failure to implement such a program may expose directors to claims of breach of fiduciary duty.³ Further, to the extent effective compliance programs are aligned with good organizational hygiene, their implementation can result in a better-functioning organization and happier employees.

2. U.S. Dep’t of Justice, Principles of Federal Prosecution of Business Organizations, § 9-28.700 *et seq.* [hereinafter Principles], www.justice.gov/sites/default/files/opa/legacy/2008/08/28/corp-charging-guidelines.pdf (“In conducting an investigation, determining whether to bring charges, and negotiating plea or other agreements, prosecutors should consider” among other things, “the existence and effectiveness of the corporation’s pre-existing compliance program.” *Id.* § 9-28.800).

3. See discussion *infra* section 7:5.

This chapter examines the structure and methodology of the Guidelines, with particular emphasis on the effect of the mitigating “prevention” program. The first task in understanding the significance of this feature of the Guidelines is to understand the calculations used to set organizational sentences.

§ 7:2 The Organizational Sentencing Guidelines Methodology

An organization’s fine under the Guidelines is a function of: (i) the severity of the organization’s offense and (ii) the degree of its culpability. Although the Guidelines provide a multi-step process for determining an organization’s fine, the critical calculations involve the “Base Fine” and the “Culpability Score.” The Base Fine reflects the type and severity of the offense. The Culpability Score quantifies the offense’s aggravating or mitigating features, including credit for an effective compliance program.

The Culpability Score determines the minimum and maximum multipliers that, when applied to the Base Fine, produce a sentencing fine range. Although the Guidelines are advisory, the government will likely recommend a sentence within the range, and courts will likely impose such a sentence.⁴

§ 7:2.1 Base Fine

As set forth in chapter 2 of the Guidelines, a “base offense level” is assigned to each offense governed by the Guidelines. The base offense level may be increased or decreased through application of “specific offense characteristics” reflecting the severity of the actual crime.⁵ Organizational fine amounts, ranging from \$8,500 to \$150,000,000, are derived from the Offense Level Fine Table (“Table”).⁶

A defendant’s Base Fine is the greatest of:

- (i) the appropriate fine amount from the Table, based on the offense level;

4. In 2005, the U.S. Supreme Court held that the U.S. Sentencing Guidelines were not binding on the federal courts, although sentencing judges, in the exercise of discretion, “must consult those Guidelines and take them into account.” *United States v. Booker*, 543 U.S. 220, 264–65 (2005); *see also* *Kimbrough v. United States*, 552 U.S. 85, 101 (2007) (reemphasizing that, although a district court must consider the Guidelines’ range as one of many factors in sentencing, the Guidelines are still advisory in nature).

5. *See* GUIDELINES MANUAL ch. 2 intro.

6. Base fines were recently increased for offenses committed after November 1, 2015. *See id.* § 8C2.4(d).

- (ii) the pecuniary gain to the organization from the offense; or
- (iii) the pecuniary loss from the offense caused by the organization, to the extent that the loss was caused intentionally, knowingly, or recklessly.⁷

The Guidelines instruct the court to use the amount from the Table as the Base Fine where calculating pecuniary gain or loss would “unduly complicate or prolong the sentencing process.”⁸

§ 7:2.2 Culpability Score—Minimum/Maximum Multipliers

After determining a defendant’s Base Fine, the court calculates a “Culpability Score.” At the outset, the organizational defendant is assigned a Culpability Score of five points, from which subtractions or additions are made.⁹ Subtractions or additions depend on:

- (i) the organization’s involvement in or tolerance of criminal activity;
- (ii) its prior history;
- (iii) whether it violated a judicial order, injunction, or a condition of probation in the course of the offense;
- (iv) whether the organization obstructed justice in connection with the offense;
- (v) the existence of an effective compliance and ethics program; and
- (vi) any “self-reporting, cooperation and acceptance of responsibility.”¹⁰

For example, an organizational defendant’s Culpability Score increases five points if the organization had 5,000 or more employees and an individual with a substantial controlling or policy-making role in the organization participated in, condoned, or was willfully ignorant of the offense.¹¹ Similarly, the Culpability Score increases one to two points if the organization had prior criminal or civil adjudications based on similar misconduct within specified periods before the offense.¹²

7. *Id.* § 8C2.4(a).

8. *Id.* § 8C2.4(c).

9. *See id.* § 8C2.5(a).

10. *Id.* § 8C2.5.

11. *See id.* § 8C2.5(b)(1)(A)(i).

12. *See id.* § 8C2.5(c).

Two circumstances may reduce the Culpability Score. One is the existence of an effective compliance and ethics program. Such a program, described in detail below, may result in a reduction of three points in the Culpability Score.¹³ The reduction will not be available to the corporation, however, if the corporation unreasonably delayed reporting the offense to appropriate governmental authorities.¹⁴ And where “high-level personnel” are involved in the offense, the following four factors must be met:

- (i) “the individual or individuals with operational responsibility for the compliance and ethics program . . . have direct reporting obligations to the governing authority or an appropriate subgroup thereof . . .”;
- (ii) the compliance program detected the offense “before discovery outside the organization or before such discovery was reasonably likely”;
- (iii) the defendant “promptly reported the offense to appropriate governmental authorities”; and
- (iv) “no individual with operational responsibility for the compliance and ethics program participated in, condoned, or was willfully ignorant of the offense.”¹⁵

These factors create a substantial incentive to separate the compliance function from other functions within the organization, as well as to have the person(s) in charge of the compliance program report directly to the board of directors, a committee of the board, the CEO, or an equivalent authority within the organization.

The other possible ground for reducing the Culpability Score involves the organization’s “[s]elf-reporting, [c]ooperation, and [a]cceptance of [r]esponsibility.”¹⁶ A five-point reduction may be afforded for:

- (i) reporting the offense “to appropriate governmental authorities” prior to an “imminent threat of disclosure or government investigation” and “within a reasonably prompt time after becoming aware of the offense”;

13. *See id.* § 8C2.5(f).

14. *See id.* § 8C2.5(f)(2).

15. *Id.* § 8C2.5(f)(3)(C). When the Guidelines were amended in 2010, the Sentencing Commission rejected additional amendments regarding document retention and pre-sentencing restitution.

16. *Id.* § 8C2.5(g).

- (ii) fully cooperating in the investigation; and
- (iii) clearly demonstrating “recognition and affirmative acceptance of responsibility” for the conduct.¹⁷

Two points are subtracted for accepting responsibility—that is, pleading guilty and fully cooperating in the investigation.¹⁸ A guilty plea, without cooperation or voluntary disclosure, merits only a one-point reduction.¹⁹

Once the court calculates the Culpability Score, it determines the minimum and maximum multipliers from the table provided in section 8C2.6. For example, for offenses other than antitrust, if the Culpability Score is zero or less, the corresponding minimum multiplier is 0.05 and the maximum multiplier is 0.20. At the other end of the scale, if the Culpability Score is 10 or more, then the minimum multiplier is two and the maximum multiplier is four.²⁰

§ 7:2.3 Applicable Fine Range

The court multiplies the Base Fine by the minimum and maximum multipliers from section 8C2.6 to obtain a fine range.²¹ The following example illustrates how fine ranges are calculated under the Guidelines and how the ranges for a given Base Fine (here \$100 million) can vary significantly depending on the Culpability Score:

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- 17. *See id.* § 8C2.5(g)(1). The *U.S. Attorneys’ Manual*, which provides guidance for federal prosecutors in pursuing cases, provides that “[i]n order for a company to receive any consideration for cooperation under this section, the company must identify all individuals involved in or responsible for the misconduct at issue, regardless of their position, status or seniority, and provide to the Department all facts relating to that misconduct.” U.S. ATTORNEYS’ MANUAL § 9-28.700 (rev. Nov. 2017), www.justice.gov/usam/usam-9-28000-principles-federal-prosecution-business-organizations#9-28.700; *see also id.* § 9-28.720 (rev. Nov. 2017), www.justice.gov/usam/usam-9-28000-principles-federal-prosecution-business-organizations#9-28.720. Although the Department of Justice (DOJ) may advocate to the court that a company’s Culpability Score not be reduced based on the DOJ’s aforementioned policy, the extent to which a court will follow the DOJ’s recommendation when determining a company’s Culpability Score is unclear.
 - 18. *See* GUIDELINES MANUAL § 8C2.5(g)(2).
 - 19. *See id.* § 8C2.5(g)(3).
 - 20. *See id.* § 8C2.6.
 - 21. *See id.* § 8C2.7.

EXAMPLE: Base Fine = \$100 million			
Culpability Score	Minimum Multiplier	Maximum Multiplier	Fine Range (in millions)
≥ 10	2.00	4.00	\$200–400
9	1.80	3.60	\$180–360
8	1.60	3.20	\$160–320
7	1.40	2.80	\$140–280
6	1.20	2.40	\$120–240
5	1.00	2.00	\$100–200
4	0.80	1.60	\$80–160
3	0.60	1.20	\$60–120
2	0.40	0.80	\$40–80
1	0.20	0.40	\$20–40
≤ 0	0.05	0.20	\$5–20

If the Culpability Score is 5, then the minimum and maximum multipliers are 1.00 and 2.00. Assuming a Base Fine of \$100 million, the fine range will be \$100 million to \$200 million. If the Culpability Score is 1 (multipliers of 0.20 and 0.40)—perhaps because the company had an effective compliance program (minus 3 points) and acknowledged its responsibility (minus 1 point)—the fine range will be \$20 million to \$40 million.

§ 7:2.4 Determining the Actual Fine

The court then determines the actual fine. In exercising discretion, the court considers the Guidelines' fine range as well as the other factors identified in 18 U.S.C. § 3553(a).²²

The Guidelines provide that fines must conform to the statutory minimums and maximums when the two conflict.²³ Thus, for example, “[w]here the minimum guideline fine is greater than the maximum fine authorized by statute, the maximum fine authorized by statute shall be the guideline fine.”²⁴

22. The court is to consider, for example, whether the sentence reflects the seriousness of the offense, an adequate deterrence, protection of the public from further crimes by the defendant, avoidance of sentencing disparity for similar offenses. *See* 18 U.S.C. § 3553(a).

23. GUIDELINES MANUAL § 8C3.1.

24. *Id.* § 8C3.1(b).

The statutory maximum for a conviction on multiple counts, however, is the sum of the maximum fines for each count. For example, if an organizational defendant is convicted of ten counts of fraud on a financial institution,²⁵ because each count carries a \$1 million maximum, the maximum statutory fine will be \$10 million. Moreover, an even greater statutory maximum may result from application of the Fines Enhancement Act, which allows imposition of a fine of *twice* the gross gain or loss caused by the offense.²⁶

§ 7:2.5 Disgorgement

Finally, the Guidelines provide that any gain to the organization not paid as restitution, or by way of any other remedial measure, must be added to the fine determined above.²⁷

§ 7:2.6 Fines for Antitrust Offenses

Regarding antitrust offenses, the Guidelines specify that, in lieu of determining actual pecuniary loss, courts must assume that pecuniary loss equals twenty percent of the volume of affected commerce.²⁸ This percentage generally will be greater than either the fine amount under the Table or a defendant's pecuniary gain. Accordingly, the Base Fine for antitrust offenses will usually be 20% of the total volume of commerce "done by [the defendant] in goods or services that were affected by the violation."²⁹

Moreover, organizational offenders who voluntarily disclose antitrust violations or implement compliance programs will not receive the same reduction in the Base Fine for antitrust offenses. Under a special exception for antitrust offenses, the minimum multiplier for those offenses is 0.75 (for all other offenses, the minimum multiplier is 0.05) regardless of whether the corporation voluntarily disclosed the offense, cooperated, and accepted responsibility, or whether it had an effective compliance program.³⁰

25. See 18 U.S.C. § 1344.

26. See *id.* § 3571(d); GUIDELINES MANUAL § 8C3.1 cmt. In *Southern Union*, the Court observed that gain or loss under 18 U.S.C. § 3571 is also a sentencing fact that must be submitted to the jury. *S. Union Co. v. United States*, 567 U.S. 343, 132 S. Ct. 2344, 2351–52 (2012); see Amended Judgment, *United States v. LG Display Co.*, No. 08-CR-803-SI (N.D. Cal.).

27. GUIDELINES MANUAL § 8C2.9.

28. See *id.* § 2R1.1(d).

29. See *id.* § 2R1.1 & cmt. n.3. See chapter 12, *infra*, for a more detailed discussion of corporate fines in antitrust cases.

30. See *id.* §§ 2R1.1(d)(2) & 8C2.6 cmt. n.1. The DOJ's Antitrust Division, however, has promulgated its own amnesty policy assuring that, provided specific conditions are met, there will be no criminal prosecution of an

§ 7:3 Remedial Sanctions and Probation Under the Guidelines

In addition to imposing a fine, the Guidelines state that “[a]s a general principle, the court should require that the organization take all appropriate steps to provide compensation to victims and otherwise remedy the harm caused or threatened by the offense.”³¹

The Guidelines provide the court with four alternatives to compel organizational defendants to remedy the harm caused by their offenses:

- (i) orders of restitution;
- (ii) remedial orders;
- (iii) community service; and
- (iv) orders of notice to victims.³²

Orders of restitution for the full amount of the victims’ losses are mandatory under the Guidelines unless the court finds that such an order is impractical due to the large number of victims or would unduly complicate or prolong the sentencing process.³³

Where an order of restitution would prove impractical, the court may, but is not obligated to, impose a remedial order that requires the organizational defendant “to remedy the harm caused by the offense and to eliminate or reduce the risk that the instant offense will cause future harm.”³⁴ The Guidelines provide that where “the magnitude of expected future harm can be reasonably estimated, the court may require the organization to create a trust fund sufficient to address that expected harm.”³⁵ The court may also order remediation through community service “reasonably designed to repair the harm caused,” or other orders.³⁶

The court also has the power to order defendants convicted of crimes involving “fraud or other intentionally deceptive practices”³⁷ to give notice of the conviction and sentence to the victims of the offense, provided the cost of notice does not exceed \$20,000.³⁸

organization that voluntarily discloses wrongdoing. *See* discussion *infra* chapter 8.

31. GUIDELINES MANUAL ch. 8, pt. B intro.

32. *See id.* §§ 8B1.1–8B1.4.

33. GUIDELINES MANUAL § 8B1.1(b)(2); *see* United States v. Oladimeji, 463 F.3d 152 (2d Cir. 2006) (*Booker* does not apply to orders of restitution).

34. *Id.* § 8B1.2(a).

35. *Id.* § 8B1.2(b).

36. *See id.* §§ 8B1.2–8B1.3.

37. 18 U.S.C. § 3555.

38. *See id.*; GUIDELINES MANUAL §§ 8B1.4, 5F1.4.

The Guidelines authorize the court to impose a term of probation of up to five years under a variety of circumstances.³⁹ One circumstance concerns a corporation that, at the time of sentencing, does not have “an effective compliance and ethics program,” despite having fifty or more employees or being “otherwise required under law” to have such a program.⁴⁰ In these circumstances, the court can require the corporation to develop such a program and submit it to the court for approval.⁴¹ Even if the program is approved, the company may be required to submit to and pay for court monitoring of the company’s adherence to its program, which includes “unannounced examinations of its books and records . . . [and] interrogation of knowledgeable individuals within the organization.”⁴²

§ 7:4 An Effective Program to Prevent and Detect Violations of Law

§ 7:4.1 Practical Considerations

Although federal prosecutions of white collar cases appear to be at a historic low,⁴³ this, of course, does not provide a safe harbor for any single company or individual. The DOJ continues to emphasize that its investigation of corporate crime will focus on individual wrongdoers.⁴⁴ However, it still considers the effectiveness of a company’s existing corporate compliance program and the fruits of those programs, such as timely voluntary disclosures, in making charging decisions and in determining fines.⁴⁵ In the current enforcement climate, legal and compliance professionals must balance “increasingly complex legal, business, and ethical challenges . . . that support-business growth objectives while strengthening and reinforcing

39. *Id.* § 8D1.2.

40. *Id.* § 8D1.1(a)(3).

41. *Id.* § 8D1.4(b)(1).

42. *Id.* § 8D1.4(b)(5).

43. *See, e.g.,* Trac Reports, Inc., *White Collar Prosecutions Fall to Lowest in 20 Years* (May 24, 2018), <http://trac.syr.edu/tracreports/crim/514/>.

44. The DOJ articulated its renewed focus on individual corporate wrongdoers in its November 2015 revisions to the *U.S. Attorney’s Manual* dealing with corporate prosecutions. *See Principles, supra* note 2, §§ 9-28.010 to 9-28.210 (“One of the most effective ways to combat corporate misconduct is by holding accountable all individuals who engage in wrongdoing. . . . Prosecutors should focus on wrongdoing by individuals from the very beginning of any investigation of corporate misconduct.” *Id.* § 9-28.010.).

45. *Id.* § 9-28.300(5)–(7) (listing relevant factors in charging decisions).

internal controls. . . .⁴⁶ Indeed, developing an effective compliance program requires a grasp of the legal requirements as well as a company's individual risk profile, "understanding both the current business model and future business strategy."⁴⁷ The remainder of this section outlines what the Guidelines require from a compliance program along with practical suggestions for implementing these requirements.

§ 7:4.2 Requirements for an Effective Compliance and Ethics Program

Section 8B2.1 describes the criteria for an "effective compliance and ethics program." The Guidelines require that organizations seeking fine leniency based on compliance programs meet two overarching standards. The organizations must (1) "exercise due diligence to prevent and detect criminal conduct" and (2) "otherwise promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law."⁴⁸ As stated in the Report of the Ad Hoc Advisory Group on the Organizational Sentencing Guidelines, dated October 7, 2003 (Advisory Committee Report), which led to the 2004 amendments to the compliance program standards:

An organizational culture that encourages a commitment to compliance with the law includes positive actions which demonstrate that law compliance is a key value within the organization. Such a culture is demonstrated by organizational actions which encourage employees to choose lawful behaviors and to expect that their conduct will be evaluated by others within the organization in terms of how well the employees have pursued lawful conduct.⁴⁹

Section 8B2.1(b) of the Guidelines then specifies the seven characteristics of an effective program that the organization must "minimally" adopt to achieve the twin goals of effective due diligence and a culture that supports law compliance.⁵⁰ Furthermore, section 8B2.1(c)

46. Amy J. Conway-Hatcher & Tiffany R. Moseley, *6 Tips for Building Stronger Compliance Foundations*, LAW360 (Jan. 15, 2015), www.law360.com/articles/610477/6-tips-for-building-stronger-compliance-foundations (subscription required).

47. *Id.*

48. GUIDELINES MANUAL § 8B2.1(a)(1)–(2).

49. AD HOC ADVISORY GROUP, U.S. SENTENCING COMMISSION, REPORT OF THE AD HOC ADVISORY GROUP ON THE ORGANIZATIONAL SENTENCING GUIDELINES 55 (Oct. 7, 2003) [hereinafter ADVISORY COMMITTEE REPORT], www.ussc.gov/sites/default/files/pdf/training/organizational-guidelines/ad_gprpt/AG_FINAL.pdf.

50. *See* ADVISORY COMMITTEE REPORT, *supra* note 49, at 56.

addresses the role of risk assessment in the implementation of those seven criteria. Each of the seven characteristics, as well as the Guidelines' direction regarding risk assessment, is discussed in turn below.⁵¹

[A] Section 8B2.1(b)(1)

The organization shall establish standards and procedures to prevent and detect criminal conduct.

Notably, the phrase "criminal conduct" does not mean that a compliance program should be confined to preventing and detecting only *criminal* conduct. Significantly, section 8B2.1(a)(2) requires an organizational culture that "encourages *ethical* conduct and a commitment to compliance with the *law*" without making a distinction between criminal, civil, and regulatory law.⁵² Indeed, for regulated industries, a company's compliance program should be tailored to its line of business and to the regulatory environment in which it operates. Prosecutors may rely on state or federal regulators to assist in evaluating compliance programs of the businesses they regulate.⁵³

One interpretation of the Commission's overall intent behind this criterion is to require corporations to establish comprehensive *written* procedures and codes of ethics. The written compliance blueprint is a standard for measuring the corporation's commitment to compliance.

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51. The Guidelines' seven characteristics of effective compliance programs has served as a basis for corporate compliance programs and as a factor in compliance models used by various U.S. regulatory and enforcement agencies, such as the Environmental Protection Agency and the various agencies that compose the Federal Acquisition Regulation. *See* Hon. Patti B. Saris, Chair, U.S. Sentencing Commission, Remarks at 12th Annual Compliance and Ethics Institute (Oct. 7, 2013); Environmental Protection Agency, Incentives for Self-Policing: Discovery, Disclosure, Correction and Prevention of Violations, 65 Fed. Reg. 19,618–627 (Apr. 11, 2000); Federal Acquisition Regulation, Contractor Business Ethics Compliance Program and Disclosure Requirements, 73 Fed. Reg. 67,064, 67,091–92 (Nov. 21, 2008); *see also* OECD, RECOMMENDATION OF THE COUNCIL FOR FURTHER COMBATING BRIBERY OF FOREIGN PUBLIC OFFICIALS IN INTERNATIONAL BUSINESS TRANSACTIONS (Nov. 26, 2009), www.oecd.org/daf/anti-bribery/44176910.pdf. The Office of the Inspector General of the U.S. Department of Health and Human Services refers to the Guidelines as the basis for "every effective compliance program." Office of Inspector General, Department of Health & Human Services, Publication of the OIG Compliance Program, Guidance for Hospices, 64 Fed. Reg. 54,031, 54,033 (Oct. 5, 1999).
52. *See* U.S. SENTENCING COMMISSION, AMENDMENTS TO THE SENTENCING GUIDELINES 85–86 (2004) ("[A]n effective compliance and ethics program not only will prevent and detect criminal conduct, but also should facilitate compliance with all applicable laws") (emphasis added), www.ussc.gov/Legal/Amendments/Official_Text/20040501_Amendments.pdf.
53. Principles, *supra* note 2, § 9-28.800(B).

In effect, this criterion establishes the proposition that, if a company is unwilling to commit comprehensive compliance procedures to writing and abide by them, it should not qualify for lenient treatment. Furthermore, a compliance program committed to writing provides ready evidence of a company's efforts in the course of an investigation or sentencing proceeding.

The documents that might form the core of the compliance blueprint include:

- *Business code of conduct.* This document generally takes the form of a comprehensive statement of a company's commitment to compliance with applicable laws and company-determined ethical standards, as well as its requirements for employees and certain third parties in order to implement the commitment. The code should, among other things, address the areas in which the company's business activities may be susceptible to violations; set forth the applicable law and company requirements; state the company's policy that such violations will result in appropriate disciplinary measures; and require employees to report violations, or even questionable business practices, that come to their attention. Once adopted, however, such a code becomes a benchmark for judging the corporation's compliance commitment. Therefore, in drafting such a code, the corporation should be careful not to set standards that it cannot meet or establish procedures that may conflict with other obligations, such as union contracts or employee rights derived from state law. A global company will need to consider whether there are conflicting laws among the countries in which it operates, or whether it wants to impose strict standards set by one country on operations in other jurisdictions. Conflicting or differing standards may call for a code that includes only high-level principles applicable in all jurisdictions where the company operates. A global company will also want to translate its code and other compliance documents into the operative languages of its employees.
- *Standard Operating Procedures and Guidance.* Depending upon the complexity of the work and the relevant rules and regulations, a more detailed set of SOPs and Guidances may be necessary to guide employees' conduct. Such documents should be drafted with sensitivity toward the difficulties of execution and should be discussed with those charged with execution to ensure they are understandable and manageable. Moreover, the company should have a mechanism for regularly updating these documents as legal and regulatory requirements change and as experience with implementation occurs.

- *Auditing.* A comprehensive audit plan reflecting a commitment of resources to auditing that is consistent with the due diligence standard demonstrates serious attention to compliance. The plan should focus on the areas of the company's business susceptible to legal violations.
- *Written internal compliance structure.* The written documents should include an organizational structure for compliance. A "compliance organization chart," for example, might create a Compliance Committee of the Board of Directors that includes outside directors. Also, as required by other criteria for an effective program, the organizational chart should designate a day-to-day compliance officer who (i) meets the standard of being from "high level personnel" and (ii) has direct responsibility for the compliance program. In turn, the chart might assign division managers, or their subordinates, responsibility for implementing compliance programs on a division-by-division basis. The compliance organization chart might also create an internal compliance working group consisting of the chief executive officer, the chief financial officer (with jurisdiction over audit programs and procedures), the general counsel, active managers, labor and employment counsel (among other responsibilities, to identify conflicts between the compliance program and employees' rights under law or contract), regulatory specialists, and public relations personnel.
- *Employee handbook/personnel policies.* In order to make available all investigative and compliance tools and techniques, the company should evaluate and consider revisions to its Employee Handbook and/or personnel policies to expressly protect the company's right, consistent with union contracts and applicable laws and regulations, to conduct comprehensive workplace searches, including desks, email, computer files, mobile devices, and lockers. In addition, the Employee Handbook and/or personnel policies can be used as a tool to describe the compliance program and state clearly that employees are expected not only to comply with all laws, regulations, and ethical standards (a reprint of the Code of Conduct could also be included), but also to cooperate in both ongoing and special audits. This should include interviews by accountants or attorneys, at which employees are expected to answer all questions fully and truthfully. The Employee Handbook and/or personnel policies could also describe other compliance mechanisms and procedures, such as the Employee Hotline, discussed below.

[B] Section 8B2.1(b)(2)

- (A) **The organization's governing authority shall be knowledgeable about the content and operation of the compliance and ethics program and shall exercise reasonable oversight with respect to the implementation and effectiveness of the compliance and ethics program.**
- (B) **High-level personnel of the organization shall ensure that the organization has an effective compliance and ethics program, as described in this guideline. Specific individual(s) within high-level personnel shall be assigned overall responsibility for the compliance and ethics program.**
- (C) **Specific individual(s) within the organization shall be delegated day-to-day operational responsibility for the compliance and ethics program. Individual(s) with operational responsibility shall report periodically to high-level personnel and, as appropriate, to the governing authority, or an appropriate subgroup of the governing authority, on the effectiveness of the compliance and ethics program. To carry out such operational responsibility, such individual(s) shall be given adequate resources, appropriate authority, and direct access to the governing authority or an appropriate subgroup of the governing authority.**

The Guidelines create a three-tier compliance structure. At the top is the company's highest authority, typically the board of directors, which the Guidelines term "governing authority." The members of a governing authority should have knowledge about such governance and compliance matters including: practical management information about the major risks of unlawful conduct facing their organization; the primary compliance program features aimed at counteracting those risks; and the types of compliance problems that the organization and other parties with similar operations have encountered in the past. However, as suggested in the Advisory Committee Report:

Typically, however, members of a governing authority will gain information on the features and operation of a program to prevent and detect violations of law through reports from senior organization managers or other experts (in large organizations), or through information about program features and operations gained in the course of day-to-day management and oversight of related organizational activities (in small organizations).⁵⁴

54. ADVISORY COMMITTEE REPORT, *supra* note 49, at 60.

As to the next tier, “high-level personnel,” the definitional section states only that this includes “individuals who have substantial control over the organization or who have a substantial role in the making of policy within the organization.”⁵⁵ As a general rule, the more senior the executive assigned overall compliance responsibility, the greater likelihood the compliance program will satisfy this criterion. Under the Guidelines, any number of executives could satisfy the “high-level personnel” requirement, although there appears to be an increasing desire by regulatory authorities to see these responsibilities vested in someone other than the general counsel or chief financial officer, but instead in someone who is a peer to them. In a large company, this may include “high-level personnel” within a specific unit or units of the company. For example, if a company has several divisions and chooses to delegate compliance responsibility to each division, high-level personnel *within each division* should be assigned to supervise compliance within the division. These organizational leaders must be knowledgeable about the content and operation of compliance and ethics programs within their organizations. Such organizational leaders should gain information about these programs on a regular basis, act on this information to improve the programs, and be attentive to matters relating to compliance with the law and appropriate responses within the bounds of their area of leadership. Further, such organizational leaders should “periodically scrutinize the adequacy of program features in their areas of leadership, analyze gaps, if any, in those features, and appropriately alter compliance practices or other organizational conduct to eliminate reasonably foreseeable risks of future illegal conduct.”⁵⁶

At the third tier, the company should expressly designate an organizational official or officials with day-to-day responsibility for the operation of the organization’s compliance and ethics program. These responsibilities, at a minimum, should include: establishing and supervising the compliance program, which includes responsibility for design and implementation of compliance mechanisms and procedures; notification to employees of the compliance standards; creation or revision of the compliance blueprint, including the corporation’s code of conduct; supervision and evaluation of auditing procedures; implementation of an employee hotline; investigation of questionable or illegal business practices; ongoing compliance reporting to the “governing authority”; and employee training and education.⁵⁷ In evaluating a compliance program, prosecutors will consider

55. GUIDELINES MANUAL § 8A1.2 cmt. n.3(B).

56. ADVISORY COMMITTEE REPORT, *supra* note 49, at 61.

57. *See id.* at 61–63.

whether the program has sufficient staffing to actually implement the program, and whether employees are aware of the program and of the company's commitment to it.⁵⁸ Prosecutors may ask how much money a company spends on its compliance program, or its compliance headcount, compared to other areas. In addition, prosecutors likely will be interested in the quality of the resources devoted to a compliance program.

As stated in the Advisory Committee Report, the activities of this executive, and the operation of the program as a whole, "must be supported by the organization with reasonable resources sufficient to ensure due diligence on the part of the organization to prevent and detect violations of law and to otherwise promote an organizational culture that encourages a commitment to compliance with the law."⁵⁹ The concept is that unless such resources are committed, the company's compliance efforts will be no more than a paper program.⁶⁰

Finally, the compliance executive(s) "should periodically report on the nature, progress, and success of that program to the governing authority of the organization or some appropriate subgroup (such as an audit committee) within the governing authority."⁶¹ The aim of this reporting is to convey information directly from the head of the program to the members of the governing authority without the potential filtering or censoring influence of senior organization managers.⁶²

[C] Section 8B2.1(b)(3)

The organization shall use reasonable efforts not to include within the substantial authority personnel of the organization any individual whom the organization knew, or should have known through the exercise of due diligence, has engaged in illegal activities or other conduct inconsistent with an effective compliance and ethics program.

This criterion suggests that a company should implement procedures to identify persons who have violated the law or engaged in conduct incompatible with a commitment to the law. One procedure is to screen applicants for employment at all corporate levels. Such procedures must, however, take into account applicable state law, which, in some jurisdictions, limits background checks of employees.

58. Principles, *supra* note 2, § 9-28.800.

59. ADVISORY COMMITTEE REPORT, *supra* note 49, at 62.

60. *See id.*

61. *Id.*

62. *See* GUIDELINES MANUAL § 8B2.1 cmt. n.3 (suggesting annual reporting obligations to the governing authority on implementation and effectiveness of the compliance and ethics program).

Subject to those limitations, a company should consider including the following inquiries on its employment applications:

- Whether the applicant has changed his name, which allows for more comprehensive background checks, including criminal records.
- Whether the applicant has been convicted of a crime, including the court and place of conviction, the nature of the offense, and the disposition. Information in addition to the mere fact of conviction facilitates criminal records checks. See the discussion below regarding termination of employees who have been arrested or convicted for violations of law.
- The applicant's Social Security number, which, unknown even to corporations that routinely request Social Security numbers, identifies (in the first three digits) the issuing geographic region. Thus, obtaining the Social Security number, which facilitates a reasonable background check, better assures that a prior criminal history will be uncovered.
- A provision for the applicant's consent for the corporation to obtain an "investigative consumer report," at least for those applicants seeking sensitive (for example, accountants, payroll personnel) and/or high-level positions in the company. An investigative consumer report contains, in addition to the normal credit information, information as to an applicant's character, general reputation, personal characteristics, and mode of living, which may be obtained through personal interviews with neighbors, friends, associates, etc. Because investigative consumer reports are significantly more intrusive than a simple credit check, some states, such as New York and California, require notice to the applicant and the applicant's consent.

In addition, where appropriate and warranted, the company should consider performing a drug screen, in conformance with state and federal law, on those applicants to whom the company makes a conditional offer of employment.

A corporation's ability to screen employment candidates for criminal histories may have been restricted in some circumstances by the U.S. Equal Employment Opportunity Commission's April 2012 Enforcement Guidance.⁶³ The EEOC cautioned that such background

63. Equal Employment Opportunity Commission, Enforcement Guidance No. 915.002, Enforcement Guidance on the Consideration of Arrest and

checks may violate Title VII of the Civil Rights Act of 1964 because, in some circumstances, such checks discriminate on the basis of race and national origin. The EEOC Guidance offers a series of Best Practices for companies making employment decisions:

General

- Eliminate policies or practices that exclude people from employment based on any criminal record.
- Train managers, hiring officials, and decision makers about Title VII and its prohibition on employment discrimination.

Developing a Policy

- Develop a narrowly tailored written policy and procedure for screening applicants and employees for criminal conduct.
 - Identify essential job requirements and the actual circumstances under which the jobs are performed.
 - Determine the specific offenses that may demonstrate unfitness for performing such jobs.
 - Identify the criminal offenses based on all available evidence.
 - Determine the duration of exclusions for criminal conduct based on all available evidence.
 - Include an individualized assessment.
 - Record the justification for the policy and procedures.
 - Note and keep a record of consultations and research considered in crafting the policy and procedures.
- Train managers, hiring officials, and decision makers on how to implement the policy and procedures consistent with Title VII.

Questions about Criminal Records

- When asking questions about criminal records, limit inquiries to records for which exclusion would be job related for the position in question and consistent with business necessity.

Conviction Records in Employment Decisions Under Title VII of the Civil Rights Act of 1964 (Apr. 25, 2012) [hereinafter EEOC Guidance], www.eeoc.gov/laws/guidance/upload/arrest_conviction.pdf.

Confidentiality

- Keep information about applicants' and employees' criminal records confidential. Only use it for the purpose for which it was intended.⁶⁴

The EEOC Guidance, however, emphasizes that employers should not exclude potential employees indefinitely and should instead take into account the length of time since the candidate's "offense, conduct, and/or completion of the sentence."⁶⁵

For current employees, a company should consider requiring employees to report any new criminal charges or convictions, although the company must be aware of any state laws that apply to collecting or acting on this information.

[D] Section 8B2.1(b)(4)

- (A) The organization shall take reasonable steps to communicate periodically and in a practical manner its standards and procedures, and other aspects of the compliance and ethics program, to the individuals referred to in subdivision (B) by conducting effective training programs and otherwise disseminating information appropriate to such individuals' respective roles and responsibilities.**
- (B) The individuals referred to in subdivision (A) are the members of the governing authority, high-level personnel, substantial authority personnel, the organization's employees, and, as appropriate, the organization's agents.**

The Guidelines require both dissemination of compliance materials *and* training. Employee notification and training techniques could include employee bulletins and newsletters, compliance policy statements distributed directly to employees, wall posters, email, compliance seminars (discussed below), and business ethics questionnaires. Depending on size and resources, a company can often assure employee notification by distributing compliance policy statements, with a request that the employee sign a certification that he or she has read and understands the policy. Subject-specific policy statements—for example, antitrust or environmental statements—should be directed to departments or divisions that are particularly susceptible to violations in such areas. As noted above, the company should periodically review, revise, and redistribute its compliance policy statements to reflect changes in the law.

64. *Id.* at 25–26.

65. *Id.* at 15.

Training, typically compliance seminars and/or computer simulation programs, requires a substantial commitment of company resources. Moreover, in a company engaged in diverse business activities, separate subject matter seminars may be necessary. An antitrust seminar for purchasing or sales personnel, for example, might cover such topics as the antitrust laws and their meaning, penalties for violations (both to the individual and the company), guidelines for avoiding even the appearance of bid or price collusion, and, as an adjunct, laws and ethical standards that prohibit payment or receipt of gratuities and kickbacks.

A seminar for employees of a chemical products division, by contrast, should cover such topics as environmental law and regulations, penalties for violations, chemical and chemical waste handling procedures, responding to a government inspection, worker health and safety, record keeping, and disclosure required by law. To the extent the company operates under an environmental consent decree, the seminar can also discuss compliance with the consent decree's terms and the penalties for noncompliance.

Seminars and e-training programs need not deal only with criminal law violations. It may be to the company's benefit if the compliance seminar addresses ethical standards or other sensitive workplace and legal issues, such as policies to avoid sexual and other types of workplace harassment and discrimination.

[E] Section 8B2.1(b)(5)

The organization shall take reasonable steps—

- (A) to ensure that the organization's compliance and ethics program is followed, including monitoring and auditing to detect criminal conduct;**
- (B) to evaluate periodically the effectiveness of the organization's compliance and ethics program; and**
- (C) to have and publicize a system, which may include mechanisms that allow for anonymity or confidentiality, whereby the organization's employees and agents may report or seek guidance regarding potential or actual criminal conduct without fear of retaliation.**

More than any other, this criterion tests whether the company is sincere in its commitment to compliance. In a variety of ways, the company is expected to engage in vigorous self-policing. Four principal self-policing techniques are:

- (i) internal auditing;
- (ii) an employee hotline and ombudsman;
- (iii) business ethics questionnaires; and
- (iv) effectiveness evaluation.

[E][1] Internal Auditing

There are three aspects to effective internal auditing: commitment of resources, focus, and periodic re-assessment. The company may be expected to devote substantial resources to auditing and should focus audits on business activities susceptible to violations of law.

For example, if a company with 30,000 employees, offices in twelve cities in the United States and six foreign countries, and a volume of sales in the billions has a written plan that assigns three auditors to compliance work, the company may not meet the “reasonable steps” criterion. Any audit plan, moreover, must be tailored to the company’s business activities. If the company handles chemical wastes, and therefore is susceptible to environmental infractions, its environmental auditing should, at a minimum, satisfy the Environmental Protection Agency’s Audit Policy, which established standards governing environmental auditing compliance programs.⁶⁶ As stated in Application Note 2(B) to section 8B2.1, “[a]n organization’s failure to incorporate and follow applicable industry practice or the standards called for by any applicable governmental regulation weighs against a finding of an effective compliance and ethics program.”⁶⁷

In some cases, with a modest effort, existing auditing procedures need only be upgraded. For example, where a company’s purchasing policy specifies that purchases above a certain amount require multiple bids, the company might consider auditing multiple purchases of similar goods from the same vendor that, while individually less than the threshold for multiple bids, in the aggregate total more than the threshold. Importantly, such upgrades of auditing procedures furnish convincing evidence of the company’s commitment to an effective program to deter and detect violations of law.

[E][2] Employee Hotlines and the Ombudsman

Employee hotlines are now in widespread use and misuse. Such lines typically are toll-free and anonymous, with such names as

66. See discussion of Audit Policy *infra* chapter 8; see also Incentives for Self-Policing: Discovery, Disclosure, Correction and Prevention of Violations, 65 Fed. Reg. 19,618, 19,625–27 (Apr. 11, 2000), www.epa.gov/Compliance/resources/policies/incentives/auditing/auditpolicy51100.pdf.

67. GUIDELINES MANUAL § 8B2.1 cmt. n.2(B).

“Helpline,” “Guideline,” and “We Care Hotline.” If a company chooses to record hotline telephone calls, it should warn callers that the call is being taped, as some states prohibit the non-consensual recording of telephone calls.

The company should implement procedures to address hotline calls. Unless the information reported consists of obviously unsubstantiated rumor or gossip, the disclosure should be investigated by an independent person, such as a compliance officer. At the conclusion of the investigation, the investigator should recommend appropriate action to the senior executive in charge of the compliance officer or other appropriate person.

A related compliance technique is the company ombudsman. An ombudsman receives disclosures from employees of suspected legal violations or unethical business practices. The ombudsman might report directly to the senior executive in charge of the compliance program and/or to the Board of Directors’ compliance or audit committees. The ombudsman can be empowered to withhold names of employees who contact him, make recommendations for investigative action, and review personnel records and procedures to ensure that disclosure of criminal activities does not result in retaliation against the employee for making the disclosure.

Some federal courts have recognized an ombudsman privilege against disclosure of employee tips. For example, in *Kientzy v. McDonnell Douglas Corp.*,⁶⁸ the district court held that confidential communications made to a company ombudsman, a non-attorney, were protected from disclosure in a suit by a former employee alleging employment discrimination. The court, relying on Rule 501 of the Federal Rules of Evidence, stated that “[i]t is important that . . . employees have an opportunity to make confidential statements and to receive confidential guidance, information, and aid to remedy workplace problems to benefit themselves and possibly the nation.”⁶⁹ A number of courts, however, have rejected such a privilege.⁷⁰

68. *Kientzy v. McDonnell Douglas Corp.*, 133 F.R.D. 570, 571–73 (E.D. Mo. 1991), *rev’d in part on other grounds*, 990 F.2d 1051 (8th Cir. 1993). *But see* *Carman v. McDonnell Douglas Corp.*, 114 F.3d 790, 793 (8th Cir. 1997) (rejecting “ombudsman privilege” and reasoning in *Kientzy*).

69. *Id.* at 572; *see* *Roy v. United Techs. Corp.*, C.A. No. H-89-680 (JAC) (D. Conn. 1990).

70. *See, e.g., Carman v. McDonnell Douglas Corp.*, 114 F.3d 790, 794 (8th Cir. 1997) (refusing to create the “wholly new evidentiary [ombudsman] privilege”); *see also* *Miller v. Regents of Univ. of Colo.*, 1999 U.S. App. LEXIS 16712, at *42 (10th Cir. July 19, 1999) (“It is clear that neither Colorado law nor federal law, including the decisions of this circuit, recognize an ombudsman privilege.”).

[E][3] Business Ethics Questionnaires

Another monitoring technique is the distribution of “business ethics questionnaires” to mid- and senior-level employees. Such questionnaires, which the employee must complete, sign, and return, ask questions about specific risk areas, such as:

- Do you have knowledge of any direct or indirect payoff or kickback received directly or indirectly by ABCo, its employees (including yourself) or any other party on behalf of ABCo?
- Do you have knowledge of any direct or indirect payment made by ABCo, its employees (including yourself) or any other party on behalf of ABCo, of any discount or rebate to any customer that may violate applicable minimum price or price-posting laws (for example, state statutes, laws or regulations that directly or indirectly establish prices or require the filing of pricing information for any regulated product)?
- Do you have knowledge of any individual (including yourself) or group inflating an expense account for the purpose of enriching the individual or individuals?

To maintain the *corporate* attorney-client and work-product protections to the maximum possible extent, the company’s general counsel should send the questionnaire under a cover letter. The letter should state, among other things, that:

- (i) it is intended that the responses will be protected by the attorney-client and work-product privileges;
- (ii) the employee should not keep a copy of the questionnaire; and
- (iii) the company reserves the right to decide to furnish the completed questionnaire, or disclose information contained in it, to one or more governmental agencies or in private litigation.⁷¹

As with hotline tips, any material disclosures on the questionnaires must be investigated.

Once such questionnaires are created, however, circumstances arise that may force the company to waive the protection of any privilege. *In re John Doe Corp.*⁷² illustrates this peril. There, a corporation

71. See *Upjohn Co. v. United States*, 449 U.S. 383, 394–96 (1981) (holding that the attorney-client privilege applied to business ethics review questionnaires where the information sought was not available from upper-level executives and was needed to enable the company’s attorneys to give legal advice).

72. *In re John Doe Corp.*, 675 F.2d 482 (2d Cir. 1982).

conducted an internal investigation using business ethics review questionnaires sent to hundreds of mid- and upper-level managers and officers.⁷³ Several of the questionnaires disclosed the existence of a bribery payment in the form of a \$96,500 legal fee to a New York City Councilman. The internal report of the investigation to the audit committee of the board of directors, however, made no mention of the bribery scheme and stated that there were no improper practices in the company's business activities.⁷⁴

The corporation's outside accountants discovered the legal fee during an audit and asked the general counsel whether it was an improper payment.⁷⁵ The general counsel responded that the company had investigated the payment and other possibly improper practices, that while earlier drafts referred to the payment, the final business ethics review report made no mention of the payment to the city councilman, and that "nothing was irregular."⁷⁶ Separately, an underwriter's counsel asked for, and was given, the business ethics review report—after threatening not to proceed with a public offering.⁷⁷

Subsequently, after a grand jury investigation began, the Second Circuit held that, by disclosing the business ethics review report to the outside parties, the corporation had waived any claim of privilege, and the court ordered production to the grand jury not only of the report, but also the business ethics questionnaires and attorneys' interview notes.⁷⁸ The questionnaires and notes were used to convict the corporation.⁷⁹

[E][4] Effectiveness Review

Increasingly, given the stakes of noncompliance, companies are internally, or by retaining outside counsel, prophylactically evaluating the set of controls in place designed to ensure compliance and manage legal risk by means of a "gap analysis." Policies are reviewed to ensure they address current and emerging legal risks; training programs are reviewed to ensure they are effective in guiding execution; and

73. *See id.* at 484.

74. *See id.* at 488–89.

75. *See id.* at 485–86.

76. *Id.* at 486, 489.

77. *See id.* at 485.

78. *See id.* at 488; *United States v. Textron, Inc.*, 507 F. Supp. 2d 138, 152–53 (D.R.I. 2007), *vacated*, 577 F.3d 21, 28–31 (1st Cir. 2009) (holding that work product protection was waived when company disclosed document to an independent auditor).

79. *Id.*; *see United States v. Southland Corp.*, 760 F.2d 1366, 1371–73 (2d Cir. 1985); *see also supra* chapter 2 (offering a more detailed discussion of waiver).

monitoring and auditing programs are evaluated to determine if they adequately capture execution risks and if mechanisms are in place to continuously improve controls based on what the monitoring and audits reveal.

These gap analyses can help demonstrate to regulatory authorities—if necessary—the seriousness with which the company approaches its compliance program. At the same time, the company ought to be mindful of the legal risks a poorly conducted gap analysis can cause. Imprecise reporting of findings, premature observations or conclusions, and aimless testing are just some of the problems that can arise. Accordingly, careful planning and execution are important.

Similarly, companies are increasingly engaging in “benchmarking,” through which they compare their compliance programs to those of their competitors. For a company with protections in place that are similar to other companies in an industry, this level of internal protection can be a valuable defensive tool if the company faces government scrutiny. This holds especially true if a company can show its policies exceed the industry standard.

[F] Section 8B2.1(b)(6)

The organization’s compliance and ethics program shall be promoted and enforced consistently throughout the organization through (A) appropriate incentives to perform in accordance with the compliance and ethics program; and (B) appropriate disciplinary measures for engaging in criminal conduct and for failing to take reasonable steps to prevent or detect criminal conduct.

This criterion requires the company to incentivize compliance and punish employees for noncompliance. The reference to “incentives” recognizes that a “culture of compliance can be promoted where organizational actors are judged by, and rewarded for, their positive compliance performance.”⁸⁰ While a range of disciplinary measures is available to punish noncompliance—warning, suspension, loss of pay, reduction in position, transfer, and termination—the Guidelines’ emphasis on “due diligence” may leave a company little choice but to fire employees whose proved or conceded criminal acts force the

80. ADVISORY COMMITTEE REPORT, *supra* note 49, at 86. Similarly, companies may attempt to limit programs that potentially incentivize improper behavior. For example, linking employee bonuses solely to achieving sales goals may incentivize improper activities that increase sales. Reducing or removing the link between bonuses and sales can help generate a greater culture of compliance.

company to plead for leniency on the basis of a commitment to compliance.

A difficult question arises when a company has only circumstantial evidence of an employee's misdeeds—enough, perhaps, to establish probable cause—but the employee denies any wrongdoing. In the event of a subsequent prosecution and conviction of the employee and the corporation, the company's failure to have fired the employee may result in the company's losing a reduction in fine under the Guidelines' compliance provisions. On the other hand, the company may not want to adjudicate an employee's guilt or innocence, particularly when it lacks the tools available to prosecutors such as grand jury subpoenas, immunity powers, eavesdropping authority, and vast investigative resources. In that situation, the company might opt for suspending the employee with pay (and, depending on indemnity obligations, indemnifying the employee's attorney fees). But, in the absence of case authority, there is no legal guidance as to whether the company will still qualify for a fine reduction.⁸¹

Moreover, in considering disciplinary measures, the company must be mindful of limitations imposed by state law or contract. The following sections discuss some basic principles of New York and California law regarding termination of employees who are suspected of violating the law, formally accused (but not convicted), and convicted.

[F][1] Termination Under New York Law of Employees Implicated in or Under Suspicion of a Violation of Law

Under New York law, a private employer may discharge an employee "at-will" (that is, at the employer's option, without recourse),⁸² except where limited or restricted by:

- employment contract;
- union contract;
- employee handbook exception;

81. In any such circumstance, the company should be sensitive to the risks of defamation and wrongful termination claims by the employee.

82. See *Murphy v. Am. Home Prods. Corp.*, 448 N.E.2d 86, 89 (N.Y. 1983). "In the decades since *Murphy*, we have repeatedly refused to recognize exceptions to, or pathways around [this general principle]." *Smalley v. Dreyfus Corp.*, 882 N.E.2d 882, 884 (N.Y. 2008); see also *Negron v. J.P. Morgan Chase/Chase Manhattan Bank*, 789 N.Y.S.2d 257, 258 (App. Div. 2005).

- state or federal whistleblower laws;^{82.1} and
- discrimination law;⁸³

Under New York law, the remedy for discharge in violation of a contractual restriction is normally backpay minus mitigation (and possibly reinstatement); the remedies for violations of the civil rights law are broader and may include front and backpay, compensatory damages and, under federal law, punitive damages, plus attorney fees in appropriate cases. In discharging an employee based on suspicion of wrongdoing, the employer must guard against creating a basis for a defamation claim by nonprivileged disclosure of defamatory statements.

[F][2] Termination Under California Law of Employees Implicated in or Under Suspicion of a Violation of Law

Under California law, a private employer may discharge an employee on an “at-will” basis,⁸⁵ but this rule is subject to exceptions, some of which are not present in New York:

- employment contract;
- union contract;
- discrimination law;
- state and federal whistleblower laws;
- wrongful discharge;
- employer handbook, termination guidelines, or other writings, conduct, and practices;⁸⁶ and
- employer bad faith.

82.1. A number of federal statutes protect whistleblowers who lawfully report or assist in the investigation of fraud upon the government. *See, e.g.*, False Claims Act, 31 U.S.C. §§ 3729–33 (discussed *infra* section 11:8); Dodd-Frank Wall Street Reform and Consumer Protection Act, 15 U.S.C. § 78u-6 (discussed *supra* section 6:1). Some federal statutes reward them. Both the False Claims Act and Dodd-Frank include a double-backpay remedy. *See* 31 U.S.C. § 3730(h)(2); 15 U.S.C. § 78u-6(h)(1)(C)(ii).

83. Employees of a different race, age, sex, or national origin, and other protected characteristics under the civil rights laws, under similar suspicion have received lesser discipline in similar circumstances, suggesting that the discharge in question is discriminatory.

84. [Reserved.]

85. *See* CAL. LAB. CODE § 2922.

86. *See* *Foley v. Interactive Data Corp.*, 765 P.2d 373, 384–88 (Cal. 1988). Normally, an employer can avoid such actions with a clear handbook disclaimer preserving its right to discharge at will.

Under California law, the remedy for breach of an employment contract or for breach of the covenant of good faith and fair dealing is normally an award of backpay, less mitigation (and possibly reinstatement or front pay). Wrongful discharge actions, however, can also lead to punitive damage awards.

Risks of defamation, “false light in the public eye,” and invasion of privacy actions are especially serious under California law.⁸⁷

[F][3] Termination Under New York Law of Employees Formally Accused (i.e., Arrested or Indicted) of a Violation of Law

In New York, discharge of an arrested employee (or the refusal to hire an applicant with a pending arrest) does not violate state discrimination laws, which exempt employment actions based on “pending” arrests.⁸⁸ Generally, an employer is prohibited from basing decisions solely on an employee’s or applicant’s *prior* arrest that did *not* result in a conviction. An employer may, however, refuse to hire an applicant on the basis of a prior conviction, provided there is a “direct relationship” between the conviction and the employment sought or where granting employment would involve “unreasonable risk” to property, the safety of other employees, or the general public.⁸⁹ For existing employees who are convicted while employed, arguably the “job related” or “unreasonable risk” limitations are satisfied.⁹⁰

[F][4] Termination Under California Law of Employees Formally Accused (i.e., Arrested or Indicted) of a Violation of Law

California state law prohibits basing any condition of employment, including the refusal to hire or discharge, on any “record” of arrest “that did not result in conviction.”⁹¹ Convictions include pleas, verdicts, or other findings of guilt, regardless of sentence.⁹² There is, therefore, unlike in New York State, no exception for discharging an employee because of a pending arrest, although the employer may

87. See, e.g., *Marshall v. Brown*, 190 Cal. Rptr. 392, 397 (Ct. App. 1983) (upholding defamation award based on statements to subsequent employer); *Payton v. City of Santa Clara*, 183 Cal. Rptr. 17 (Ct. App. 1982) (invasion of privacy action based on posting of employee’s termination notice on bulletin board).

88. See N.Y. EXEC. LAW § 296(16).

89. N.Y. EXEC. LAW § 296(15); N.Y. CORRECT. LAW § 752.

90. See *Pisano v. McKenna*, 466 N.Y.S.2d 231 (Sup. Ct. Oneida Cty. 1983).

91. CAL. LAB. CODE § 432.7.

92. *Id.*

legitimately inquire into the fact of the arrest and the underlying circumstances.⁹³

An employer may, however, find a basis for discharge independent of the arrest itself:

- The employer's own internal investigation may reveal violations of company policies or procedures that form an independent basis for discharge. Indeed, the company's personnel policies should provide that any action or conduct which would constitute a criminal offense (or give that appearance), committed at work or away from work (if work-related), will be grounds for dismissal and criminal prosecution. Under such a policy, the underlying conduct, rather than the fact of the arrest alone, may lead to discharge.
- Attendant adverse publicity may create a reasonable loss of confidence in the continued capability of an employee, or leave the employee unable to perform his duties adequately.
- If the employee is jailed awaiting trial and thus cannot perform his job duties, discharge also may be permissible.

[F][5] Executive Contract Issues

A pending arrest or indictment, along with the underlying conduct, may constitute "cause" under an executive employment contract. Employment agreements should be negotiated to provide that any action or conduct that would constitute a criminal offense (or give that appearance, such as arrest or indictment), committed at work or away from work (if work-related) is cause for discharge.

Thus, adverse publicity and public loss of confidence, or violations of company policies and procedures could constitute a basis for "cause." Ultimate vindication of most or all criminal charges, however, does not necessarily negate the existence of contractual "cause" for discharge. Cause is predicated on business concerns and adherence to internal policies. Proof of criminal conduct requires a higher standard of proof than is necessary to prove contractual "cause."

[F][6] Union Contract Issues

Arrest or indictment, along with the underlying conduct, may constitute "just cause" under a union contract, especially where an internal investigation reveals violations of company rules and policies.

93. Pitman v. City of Oakland, 243 Cal. Rptr. 306, 309 (Ct. App. 1988).

Labor contract arbitrators, however, are likely to take mitigating factors into account in determining the propriety of discharge (for example, employee's culpability, seniority, level of authority, severity of offense, its job-relatedness, the employee's overall work record). In close cases, suspension pending investigation may be a viable alternative to immediate dismissal. (In California, the suspension must be predicated on matters other than the arrest itself (for example, suspected violation of company rules).)

[F][7] Practical Considerations

Terminating an employee who acted within the scope of his authority could be construed as an admission of wrongdoing by the company under the doctrine of *respondeat superior*. This is especially true where the company must contend that it terminated an executive employee under contract for "cause." Moreover, terminated employees might become witnesses against the company.

There are, however, also significant advantages; in particular, firing an employee found to have violated the law demonstrates the company's commitment to compliance and ethical standards. For example, if the company seeks to qualify for more lenient treatment under the Guidelines on the basis of its compliance program, it must demonstrate an adequate response to violations of law by its employees. Terminating such employees is one way to satisfy this element.

If the decision is made to terminate an employee, the employer should take immediate steps to prevent the employee from gaining access to any documents or computer files, as well as to bar further access to the company's premises.

[F][8] General Principles Governing Termination of Employees Convicted of a Crime (Misdemeanor or Felony)

In the case of an executive contract, conviction (and attendant publicity) will typically constitute "cause." Indeed, as mentioned above, the executive's contract may specifically provide that a conviction, or even an arrest or indictment, whether or not for work-related conduct, may constitute cause for discharge.

The conviction itself need not be the only basis for cause (for example, loss of public confidence, inability to perform, violation of company policies). Vindication on certain criminal charges does not preclude a finding of contractual "cause" for termination.

In the case of a union contract, a conviction stemming from conduct at the workplace will almost certainly constitute "just cause" because it will have also constituted a violation of company rules, unless significant mitigating circumstances are present.

[G] Section 8B2.1(b)(7)

After criminal conduct has been detected, the organization shall take reasonable steps to respond appropriately to the criminal conduct and to prevent further similar criminal conduct, including making any necessary modifications to the organization's compliance and ethics program.

In addition to disciplining employees involved in criminal conduct, an organization should “take reasonable steps, as warranted under the circumstances, to remedy the harm resulting from the criminal conduct,” which may include “providing restitution to identifiable victims, as well as other forms of remediation” and/or “self-reporting and cooperation with authorities.”⁹⁴ The Commentary also directs that a defendant organization “act appropriately to prevent further similar criminal conduct, including assessing the compliance and ethics program and making modifications necessary to ensure the program is effective.”⁹⁵ This review of the compliance program “may include the use of an outside professional advisor to ensure adequate assessment and implementation of any modifications.”⁹⁶

[H] Section 8B2.1(c) (Risk Assessment)

In implementing subsection (b), the organization shall periodically assess the risk of criminal conduct and shall take appropriate steps to design, implement, or modify each requirement set forth in subsection (b) to reduce the risk of criminal conduct identified through this process.

The Guidelines direct that a corporation periodically assess the effectiveness of how it implements each of these seven requirements and modify them, if necessary, to reduce the risk of any potential criminal conduct. The Commentary following section 8B2.1(c) clarifies that “an organization shall” periodically assess the nature and seriousness of any criminal conduct and the likelihood that criminal conduct may occur because of “the nature of the organization's business.” If “there is a substantial risk” of illegal conduct, the organization is required to “take reasonable steps to prevent and detect that type of criminal conduct.”⁹⁷

94. GUIDELINES MANUAL § 8B2.1 cmt. n.6.

95. *Id.*

96. *Id.*

97. *See id.* § 8B2.1 cmt. n.7(A)(ii).

[I] Other Guidance

In addition to section 8B2.1 of the Guidelines, in February 2017, the DOJ Criminal Division's Fraud Section released guidance on common questions and topics they take into consideration when evaluating compliance programs.⁹⁸

The "Evaluation of Corporate Compliance Programs" guidance outlines eleven key topics with a corresponding set of "common questions" that DOJ typically asks when determining whether a compliance program is effective for the purposes of recommending leniency at the charging or penalty stage. Drawing on existing guidance in the *U.S. Attorney's Manual*, the DOJ and SEC's *A Resource Guide to the U.S. Foreign Corrupt Practices Act*,⁹⁹ and the Organisation for Economic Co-operation and Development (OECD)'s *Good Practice Guidance on Internal Controls, Ethics, and Compliance*¹⁰⁰ and *Anti-Corruption Ethics and Compliance Handbook for Business*,¹⁰¹ DOJ's Compliance Evaluation Guidance identifies the following eleven topics "that the Fraud Section has frequently found relevant in evaluating a corporate compliance program"¹⁰²:

- (1) analysis and remediation of underlying misconduct;
- (2) compliance commitment of and oversight by senior and middle management;
- (3) autonomy and resources of compliance function team and department(s);
- (4) policies and procedures (design and accessibility, as well as operational integration of the compliance program into the business);
- (5) risk assessment;
- (6) training and communications;
- (7) confidential reporting and investigation;

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98. U.S. DEP'T OF JUSTICE, EVALUATION OF CORPORATE COMPLIANCE PROGRAMS, www.justice.gov/criminal-fraud/page/file/937501/download [hereinafter DOJ'S COMPLIANCE EVALUATION GUIDANCE].
 99. U.S. DEP'T OF JUSTICE & SEC. & EXCH. COMM'N, A RESOURCE GUIDE TO THE U.S. FOREIGN CORRUPT PRACTICES ACT (Nov. 14, 2012), www.justice.gov/sites/default/files/criminal-fraud/legacy/2015/01/16/guide.pdf.
 100. OECD, GOOD PRACTICE GUIDANCE ON INTERNAL CONTROLS, ETHICS, AND COMPLIANCE (Feb. 18, 2010), www.oecd.org/daf/anti-bribery/44884389.pdf.
 101. OECD, ANTI-CORRUPTION ETHICS AND COMPLIANCE HANDBOOK FOR BUSINESS (2013), www.oecd.org/corruption/Anti-CorruptionEthicsComplianceHandbook.pdf.
 102. DOJ'S COMPLIANCE EVALUATION GUIDANCE, *supra* note 98, at 1.

- (8) incentives and disciplinary measures;
- (9) continuous improvement, periodic testing, and review of the compliance program;
- (10) management of third parties; and
- (11) due diligence and integration procedures in the context of mergers and acquisitions.¹⁰³

While DOJ's Compliance Evaluation Guidance is advisory rather than binding in nature, it provides valuable insights into the factors that federal prosecutors may consider when assessing the effectiveness of a company's compliance program.

§ 7:5 Caremark Liability

In the seminal case *In re Caremark International, Inc. Derivative Litigation*, the Delaware Court of Chancery recognized that a corporate director's fiduciary duties include an obligation to "assure that a corporate information and reporting system" exists and is adequate.¹⁰⁴ In that case, Caremark International paid out \$250 million in civil and criminal fines as a result of alleged violations of numerous federal and state healthcare laws. Shareholders then brought a derivative lawsuit to recover this loss from the company's board of directors.¹⁰⁵ Although recognizing the potential for liability in the course of approving a settlement, the court also stated that plaintiff's theory of a director duty to implement compliance programs "is possibly the most difficult theory in corporation law upon which a plaintiff might hope to win a judgment."¹⁰⁶ Indeed, the court found a "very low probability" that directors "breached any duty to appropriately monitor and supervise" their employees.¹⁰⁷

Nonetheless, the *Caremark* court stated that directors may be found liable for breach of their fiduciary duties if they are ignorant of potential liability as a result of "a systematic failure of the board to exercise oversight," whether their ignorance results from the absence of a compliance program or the failure to ensure an existing one is adequate.¹⁰⁸ *Caremark* rests explicitly, in part, on the Organizational Sentencing Guidelines: "Any rational person attempting in good faith to meet an organizational governance responsibility would be bound

103. See *id.* at 1–7.

104. *In re Caremark Int'l, Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996).

105. *Id.* at 960–61.

106. *Id.* at 967.

107. *Id.* at 961.

108. *Id.* at 971.

to take into account . . . the enhanced penalties and the opportunities for reduced sanctions” under the Guidelines.¹⁰⁹ The implication is that a director would be acting in bad faith if he did not implement an appropriate compliance program.¹¹⁰

Nearly a decade later, in *Stone v. Ritter*,¹¹¹ the Delaware Supreme Court expressly affirmed *Caremark* and summarized the circumstances giving rise to liability as either: “(a) the directors utterly failed to implement any reporting or information system or controls; or (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.” A 2009 decision explained this standard further, stating that: “Courts look to see if there were ‘red flags’ that should have put defendants on notice of the offensive conduct or weakness of the corporation’s internal controls.”¹¹² Overcoming the *utter* or *conscious* failure threshold is no simple task, to be sure. After all, courts will scrutinize whether the necessary “red flags” were raised. Indeed, despite *Caremark*, corporate officers and directors continue to enjoy the extensive protections of the business judgment rule in fulfilling their corporate duties, including when making particularly risky decisions.¹¹³ As the Delaware Court of Chancery stated in a decision involving a *Caremark* claim, “transactions involve[ing] risk, including a risk of damaging the company’s reputation, . . . are not ‘red flags’ that would give rise to an actionable *Caremark* claim. . . .”¹¹⁴

Directors are not the only individuals susceptible to liability for failure to adequately monitor. In *World Health Alternatives, Inc. v. McDonald*,¹¹⁵ the bankruptcy court held the *Caremark* standard applicable to corporate officers, rather than directors alone, including

109. *Id.* at 970.

110. Good faith is tied to the duty of loyalty: “A director cannot act loyally towards the corporation unless she acts in the good faith belief that her actions are in the corporation’s best interest.” *Guttman v. Huang*, 823 A.2d 492, 506 n.34 (Del. Ch. 2003).

111. *Stone v. Ritter*, 911 A.2d 362, 370 (Del. 2006).

112. *In re Brocade Commc’ns Sys. Derivative Litig.*, 615 F. Supp. 2d 1018, 1048 (N.D. Cal. 2009). The Third Circuit elaborated further that “day-to-day supervision of employees,” however, is still “the work of employee-supervisors, not the board of directors.” *Belmont v. MB Inv. Partners, Inc.*, 2013 WL 646344, at *10 (3d Cir. Feb. 22, 2013) (affirming dismissal of claims against corporate directors alleging liability under, inter alia, a theory of negligent supervision).

113. *E.g.*, *In re Goldman Sachs Grp., Inc. S’holder Litig.*, 2011 Del. Ch. LEXIS 151 (Del. Ch. Oct. 12, 2011); *Raul v. Astoria Fin. Corp.*, 2014 WL 2795312 (Del. Ch. June 20, 2014).

114. *Goldman Sachs*, 2011 Del. Ch. LEXIS 151, at *67.

115. *World Health Alternatives, Inc. v. McDonald*, 385 B.R. 576, 592–93 (Bankr. D. Del. 2008).

in-house general counsel. The bankruptcy trustee had sued the corporate directors and officers of World Health for, among other things, breach of their fiduciary duties, including “failing to implement any internal monitoring system.”¹¹⁶ The general counsel for World Health moved to dismiss the claims against him on the grounds that the *Caremark* standard was only applicable to directors. In denying the motion, the court noted that the general counsel was obligated under section 307 of the Sarbanes-Oxley Act to report breaches of fiduciary duty. Furthermore, the court held that, under *Caremark*, contrary to what a narrow reading of prior Delaware case law may suggest, “it is clear that . . . both officers and directors owe fiduciary duties to the corporation.”¹¹⁷

Notwithstanding the high standard for proving liability, *Caremark* and its progeny provide additional incentive for directors and officers alike to ensure the presence of a functional monitoring and compliance program.

116. *Id.* at 591. *But see In re Galena Biopharma, Inc. Deriv. Litig.*, 83 F. Supp. 3d 1047, 1066–67 (D. Or. 2015) (summarily dismissing *Caremark* claims against non-director corporate officers).

117. *Id.* at 592–93.

