Richard Bednar
Mary Beth Buchanan
Paul Fiorelli
Richard Gruner
Eric H. Holder, Jr.
Charles Howard
Ron James
B. Todd Jones, Chair
Lisa A. Kuca
Jane Adams Nangle
Julie O'Sullivan, Reporter
Edward S. Petry
Gary R. Spratling
Winthrop M. Swenson
Gregory J. Wallance

REPORT OF THE AD HOC ADVISORY GROUP ON THE ORGANIZATIONAL SENTENCING GUIDELINES

OCTOBER 7, 2003

TABLE OF CONTENTS

Page

I. INTRODUCTION 1

II. EXECUTIVE SUMMARY 3

A. OVERVIEW 3

B. SEPARATE GUIDELINE FOR EFFECTIVE PROGRAMS 3

C. ROLE OF WAIVER IN COOPERATION 5

D. THE LITIGATION DILEMMA 6

E. FAILURE TO IMPLEMENT A COMPLIANCE PROGRAM 7

F. OTHER ASPECTS OF ORGANIZATIONAL SENTENCING 7

III. UNDERSTANDING THE ORGANIZATIONAL SENTENCING GUIDELINES 8

A. STANDARDS GOVERNING ORGANIZATIONAL CRIMINAL RESPONSIBILITY 8

B. FORMULATION OF THE ORGANIZATIONAL SENTENCING GUIDELINES 11

C. PRIMER ON THE ORGANIZATIONAL SENTENCING GUIDELINES 15
1. Remediation and Restitution Provisions: Part B 15
2. Fine Provisions: Part C 16
3. Organizational Probation Provisions: Part D 23

D. SENTENCING DATA 25

E. SUCCESS OF ORGANIZATIONAL SENTENCING GUIDELINES IN FOCUSING ATTENTION ON COMPLIANCE PROGRAMS 28

Page

F. RECENT CORPORATE SCANDALS AND LEGISLATIVE AND REGULATORY RESPONSES . . . 35
1. SEC Code of Ethics Regulations . . . 39
2. NYSE Governance Standards . . . 41
3. Sarbanes-Oxley Certification Requirement . . . 43
4. Sarbanes-Oxley Reporting Provisions and Whistleblower Protections . 43
5. Anti- Money Laundering Compliance Standards . . . 45

G. THE NEED FOR AMENDMENT OF THE COMPLIANCE CRITERIA . . . 48

IV. SPECIFIC PROPOSALS FOR AMENDMENTS TO THE DEFINITION OF AN "EFFECTIVE PROGRAM TO PREVENT AND DETECT VIOLATIONS OF LAW" 51

A. CULTURE AND THE RESPONSIBILITIES OF ORGANIZATIONAL LEADERSHIP . . . 52
1. Background to §8B2.1(a) . . . 52
2. Section 8B2.1(a) . . . 54
3. Section 8B2.1(b)(1) . . . 56
4. Background to §8B2.1(b)(2) . . . 57
5. Section 8B2.1(b)(2) . . . 60
6. Background to §8B2.1(b)(3) . . . 64
7. Section 8B2.1(b)(3) . . . 67

B. EFFECTIVE COMMUNICATION OF STANDARDS AND TRAINING . . . 69
1. Background to §8B2.1(b)(4) . . . 69
2. Section 8B2.1(b)(4) . . . 71

C. MONITORING, AUDITING, AND EVALUATION . . . 73
1. Background to §§8B2.1(b)(5)(A) & (B) . . . 73
2. Sections 8B2.1(b)(5)(A) & (B) . . . 77

D. REPORTING SYSTEMS . . . 78
1. Background to §8B2.1(b)(5)(C) . . . 78
2. Section 8B2.1(b)(5)(C) . . . 84

E. ACCOUNTABILITY AND REMEDIATION . . . 87
1. Section 8B2.1(b)(6) . . . 87
2. Section 8B2.1(b)(7) . . . 88

Page

F. RISK ASSESSMENT 88
1. Section 8B2.1(c) 88

G. CONCLUSION 92

V. THE EFFECT OF PRIVILEGE WAIVERS ON COMPLIANCE INCENTIVES, COOPERATION, AND SELF-REPORTING 93

A. BACKGROUND: RELEVANT PROVISIONS OF THE ORGANIZATIONAL SENTENCING GUIDELINES AND RELATED POLICIES 93

B. METHODOLOGY 94

C. THE U.S. DEPARTMENT OF JUSTICE POLICY ON THE ROLE OF PRIVILEGE WAIVERS IN COOPERATION 95
1. Criminal Division and United States Attorneys: The United States Attorneys Manual 95
2. Other Relevant Enforcement Agencies 97
3. Survey of United States Attorneys 99
4. Themes of Public Comment 100
5. Proposal for Consideration 104

VI. THE LITIGATION DILEMMA: INFORMATION GENERATED BY ORGANIZATIONS TO STRENGTHEN COMPLIANCE PROGRAMS MAY BE USED AGAINST THEM IN NON-SENTENCING CONTEXTS 106

A. APPLICABLE GUIDELINE PROVISIONS 106

B. CONSIDERATIONS THAT INFLUENCE COMPLIANCE DECISIONMAKING 107

C. THE LIMITATIONS OF EXISTING PRIVILEGES AND PROTECTIONS . 109
1. The Attorney-Client Privilege and Work Product Protection Doctrine . 110
2. The Federal Self-Evaluative Privilege. 115

D. THE LITIGATION DILEMMA 117

E. THE RECORD DEVELOPED BY THE ADVISORY GROUP 122

F. RECENT DEVELOPMENTS 127

G. RECOMMENDATION FOR FURTHER STUDY 129

Page

VII. RECOMMENDATIONS 131

A. GUIDELINE CHANGES 131
1. New Guideline Containing Compliance Criteria 131
2. Guideline Reference to Waiver of Privileges 131

B. FAILURE TO IMPLEMENT A COMPLIANCE PROGRAM 132

C. PROBATION 134

D. FINE PROVISIONS 135

E. LOSS DEFINITION 136

F. DATA COLLECTION 137

G. CONCLUSION 137

I. INTRODUCTION

The United States Sentencing Guidelines that control the sentencing of organizations for most federal criminal violations became effective on November 1, 1991.[1] A critical component of the Sentencing Commission's effort to prevent and deter organizational wrongdoing through its design of the organizational sentencing guidelines was its creation of a sentencing credit for organizations that put in place "effective programs to prevent and detect violations of law."[2]

Shortly after the tenth anniversary of the implementation of the organizational sentencing guidelines, the United States Sentencing Commission announced its intention to form an Ad Hoc Advisory Group to review the general effectiveness of these guidelines.[3] The Sentencing Commission asked that its Advisory Group, in evaluating the organizational sentencing guidelines, "place particular emphasis on examining the criteria for an effective program to ensure an organization's compliance with the law."[4]

The Advisory Group is composed of fifteen individuals with a broad range of experience in business, federal criminal prosecution and defense, federal probation, legal scholarship, corporate compliance and business ethics.[5] The Advisory Group conducted its review over a period of 18 months during which it regularly met, solicited and received public comment on the effectiveness of the compliance criteria of the organizational sentencing guidelines[6] and held a public hearing to which a variety of invited representatives with a broad range of perspectives submitted oral and written comments.[7] The Advisory Group extensively canvassed the practice commentary and scholarly literature, surveyed current representatives of the U.S. Department of Justice regarding prosecutorial decisionmaking, and familiarized itself with the policies of a variety of other governmental agencies and departments. During the Advisory Group's tenure,

---

[1] U.S. SENTENCING GUIDELINES MANUAL ch. 8 (Nov. 2002) [hereinafter "USSG"] available at <http://www.ussc.gov/2002guid/tabconchapt8.htm>.

[2] *Id*. §8C2.5(f); *see also* §8A1.2, Application Note 3(k).

[3] 66 Fed. Reg. 48306 (September 19, 2001) available at <http://www.ussc.gov/FEDREG/fedr901_0A.htm>.

[4] *See* U.S. Sentencing Sentencing Commission, News Release (Feb. 21, 2002) <http://www.ussc.gov/PRESS/rel0202.htm>.

[5] *See* Appendix A for list of Advisory Group members and relevant backgrounds.

[6] *See* Advisory Group for Organizational Sentencing Guidelines: Request for Additional Public Comment Regarding the U.S. Sentencing Guidelines for Organizations (Oct. 15, 2002), available at <http://www.ussc.gov/corp/pubcom8_02.pdf>. Advisory Group for Organizational Sentencing Guidelines: Request for Public Comment (March 19, 2002), available at <http://www.ussc.gov/corp/pubcom_302/PC_302.htm>. Responses to these requests for comment are available to the public and may be found online at the U.S. Sentencing Commission's website. *See* <http://www.ussc.gov/corp/pubcom_1002/PC-1002.htm>.

[7] Transcripts of the Public Hearing sessions, as well as the written comments submitted to the Advisory Group, are available online at the U.S. Sentencing Commission's website. *See* <http:www.ussc.gov/hearings.htm>.

revelations regarding corporate accounting and other misconduct at such high-profile public companies as Enron, WorldCom, Tyco International, and Adelphia Communications[8] spurred to action Congress and a variety of regulators. The Advisory Group continuously kept abreast of Congress's response to the corporate scandals, most notably in the Sarbanes-Oxley Act of 2002,[9] as well as the relevant output of public and private regulators.[10]

The following Report is the result of the Advisory Group's informed investigation, deliberations, and personal expertise in the areas of criminal law, business ethics, regulatory compliance, and corporate governance. This Report is intended to assist the United States Sentencing Commission in its future consideration of potential amendments to Chapter Eight of the federal sentencing guidelines. As the Advisory Group's 18-month term draws to a close, it wishes to thank the Commission's Chair, Judge Diana E. Murphy, for her unflagging support of its efforts, and to acknowledge the invaluable assistance of Commission staff with research and technical assistance during the Group's tenure.

II. EXECUTIVE SUMMARY

---

[8] *See The Role of the Board of Directors in Enron's Collapse*, S. Rep. No. 107-70 (2002) available at <http://news.findlaw.com/hdocs/docs/enron/senpsi70802rpt.pdf>.
Preliminary Report of the American Bar Association Task Force on Corporate Responsibility (July 16, 2002), available at <http://www.abanet.org/buslaw/corporate responsibility/preliminary_report.pdf>.

[9] *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745; *see also Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002*, 68 Fed. Reg. 5110, 5117-20 (Jan. 31, 2003) (to be codified at 17 C.F.R. pts. 228-29, 249), as amended March 31, 2003; *Implementation of Standards of Professional Conduct for Attorneys*, 68 Fed. Reg.6296 (Feb. 6, 2003) (to be codified at 17 C.F.R., pt. 205) (SEC final rules to implement Section 307 of the Sarbanes-Oxley Act by setting "standards of professional conduct for attorneys appearing and practicing before the Sentencing Commission in any way in the representation of issuers"); <http://www.sec.gov/rules/final/33-8193.htm> (Feb. 20, 2003) (SEC's Regulation AC pursuant to Section 501 of the Sarbanes-Oxley Act).

[10] *See, e.g.*, Corporate Governance Rule Proposals Reflecting Recommendations from NYSE Corporate Accountability and Listing Standards Committee as Approved by the NYSE Board of Directors, Aug. 1, 2002, § 303A.9-10 (to be codified at section 303A of the NYSE Listed Company Manual), available at <http://www.nyse.com/pdfs/corp_gov_pro_b.pdf>, as modified on March 12, 2003, Form 19b-4 Proposed Rule Change by National Association of Securities Dealers, Inc. (Jan. 15, 2003), available at <http://www.nasdaq.com/about/SR-NASD-2002-139-Amendment1.pdf>, as modified on March 11, 2003, available at <http://www.nasdaq.com/about/ProposedRules.stm#boards>. These listing standards have not yet been formally published for comment and officially approved by the SEC.

A. OVERVIEW

The Advisory Group's review of the operation and impact of the organizational sentencing guidelines, detailed in Part III of this Report, compelled the conclusion that the organizational sentencing guidelines have been successful in inducing many organizations, both directly and indirectly, to focus on compliance and to create programs to prevent and detect violations of law. The Advisory Group also concluded, however, that changes can and should be made to give organizations greater guidance regarding the factors that are likely to result in *effective* programs to prevent and detect violations of law. Two circumstances were particularly influential in shaping the Advisory Group's efforts in this respect.

First, the Advisory Group concluded that recent revelations of widespread misconduct in some of the nation's largest publicly held companies – misconduct perpetrated at the highest levels of corporate leadership that went undetected despite the existence of compliance programs – required evaluation of whether the compliance efforts precipitated by the organizational sentencing guidelines could be made more effective in preventing and detecting violations of law. The Advisory Group drew a variety of lessons from the legislative and regulatory responses to the organizational misconduct revealed over the last several years. For example, the Advisory Group concluded that the guidelines should better address the role of organizational leadership in ensuring that compliance programs are valued, supported, periodically re-evaluated, and operate for their intended purpose. Further, the recent emphasis by Congress and regulators on a number of additional factors, including organizational culture, improved internal reporting systems, adequate training, auditing and monitoring, and periodic risk assessments, also influenced the Advisory Group's analysis and final recommendations.

Second, much has changed in the field of organizational compliance since the advent of the organizational sentencing guidelines in November 1991. Over the last twelve years legal standards in a remarkably diverse range of fields have recognized organizational law compliance programs as important features of responsible organizational conduct. The legal standards which have emerged are often built upon the original organizational sentencing guidelines model. However, these standards have increasingly articulated more detailed and sophisticated criteria for identifying organizational law compliance programs that warrant favorable organizational treatment. Efforts and experience by industry and private organizations have also contributed to an evolution of "best practices" during the last decade. In short, the Advisory Group believes that the organizational guidelines should be updated to reflect the learning and progress in the compliance field since 1991.

B. SEPARATE GUIDELINE FOR EFFECTIVE PROGRAMS

The Advisory Group proposes that the Sentencing Commission consider several specific revisions to the current organizational sentencing guidelines to reflect these developments. The Advisory Group recommends that the Sentencing Commission promulgate a stand-alone guideline at §8B2.1 defining an "effective program to prevent and detect violations of law." (*See*

Appendix B). Many of the concepts detailed in the proposed guideline provision are well recognized and are currently reflected in Application Note 3(k) to §8A1.2.

Within the proposed new guideline that is accompanied by a section-by-section analysis in Part IV, the Advisory Group recommends that the Sentencing Commission make the following modifications and additions:

- Emphasize the importance within the guidelines of an organizational culture that encourages a commitment to compliance with the law
- Provide a definition of "compliance standards and procedures"
- Specify the responsibilities of an organization's governing authority and organizational leadership for compliance
- Emphasize the importance of adequate resources and authority for individuals within organizations with the responsibility for the implementation of the effective program
- Replace the current terminology of "propensity to engage in violations of law" with language that defines the nature of an organization's efforts to determine when an individual has a reason to know, or history of engaging in, violations of law
- Include training and the dissemination of training materials and information within the definition of an "effective program"
- Add "periodic evaluation of the effectiveness of a program" to the requirement for monitoring and auditing systems
- Require a mechanism for anonymous reporting
- Include the phrase "seek guidance about potential or actual violations of law" within the criteria in order to more specifically encourage prevention and deterrence of violations of law as part of compliance programs
- Provide for the conduct of ongoing risk assessments as part of the implementation of an "effective program"

These proposed changes are intended to eliminate ambiguities revealed by twelve years of sentencing experience and to describe more fully those essential attributes of successful compliance programs revealed by many years of program development and testing. They are also designed to respond to the lessons learned through the experience of national corporate scandals over the last two years and to synchronize the organizational sentencing guidelines with new federal legislation and emerging public and private regulatory requirements.

C. ROLE OF WAIVER IN COOPERATION

The Advisory Group also evaluated whether the current organizational sentencing guidelines adequately define self-reporting and cooperation, and whether the guidelines sufficiently encourage organizations to self-report their own illegal conduct and cooperate with federal law enforcement. The Advisory Group also examined whether the guidelines should provide commentary on role of the waiver of the attorney-client privilege and the work product protection doctrine in receiving credit for cooperation under the guidelines. These issues, particularly the question of whether the guidelines should be amended to provide some commentary on the role of waivers, are of great interest and concern to both the U.S. Department of Justice and to members of the defense bar.

As described at length in Part V of this Report, there is a significant divergence of opinion and perceptions among practitioners within the defense bar and the U.S. Department of Justice as to this important issue. Several of the critical issues examined by the Advisory Group include: (1) the appropriate use of, or need for, waivers of privilege as a part of the cooperation process; (2) the level of communication and understanding of the U.S. Department of Justice policies and practices, and whether there is consistency within various U.S. Attorney's Offices; and, (3) the value of suggesting that the organizational sentencing guidelines address the role of waivers in obtaining credit for cooperation. Following significant analysis and discussion, including a field survey of a number of United States Attorney's Offices, the Advisory Group has identified a possible approach to modifying the organizational sentencing guidelines in this regard.

Accordingly, the Advisory Group recommends adding clarifying language regarding the role of waiver of such privileges and protections for purposes of receiving sentencing credit based on cooperation with the government during the investigation and prosecution of an organization. In particular, it suggests amending the Commentary to §8C2.5 and adding Commentary to §8C4.1 as follows:

- Amend the Commentary at Application Note 12 of existing Section 8C2.5 by adding the following sentence:

> **If the defendant has satisfied the requirements for cooperation set forth in this note, waiver of the attorney-client privilege and of work product protections is not a prerequisite to a reduction in culpability score under subsection(g). However, in some circumstances waiver of the attorney-client privilege and of work product protections**

may be required in order to satisfy the requirements of cooperation.

- Amend the Commentary at existing Section 8C4.1 by adding an Application Note 2 as follows:

  <u>Waiver of Certain Privileges and Protections</u>. – If the defendant has satisfied the requirements for substantial assistance set forth in subsection(b)(2), waiver of the attorney-client privilege and of work product protections is not a prerequisite to a motion for a downward departure by the government under this section. However, in some circumstances, the government may determine that waiver of the attorney-client privilege and of work product protections is necessary to ensure substantial assistance sufficient to warrant a motion for departure.

D. THE LITIGATION DILEMMA

The Advisory Group also studied whether the effectiveness of compliance programs could be enhanced, not only by focusing on internal organizational efforts, but also by addressing the exogenous pressures that temper the clear benefits of proactive structures. There is substantial evidence demonstrating that, as strong as the guidelines' compliance incentives are, equally weighty incentives created by forces *outside* the organization may persuade organizations to pursue less than optimal, and in some cases, ineffective compliance programs.

Specifically, as is explored at length in Part VI of this Report, the institution of truly effective programs, the auditing and monitoring that such programs require, and the training and internal reporting systems that such programs contemplate, all create a real risk that information generated by these admirable practices will be used by other potential litigants to harm the organization. This situation is often referred to as the "litigation dilemma," and it is recognized as one of the major greatest impediments to the institution or maintenance of truly effective compliance programs.

The litigation dilemma, and the related issue of waivers of attorney-client privilege and the work product protection doctrine, also have a potential negative impact on organizational incentives to self-report misconduct and cooperate in the investigation and rededication of that wrongdoing. Recognizing that the litigation dilemma cannot be resolved within the organizational sentencing guidelines themselves, the Advisory Group is compelled by practicality to signal the pivotal role that the organizational sentencing guidelines play in this dilemma. Consequently, the Advisory Group recommends that the Sentencing Commission initiate and foster further dialogue toward a resolution of the "litigation dilemma" with appropriate policy makers, including Congress, based on the preliminary observations outlined by the Advisory Group in Part VI.

E. FAILURE TO IMPLEMENT A COMPLIANCE PROGRAM

The Advisory Group considered the recommendation received in the public comment for an increase in the culpability score of sentenced organizations for the absence of an "effective program." The Advisory Group recommends against such an increase because of the disparate impact that such an increase may have on small organizations, as is discussed more extensively at Part VII.

F. OTHER ASPECTS OF ORGANIZATIONAL SENTENCING

Finally, in the course of its work, the Advisory Group identified a number of areas relating to the sentencing of organizations that are beyond the scope of its mandate and term, but that are in strong need of further study and evaluation. Accordingly, as set forth more fully in Part VII, the Advisory Group recommends that the Sentencing Commission:

- Study the supervision of organizations on probation, particularly with respect to implementing compliance programs, and consider whether the statutory maximum of five years is too limiting for this and other purposes of probation

- Study the relationship of the fine table to the statutory maximum fine

- Evaluate the revised definitions of "loss" at §2B1.1 in the context of Chapter Eight and the impact upon organizational defendants

- Focus on training and outreach to small business organizations

The members of the Advisory Group wish to thank the Sentencing Commission for this opportunity to serve the public through its service these past eighteen months, and individual members stand ready to assist the Commission and other policy makers if called upon for further assistance.

III. UNDERSTANDING THE ORGANIZATIONAL SENTENCING GUIDELINES[11]

The Sentencing Commission faces a two-pronged challenge with the organizational guidelines: (1) to create incentives for organizations to put in place policies, practices, and cultures to deter and prevent misconduct; and (2) to punish those that fail to do so. Given these tasks, it is clear that the principles governing organizational criminal liability provide the foundation, which shapes and informs reform efforts in this area. However, the organizational guidelines (Chapter Eight of the *Federal Sentencing Guidelines Manual*) themselves play an equally important role, for their structure, from fine calculations to probation provisions, and the experience gained through their implementation, yield many valuable insights. The current assessment and recommendations of the Advisory Group reflect an appreciation of this context.

A. STANDARDS GOVERNING ORGANIZATIONAL CRIMINAL RESPONSIBILITY

The black letter law of corporate criminal liability is straightforward: a corporation is liable under federal law for the criminal misdeeds of its agents acting within the actual or apparent scope of their employment or authority if the agents intend, at least in part, to benefit the corporation, even though their actions may be contrary to corporate policy or express corporate order. Some commentators contend that this automatic imputation of an agent's wrong to an organization does not necessarily provide a rational basis for separating culpable from non-culpable organizations. As Jennifer Moore has argued:

> The first troubling feature of the theory of imputed culpability is that it imputes to the corporation only the *mens era* of the agent who committed the crime, and ignores the mental states of other corporate agents. But if corporations have "characters,". . . , and if corporate policies and procedures can cause crime, the culpability of the corporate entity is likely to depend on more than the intent of a single agent. By imputing only the *mens era* of the criminal, the imputed culpability theory fails to distinguish between offenses committed with the participation or encouragement of upper management, pursuant to corporate policies or procedures, and those committed by "rogue employees" whose acts violated company policy or could not have been prevented by careful supervision. For this reason, the theory has seemed to many commentators to be unfairly over inclusive. It labels corporations "culpable" even when they do not have a "bad"

[11] Portions of the following sections have been excerpted from JULIE R. O'SULLIVAN, FEDERAL WHITE COLLAR CRIME, Ch. 4 (2d ed. 2003) (c) West Publishing.

> character, that is, even where corporate policies and procedures bear no causal relationship to the crime.[12]

The "over inclusiveness" of *respondent superior* liability is likely to be most troubling in circumstances where the wrongdoing agent's actions are not encouraged by the corporation and indeed are not necessarily in the best interests of the corporation. In such cases, the corporation may look more like a victim than a truly culpable actor.[13] The law is clear, however, that even if corporate agents act contrary to express corporate policy or in spite of good faith corporate compliance efforts, it will not defeat vicarious corporate criminal liability.[14] Despite calls for the creation of a "due diligence" defense for those companies that have acted in good faith to

---

[12] Jennifer Moore, *Corporate Culpability Under the Federal Sentencing Guidelines*, 34 ARIZ. L. REV. 743, 759 (1992).

[13] The requirement that the agent must act with the intention to benefit, at least in part, the organization is supposed to serve as "[o]ne major limitation on the imposition of corporate liability for crimes requiring mens era . . ." Kathleen F. Bricked, *Corporate Criminal Liability: A Primer for Corporate Counsel*, 40 BUS. LAW. 129, 134–35 (1984) (footnotes omitted). At least in theory, the "'intent to benefit rule' serves to prevent successful prosecution of a corporation that is the victim rather than a mere vehicle for criminal conduct, by requiring that the wrongdoing agent must act with some purpose of forwarding corporate business." *Id*. In short, this requirement potentially could be used to bring vicarious liability more in line with assessments of organizational culpability. In practice, however, courts are reluctant to conclude that there was insufficient evidence that the wrongdoing agent intended to benefit the organization and will find liability even where the organizational agent's scheme ultimately resulted in the financial loss from the violation being suffered by the organization due to the agent's fraud on the organization. *See, e.g.*, *United States v. Sun-Diamond Growers of California*, 138 F.3d 961 (D.C. Cir. 1998), *aff'd on other grounds*, 526 U.S. 398 (1999).

[14] *See, e.g.*, *United States v. Hilton Hotel Corp*., 467 F.2d 1000 (9th Cir. 1972).

diligently institute compliance programs,[15] the existing principles of corporate criminal liability do not permit such a defense at the guilt adjudication stage.

Under these *respondent superior* principles, as traditionally employed, vicarious liability may only be imposed where there is a primary violator—that is, where an agent of the corporation has committed a crime. This requirement would seem to imply "that the corporation could not be convicted if the agent committing the *actus reus* lacked the requisite intent."[16] Conceptually, then, difficulties should arise in applying these imputation principles in cases where it is not clear which individual within an organization took the actions (or failed to take the actions) alleged to lead to corporate liability, or where the knowledge or intent necessary to prove the violations may be fragmented among many employees within a large organizational hierarchy. Thus, were *respondent superior* principles to be strictly applied, they would be under inclusive as well as over inclusive because "[t]here are some situations in which corporate policies or procedures do cause a crime, yet the doctrine of *respondent superior* is unable to find the corporation culpable because there is no individual culpability to impute."[17]

This conceptual difficulty has been obviated by the following developments:

---

[15] *See, e.g.*, Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833 (1994) (arguing that strict corporate liability may deter corporate monitoring by making criminal exposure more likely, so that its imposition may increase the likelihood of crime); H. Lowell Brown, *Vicarious Criminal Liability of Corporations for the Acts of Their Employees and Agents*, 41 LOY. L. REV. 279, 324 (1995) ("The fundamental flaw in limiting the benefit of a company's compliance efforts to mitigation of punishment is that the message sent to corporate management is that no matter what the corporation does to prevent criminality in the work force and regardless of the resources that are directed to compliance efforts, the corporation cannot avoid vicarious liability. In such circumstances, even the most conscientious and well intentioned executives must carefully consider whether increasingly scarce resources should be channeled into a compliance program."); Richard S. Gruner and Louis M. Brown, *Organizational Justice: Recognizing and Rewarding the Good Citizen Corporation,* 21 J. CORP. L. 731, 749-65 (1996) (recommending a due diligence defense to criminal liability for firms which operate law compliance programs where such programs are construed and operated in accordance with management principles applied to other types of corporate business performance); *Developments in the Law–Corporate Crime: Regulating Corporate Behavior Through Criminal Sanction*, 92 HARV. L. REV. 1231, 1241-58 (1979) (identifying three different theories of corporate blameworthiness and proposing a standard of liability under which a corporation would be liable under *respondent superior* principles but the corporation could rebut the presumption of liability created by *respondent superior* by proving that it, as an organization, exercised due diligence to prevent the crime); *cf.* Pamela H. Bucy, *Corporate Ethos: A Standard for Imposing Criminal Liability*, 75 MINN. L. REV. 1095, *passim* (1991) (proposing a corporate "ethos" standard of liability that states that a corporation should be found criminally liable only when "its ethos encourages criminal conduct by agents of the corporation.").

[16] John C. Coffee, Jr., *Corporate Criminal Responsibility,* in ENCYCLOPEDIA OF CRIME & JUSTICE 253, 255 (S. Kadish ed., 1983).

[17] Jennifer Moore, *Corporate Culpability Under the Federal Sentencing Guidelines*, 34 ARIZ. L. REV. 743, 762 (1992).

> First, intent may be imputed to the corporation from a person distinct from the one who commits the *actus reus*, such as the supervisory official who realized the significance of the act. Nor has it been necessary for the prosecutor to identify the actual agent who committed the crime if the prosecutor can show that some person within the corporation must have so acted.
>
> Even more significantly, inconsistent verdicts are tolerated under which the corporation is convicted but all conceivable individual agents are acquitted.
>
> Finally, some decisions have accepted a theory of "collective knowledge," under which no single individual had the requisite knowledge to satisfy the intent requirement, but various individuals within the organization possessed all the elements of such knowledge collectively.[18]

The recent jury instructions in the trial of Arthur Andersen LLP for obstruction of justice in connection with the Enron scandal appear to some commentators to be extending the "collective knowledge" theory even further, perhaps into a "collective intent" theory.[19]

In short, the application of these rules provide substantial latitude in the imposition of criminal sanctions on organizations. More important, for present purposes, the standards governing organizational criminal liability are indifferent to the culpability of the organization—as opposed to those agents within the organization—for the criminal acts. Thus, at least at the liability stage, organizations whose policies, practices, procedures, or cultures foster or condone wrongdoing are treated the same as organizations whose rogue agents commit the wrongful acts despite the best efforts of the organizations to promote and police law-abiding behavior.

B. FORMULATION OF THE ORGANIZATIONAL SENTENCING GUIDELINES

In the Sentencing Reform Act of 1984,[20] Congress created the United States Sentencing Commission, as an independent agency within the federal judiciary, and charged it with generating guidelines for federal sentencing proceedings. The Sentencing Commission first promulgated sentencing guidelines applicable to individual defendants in 1987. The Sentencing Commission then turned its attention to the formulation of guidelines for the sentencing of

---

[18]Coffee, *supra* note 6, *Corporate Criminal Responsibility,* in ENCYCLOPEDIA OF CRIME & JUSTICE at 255–56.

[19]*See* Elkan Abramowitz and Barry A. Bohrer, *Andersen Jury Instruction: A New Collective Corporate Liability?*, N.Y. L.J. 3, col. 1 (July 2, 2002).

[20]Pub. L. No. 98-473, 98 Stat. 1987.

organizations. After three years of study by various working groups and public comment,[21] the organizational sentencing guidelines became effective on November 1, 1991.

The Sentencing Commission concluded that existing organizational sentencing practices were incoherent and inconsistent.[22] Judges struggled to find appropriate sanctions to levy on corporate wrongdoers, and scholars disagreed about how best to address corporate crime.[23] Empirical research revealed that corporate offenders that engaged in similar misconduct were treated differently.[24] Further, overall, the fines imposed on such offenders were so low as to be, on average, "less than the cost corporations had to pay to obey the law. This seemed to raise the specter that corporate crime did in fact 'pay,' as some had historically claimed."[25]

The Sentencing Commission also concluded that corporate crime enforcement was subject to two pathologies, "speed trap enforcement" and a "circle the wagons" corporate response.[26] The former involved a reactive policy to corporate lawbreaking. The government seemed to concentrate on nabbing those offenders who came within readily available radar, but little effort was made to create incentives for corporations to prevent the lawbreaking in the first instance. The "circle the wagons" response of corporations to government enforcement efforts grew out of the fact that corporations had little reason to respond in a more constructive fashion. The unpredictability and variation in the sanctions imposed upon convicted corporations meant that there was no obvious incentive to galvanize resources to avoid such sanctions. Indeed, in many cases, the sanctions were less expensive than avoiding liability in the first instance. Further, there

---

[21] *See* Supplementary Report on Sentencing Guidelines for Organizations (August 30, 1991) pp. 1-3 and Appendix B. (Available at USSC).

[22] *See* Ilene H. Nagel & Winthrop M. Swenson, *The Federal Sentencing Guidelines for Corporations: Their Development, Theoretical Underpinnings, and Some Thoughts About Their Future*, 71 WASH. U. L.Q. 205, 214–17 (1993); Winthrop M. Swenson, *The Organizational Guidelines' "Carrot and Stick" Philosophy, and Their Focus on "Effective" Compliance* 1–3, *reprinted in* U.S. SENTENCING COMMISSION, MATERIALS FOR PROGRAM ON CORPORATE CRIME IN AMERICA: STRENGTHENING THE "GOOD CITIZEN" CORPORATION (Sept. 7, 1995).

[23] Nagel & Swenson, *supra* note 12, 71 WASH. U. L.Q. at 214 & n.45.

[24] Preliminary Draft Report to the U.S. Sentencing Commission on the Sentencing of Organizations in the Federal Courts, 1984 - 1987, at p.10, published in Discussion Materials on Organizational Sanctions (July 1988) (available at USSC).

[25] Winthrop M. Swenson, *The Organizational Guidelines' "Carrot and Stick" Philosophy, and Their Focus on "Effective" Compliance* 1–3, *reprinted in* U.S. SENTENCING COMMISSION, MATERIALS FOR PROGRAM ON CORPORATE CRIME IN AMERICA: STRENGTHENING THE "GOOD CITIZEN" CORPORATION (Sept. 7, 1995) at 3; *see also* Ilene H. Nagel & Winthrop M. Swenson, *The Federal Sentencing Guidelines for Corporations: Their Development, Theoretical Underpinnings, and Some Thoughts About Their Future*, 71 WASH. U. L.Q. 205, 215 (1993).

[26] Swenson, *supra* note 15, U.S. SENTENCING COMMISSION, MATERIALS FOR PROGRAM ON CORPORATE CRIME IN AMERICA: STRENGTHENING THE "GOOD CITIZEN" CORPORATION at 3–4.

was no guarantee that corporate cooperation or compliance efforts would be rewarded in a concrete way, either in charging decisions or at sentencing.[27]

Notably, the Sentencing Commission did not limit the new guidelines to corporate or business entities, although much of the discussion focused upon that sector. Instead, the Sentencing Commission applied the guidelines to all organizations, which the federal criminal law defines as "a person other than an individual."[28] The Sentencing Commission explained that this term includes "corporations, partnerships, associations, joint-stock companies, unions, trusts, pension funds, unincorporated associations, government and political subdivisions thereof, and non-profit organizations."[29]

In formulating the organizational sentencing guidelines, the Sentencing Commission considered and rejected a law and economics based "optimal penalties" approach. This approach centered upon a formula designed to achieve fines perfectly calibrated to "bring about perfectly efficient crime-avoiding responses by corporations. Under the approach, fines were to be set according to this formula: the optimal fine = monetized harm (*i.e.*, loss) [divided by the] probability of conviction."[30]

> This approach was really an idealized version of the pre-existing, "speed trap" approach to corporate crime enforcement. It assumed that government policy need be little more than a commitment to catch *some* corporate wrongdoers and fine them. Fines for the unlucky corporations that were caught would then be set in inverse relationship to the likelihood of being caught, and corporate managers—carefully, coldly scrutinizing these perfectly calibrated fines and concluding that crime could not pay—would rationally choose, instead, to spend resources obeying the law.[31]

---

[27] *See id.*

[28] 18 U.S.C. § 18.

[29] USSC §8A1.1, App. Note 1.

[30] Winthrop M. Swenson, *The Organizational Guidelines' "Carrot and Stick" Philosophy, and Their Focus on "Effective" Compliance, reprinted* IN U.S. SENTENCING COMMISSION, MATERIALS FOR PROGRAM ON CORPORATE CRIME IN AMERICA: STRENGTHENING THE "GOOD CITIZEN" CORPORATION (SEPT. 7, 1995) AT 5.

[31] *Id.*

In the final analysis, the optimal penalties approach was rejected for a variety of reasons. Perhaps the most significant of these was the difficulty encountered in reducing to an administrable and consistent formula the likelihood of conviction for particular kinds of offenses.[32]

Ultimately, the Sentencing Commission adopted what some characterize as a "carrot and stick," and others term a "deterrence and just punishment" approach:

> The centerpiece of the Sentencing Guidelines structure is the fine range, from which a sentencing court selects the precise fine to impose on a convicted organization. The [Sentencing] Commission designed the guideline provisions that established the fine range to meld the two philosophical approaches to sentencing emphasized in the enabling legislation: just punishment for the offense, and deterrence. By varying the fine based on whether, and to what extent, a company has acted "responsibly" with respect to an offense, the Guidelines embody a "just punishment for the offense" philosophy. Consistent with this paradigm, the Guidelines provide for substantial fines when a convicted organization has encouraged, or has been indifferent to, violations of the law by its employees, but impose significantly lower fines when a corporation has clearly demonstrated in specified ways its antipathy toward lawbreaking. At the same time, the guideline structure embodies principles derived from the deterrence paradigm. The specified ways in which a convicted organization may demonstrate its intolerance of criminal conduct, thus entitling it to a more lenient sentence, are actions that, at least theoretically, should discourage employees from committing offenses.[33]

The "carrot and stick approach" grew out of the Sentencing Commission's acceptance of three propositions. First and foremost, the Sentencing Commission recognized that the *respondent superior* principles of liability did not adequately respond to gradations in organizational culpability. The simple equation of the organization with the organizational actor necessary for liability does not reflect on the relative blameworthiness of the organization itself.[34]

---

[32] Ilene H. Nagel & Winthrop M. Swenson, *The Federal Sentencing Guidelines for Corporations: Their Development, Theoretical Underpinnings, and Some Thoughts About Their Future*, 71 WASH. U. L.Q. 205, 219-22 (1993).

[33] *Id.* at 210–11.

[34] Winthrop M. Swenson, *The Organizational Guidelines' "Carrot and Stick" Philosophy, and Their Focus on "Effective" Compliance* 1, *reprinted in* U.S. SENTENCING COMMISSION, MATERIALS FOR PROGRAM ON CORPORATE CRIME IN AMERICA: STRENGTHENING THE "GOOD CITIZEN" CORPORATION (Sept. 7, 1995) at 5 ("The Sentencing Commission came to recognize that the doctrine of vicarious criminal liability for corporations operates in such a way that very different kinds of corporations can be convicted of crimes; from companies whose managers did everything reasonably possible to prevent and uncover wrongdoing, but whose employees broke the law anyway, to

Second, the Sentencing Commission came to believe that organizations could "hold out the promise of fewer violations in the first instance and greater detection and rededication of offenses when they occur"[35] through the following: internal discipline; reformation of standard operating procedures; auditing standards, and the organizational culture; and the institution of compliance programs. Finally, the Sentencing Commission concluded that it could create incentives for responsible organizational actors to foster crime control by the creation of a mandatory guidelines penalty structure that rewarded responsible organizational behavior by mitigating punishment and sanctioned truly culpable organizations. The Sentencing Commission structured its framework to create a model for the good "corporate" citizen; use the model to make organizational sentencing fair and predictable; and ultimately employ the model to create incentives for organizations to take steps to deter crime.

C. PRIMER ON THE ORGANIZATIONAL SENTENCING GUIDELINES

The organizational sentencing guidelines in Chapter Eight have three principal substantive parts: (1) Part B—"Remedying the Harm From Criminal Conduct;" (2) Part C—"Fines;" and (3) Part D—"Organizational Probation." Each of these will be discussed briefly below.

1. Rededication and Restitution Provisions: Part B

Part B, dealing with remedying the harm from the offense, and Part D, dealing with organizational probation, apply to the sentencing of all organizations[36] for felony and Class A misdemeanor offenses.[37] Part B is intended to be remedial, not punitive. Regardless of the perceived culpability of an organization, the Sentencing Commission determined that all convicted organizations must be required to remedy any harm caused by the offense.[38] This will generally take the form of an order of restitution "for the full amount of the victim's loss."[39] It may also take the form of remedial orders requiring the organization "to remedy the harm caused by the offense and to eliminate or reduce the risk" that the offense will cause future harm.[40]

---

companies whose managers encouraged or directed the wrongdoing.").

[35] *Id.* at 6.

[36] *See* USSG §8A1.1, Application Note 1 (" 'Organization' means 'a person other than an individual' " and includes, among other entities, corporations, partnerships, unions, unincorporated organizations, governments and political subdivisions thereof, and non-profit organizations).

[37] *Id.* §8A1.1.

[38] *Id*. Chapter 8, Introductory Commentary.

[39] *Id.* §8B1.1 ("Restitution – Organizations").

[40] *Id.* §8B1.2 ("Remedial Orders—Organizations").

For example, if an organization's wrongdoing caused $10 million in losses, it will generally be required to make restitution in that amount *and* to pay a fine that may amount to as much as $40 million (or more if an upward departure, e.g., increase to the recommended fine range, is warranted). An order of restitution is not appropriate "when full restitution has been made" or when the court finds that "the number of identifiable victims is so large as to make restitution impracticable."[41] It is also not required when "determining complex issues of fact related to the cause or amount of the victim's losses would complicate or prolong the sentencing process to a degree that the need to provide restitution to any victim is outweighed by the burden on the sentencing process."[42]

2. Fine Provisions: Part C

a. Limitations on Applicability of Fine Provisions

It is important to note at the outset that the fine provisions of Part C do not apply to all organizational sentencings. First, although Parts B and D apply to all federal felony and Class A misdemeanor convictions, §8C2.1 lists those offenses that are not covered by the fine provisions in Part C. Important categories of cases, such as environmental offenses food and drug, RICO, and export control violations, are *not* presently covered by the fine guidelines.[43] The fines for such excluded offenses must be determined by reference to traditional criteria contained in the general sentencing provisions of Title 18.[44]

A second, preliminary qualification is that where it is "readily ascertainable that the organization cannot and is not likely to become able (even on an installment schedule) to pay restitution," no fine calculation need be done because restitution obligations trump any fine imposed.[45] Further, where it is "readily ascertainable through a preliminary determination of the minimum of the guideline fine range" that the organization cannot pay and is unlikely to become able to pay the minimum fine, the court need not engage in further application of the fine guidelines.[46] Instead, the court will use the preliminary determination and impose a fine based on the guidelines section that provides for reductions in fines due to inability to pay.[47]

---

[41]*Id.* §8B1.1(b)(1)(2).

[42]*Id.* §8B1.1(b)(2).

[43]*See* Ilene H. Nagel & Winthrop M. Swenson, *The Federal Sentencing Guidelines for Corporations: Their Development, Theoretical Underpinnings, and Some Thoughts About Their Future*, 71 WASH. U. L.Q. 205, 254 &n. 268 (1993).

[44]*See* USSG §8C2.10 (requiring courts to apply provisions of 18 U.S.C. §§ 3553, 3572).

[45]USSG §8C2.2(a); *see also id.* §8C3.3(a).

[46]*Id.* §8C2.2(b).

[47]*Id.*; *see also id.* §8C3.3 (Reduction of Fine Based on Inability to Pay).

Another limitation is one that applies to the guidelines generally—*the statutory maximum (or where applicable, minimum) sentence always trumps the guideline-calculated sentencing range*. Thus, even if, after applying the fine guidelines, the court arrives at a fine range that exceeds the maximum set by statute, the court *may not* exceed the statutory maximum.[48]

In general, the statutory maximum for a given count is the *greatest* of (1) the amount (if any) specified in the law setting forth the offense; (2) for an organization convicted of a felony, $500,000; or (3) "[i]f any person derives pecuniary gain from the offense, or if the offense results in pecuniary loss to a person other than the defendant, the defendant may be fined not more than the greater of twice the gross gain or twice the gross loss, unless imposition of a fine under this subsection would unduly complicate or prolong the sentencing process."[49] This last provision, known as the "twice gross gain or loss" provision, is likely to be the applicable figure in many cases, especially where the dollar amount of the defendant's gain or victim's loss is great.

Last, the fine provisions do not apply where the organization qualifies for an organizational "death sentence." Thus, where the court determines that the organization "operated primarily for a criminal purpose or primarily by criminal means, the fine shall be set at an amount (subject to the statutory maximum) sufficient to divest the organization of all its net assets."[50]

b. Determining the Fine Under the Fine Guidelines

If the Chapter Eight fine provisions apply, the proceeds through the steps described below. In general terms, the fine range is said to be a *product* of the *seriousness* of the offense and the *culpability* of the organization.

The *seriousness* of the offense committed is computed and reflected in a number called the "Base Fine."[51] The "Base Fine" is the greatest of (1) the amount from a table corresponding to a calculation under the individual guidelines; (2) the pecuniary gain to the organization from the offense; or (3) the pecuniary loss from the offense caused by the organization, to the extent that the loss was intentionally, knowingly, or recklessly caused.[52]

The *culpability* of the organization is assessed by totaling the organization's "Culpability Score."[53] One begins the computation with a score of five. Points are then added or subtracted

---

[48] *See id.* §8C3.1(b), (c).

[49] *See* 18 U.S.C. § 3571 (Sentence of Fine).

[50] *Id.* §8C1.1 ("Determining the Fine—Criminal Purpose Organizations").

[51] USSG §8C2.4.

[52] *Id.*

[53] *Id.* §8C2.5.

depending upon the existence or absence of certain factors that the Sentencing Commission concluded aggravate or mitigate the organization's culpability in the crime.

1. Aggravating Factors

A range of points may be added to the calculation depending upon the size of the organization (or unit of the organization within which the offense was committed) and "the hierarchical level and degree of discretionary authority" of the individuals who participated in or tolerated the illegal behavior.[54] For example, if an individual within high-level personnel of an organization with 5,000 or more employees participated in, condoned, or was willfully ignorant of the offense, five points will be added to the culpability score. If the organization had only 200 employees, and the same circumstances were present, only three points are added.

Points may also be added to the organization's culpability score if the organization had a fairly recent prior history of similar misconduct,[55] if the commission of the offense violated a judicial order or injunction or a condition of probation,[56] or if the organization willfully obstructed or attempted to obstruct justice during the investigation, prosecution, or sentencing of the offense.[57]

2. Mitigating Factors

There are two provisions under which organizational defendants may have points deducted from their culpability score. First, a credit of three points is permitted if "the offense occurred despite an effective program to prevent and detect violations of law."[58] It is important to note that this provision contains a number of express disqualifiers. This credit may not apply if certain highly-placed individuals within the organization participated in, condoned, or were willfully ignorant of the offense.[59] Second, this credit "does not apply if, after becoming aware of an offense, the organization unreasonably delayed reporting the offense to appropriate governmental authorities."[60]

---

[54] *See* Ilene H. Nagel & Winthrop M. Swenson, *The Federal Sentencing Guidelines for Corporations: Their Development, Theoretical Underpinnings, and Some Thoughts About Their Future*, 71 WASH. U. L.Q. 205, 238 (1993) (discussing rationale for selection of these factors); *see also id.* at 248–51 (discussing rationale for reliance on size of organization).

[55] USSG §8C2.5(c) ("Prior History").

[56] *Id.* §8C2.5(d) ("Violation of an Order").

[57] *Id.* §8C2.5(e) ("Obstruction of Justice").

[58] *Id.* §8C2.5(f) ("Effective Program to Prevent and Detect Violations of Law").

[59] *Id.*

[60] *Id.*

The organizational sentencing guidelines defines an "effective program to prevent and detect violations of law" as a "program that has been reasonably designed, implemented, and enforced so that it generally will be effective in preventing and detecting criminal conduct."[61] At a minimum, the guidelines state that an effective compliance program means that organizations exercised "due diligence in seeking to prevent and detect criminal conduct by [their] employees and other agents,"[62] as evidenced by taking the following seven 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.
>
> (2) Specific individual(s) within high-level personnel of the organization must have been assigned overall responsibility to oversee compliance with such standards and procedures.
>
> (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.
>
> (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.
>
> (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.
>
> (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.
>
> (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

---

[61] *Id.* §8A1.2, Application Note 3(k).

[62] *Id.*

offenses—including any necessary modifications to its program to prevent and detect violations of law.[63]

The Sentencing Commission contemplated that different organizations in different industries will have to use this general framework to create programs that work for them. Among the relevant factors to be considered in tailoring an effective compliance program are: the size of the organization, the likelihood that certain offenses may occur because of the nature of the organization's business, and the prior history of the organization.[64]

The second way in which an organization may reduce its culpability score is by self-reporting, cooperation, and acceptance of responsibility.[65] The credits to be accrued are graduated depending upon just how much the organization is willing to do. Thus, an organization earns just one point for acceptance of responsibility, that is, for pleading guilty. But, if the organization is willing to "fully cooperate in the investigation" and plead guilty, it may secure two credit points. Finally, if the organization, "prior to an imminent threat of disclosure or government investigation," and "within a reasonably prompt time after becoming aware of the offense," reports the offense to government authorities, fully cooperates, and then pleads guilty, the organization will gain five mitigating points.[66]

c. Further Fine Calculations

After the culpability score calculation is complete, reference should be made to the chart at §8C2.6 in which each culpability score is given a "minimum multiplier" and a "maximum multiplier."[67] These multipliers are then applied at the Base Fine amount (by reference to §8C2.4), and the result is a fine range.

For example, assume that the Base Fine for the loss from a criminal episode is determined to be $10 million. Assume further that the culpability score for the organization is nine: the five points with which the calculation begins, plus five points for the organization's size and level of management participation, and minus one point for acceptance of responsibility. Reference to the multiplier chart at §8C2.6 indicates that a culpability score of nine means that by multiplying the base fine (here, $10 million) by the culpability multipliers that correspond to the culpability score (here, 1.80 and 3.60), the guideline fine range is between $18 million and $36 million.

---

[63] *Id.*

[64] *Id.*

[65] USSG §8C2.5(g) ("Self–Reporting, Cooperation, and Acceptance of Responsibility").

[66] *See id.*

[67] *Id.* §8C2.6 ("Minimum and Maximum Multipliers").

This example may serve to illustrate the importance of an effective compliance program and cooperation credits. If in the hypothetical case, the organization had earned three points for an effective compliance program, its culpability score would have been reduced to six, its multipliers to 1.20 and 2.40, and its final fine range to between $12 million and $24 million. If the organization had self-reported, cooperated, and pleaded guilty, even without an effective compliance program, its culpability score would have been five, its multipliers 1.00 and 2.00, and its fine range between $10 million and $20 million.

This example may also demonstrate the importance of prosecutorial charging choices. In many cases, the statutory maximum—which, always " trumps" the guidelines—will be set at twice the gross gain or loss.[68] Because the multipliers can be higher than 2.0 (for anything over a culpability score of 5), in some cases, unless the prosecutor charges multiple counts,[69] the organizational sentence may be capped at either $500,000 or twice the gross gain or loss under 18 U.S.C. § 3571, regardless of the organization's culpability level or multipliers.

The organizational sentencing guidelines set forth the factors that judges are to consider in determining the amount of the fine *within* the applicable guideline range.[70] These are again factors that the Sentencing Commission deemed relevant to assessment of organizational culpability, and they include the organization's role in the offense, any nonpecuniary loss caused or threatened by the offense, prior misconduct by the organization not previously counted, and any prior criminal record of high-level personnel in the organization.[71]

One of these factors deserves particular mention. The Sentencing Commission recognized the reality that organizations convicted of a federal felony are likely to be subject, in addition to criminal sanctions, to substantial collateral penalties such as debarment from government contracting, treble civil damages, shareholder derivative actions, regulatory fines, and other similar sanctions.[72] "For both substantive and technical reasons," however, the Sentencing Commission decided to provide "no direct offset for collateral sanctions" that might be imposed

---

[68]*See* 18 U.S.C. § 3571.

[69]The statutory maximum for one charging instrument is the sum of the statutory maximums for all the counts charged in that instrument. Thus, if it appears that the organization's statutory maximum for one count will be lower than its guidelines exposure, prosecutors may be able to cure this problem by bringing multiple counts.

[70]USSG §8C2.8 ("Determining the Fine Within the Range (Policy Statement)").

[71]*Id.*

[72]*See* Ilene H. Nagel & Winthrop M. Swenson, *The Federal Sentencing Guidelines for Corporations: Their Development, Theoretical Underpinnings, and Some Thoughts About Their Future*, 71 WASH. U. L.Q. 205, 245 (1993).

on organizational defendants, but rather to provide means by which such sanctions may be taken into account by the sentencing court.[73]

Consideration may be given to whether a judge should *depart from* the prescribed guidelines fine range. Among the express grounds upon which such a departure may be based are the following circumstances: substantial assistance to the authorities in the investigation or prosecution "of another organization that has committed an offense, or in the investigation and prosecution of an individual not directly affiliated with the defendant who has committed an offense";[74] risk of death or bodily injury,[75] threats to national security,[76] to the environment,[77] or to a market[78] flowing from the offense; remedial costs that greatly exceed the gain from the offense;[79] or exceptional organizational culpability.[80]

Also, a court is required to reduce the fine below the otherwise applicable guidelines fine range "to the extent that imposition of such a fine would impair [the organizational defendant's] ability to make restitution to victims."[81] The court *may,* but is not required to, impose a fine below the guidelines range where the court finds that "the organization is not able and, even with the use of a reasonable installment schedule, is not likely to become able to pay the minimum fine."[82] The Ninth Circuit underscored the discretionary nature of this latter dispensation in holding that the guideline permitting the court to reduce any fine because of the organization's inability to pay did not prohibit the court from imposing a fine which substantially jeopardized

---

[73]*Id.* at 246–48. The Sentencing Commission determined that, with one limited exception for fines imposed on substantial owners of closely held corporations, *see* USSG §8C3.4, there should be "no direct and automatic offset in the corporate fine for penalties imposed on individuals." *Id.* at 244. It should be noted that the offset under §8C3.4 is discretionary, and in any case must be sought before the judgment including the organization's fine becomes final. *See United States v. Aqua–Leisure Industries*, *Inc.*, 150 F.3d 95 (1st Cir. 1998).

[74]USSG §8C4.1. It is important to note that the language of this rule seems to preclude corporations from obtaining substantial assistance departures merely by cooperating with the government in its prosecution of the organizational agent who is responsible for the organization's culpability. *See id.*, Application Note 1.

[75]*Id.* §8C4.2.

[76]*Id.* §8C4.3.

[77]*Id.* §8C4.4.

[78]*Id.* §8C4.5.

[79]*Id.* §8C4.9.

[80]*Id.* §8C4.11.

[81]*Id.* §8C3.3(a); *see United States v. Flower Aviation*, 1996 WL 38731 (D. Kan. 1996).

[82]*Id.* §8C3.3(b).

the continuing viability of the defendant "so long as the fine did not impair [the defendant's] ability to make restitution."[83]

"Immediate" payment of any fine imposed is required if the organizational "death sentence" has been imposed.[84] "Immediate" payment is also required in any other case unless the court finds that the organization is financially unable to make such a payment or such a payment would impose an undue burden on the organization.[85]

3. Organizational Probation Provisions: Part D

Part D, dealing with organizational probation, like the restitution provisions of Part B, applies to all organizations convicted of federal felonies or Class A misdemeanors. A term of organizational probation is *required* in many circumstances—two of the most common being (1) where immediate payment is excused, if probation is necessary to ensure that restitutionary or remedial obligations are met or that the fine is paid, or (2) if, at the time of sentencing, an organization having 50 or more employees does not have an effective compliance program in place.[86] Given that a court deemed an effective compliance program to have been in place in only three reported cases sentenced under the organizational fine guidelines between 1991 and 2001, probation is likely to be required in the overwhelming majority of cases. The Sentencing Commission provided courts with discretion to impose probation where the court concludes that the purposes of criminal punishment dictate,[87] or where necessary to ensure that changes are made within the organization to prevent future law-breaking.[88]

In the case of a felony, the term of probation is at least one year but not more than five years,[89] and the sentence of probation must include conditions of probation barring the organization from committing further crimes during the probationary period and providing for restitution or victim notification unless it would be unreasonable to do so.[90] If an organization violates the conditions of its probation, a sentencing court has a number of options: it may extend

[83] *United States v. Eureka Laboratories, Inc.,* 103 F.3d 908, 912 (9th Cir. 1996).

[84] USSG §8C3.2(a).

[85] *Id.* §8C3.2(b).

[86] USSG §8D1.1(a)(1), (2), (3).

[87] *Id.* §8D1.1(a)(8).

[88] *Id.* §8D1.1(a)(6).

[89] *Id.* §8D1.2(a)(1).

[90] *Id.* §8D1.3(a), (b).

the term of probation, impose more restrictive conditions, or revoke probation and resentence.[91] However, even in the case of a violation, the court may not extend the probationary term and accompanying conditions beyond the statutory maximum of five years.

As a condition of probation, the court may order the convicted organization to take a variety of actions intended to punish and deter corporate misconduct. "The court may order the organization, at its expense and in the format and media specified by the court, to publicize the nature of the offense committed, the fact of conviction, and the nature of the punishment imposed, and the steps that will be taken to prevent the recurrence of similar offenses."[92] If probation is imposed to ensure that the organization meets its restitutionary or fine obligations, the court may order a number of steps. For example, the court may order the organization to make "periodic submissions to the court or probation officer, at intervals specified by the court, reporting on the organization's financial conditions and results of business operations, and accounting for the disposition of all funds received."[93]

The court may also order that the organization submit to regular or unannounced examinations of its books and records by the probation officers or experts hired by the court (but paid by the organization) and "interrogation of knowledgeable individuals within the organization."[94] Finally, if probation is ordered for other reasons, including the absence of an effective compliance program, the court may order the organization to develop and submit to the court a compliance plan, to notify its employees and shareholders of its criminal behavior and its new program, to make periodic reports to the court or probation officer regarding the progress of the compliance program, and to submit to the types of examinations of books and records and "interrogation[s]" mentioned above.[95]

D. SENTENCING DATA

---

[91] *Id.* §8D1.5.

[92] *Id.* §8D1.4(a).

[93] *Id.* §8D1.4(b)(1).

[94] *Id.* §8D1.4(b)(2).

[95] *Id.* §8D1.4(c). For example, in *United States v. Sun–Diamond Growers of California*, in which the defendant cooperative did not have an extant compliance program, the district judge required as conditions of probation that the defendant submit a compliance program for the court's approval, make quarterly reports to demonstrate its progress in implementing the program, and submit to inspections of its books and records, as well as interviews of knowledgeable individuals, to ensure compliance. On appeal, the D.C. Circuit held invalid only that portion of the sentence that imposed reporting requirements on members of the defendant cooperative on the theory that those members were not defendants or even agents of the defendant organization. 138 F.3d 961, 977 (D.C. Cir. 1998), *aff'd on other grounds*, 526 U.S. 398 (1999).

The data contained in the Sentencing Commission's Annual Reports,[96] as well as data from outside researchers, provides certain helpful information, but it is rather limited in showing trends. The data does not provide an adequate basis for identifying trends because the sample sizes are generally small, the fine guidelines are not applicable in many cases, and the Commission does not receive data on every organizational case sentenced.[97]

Sentencing Commission data reflects that 1,642 organizations have been sentenced under Chapter Eight since the Commission began receiving this information.[98] The fine guidelines apply to less than 65% of the cases in the past three years because the fine guidelines at §8C2.1 do not apply to certain categories of offenses, such as environmental crimes and food and drug crimes, among others. In addition, the fine guidelines are not used when an organization does not have the ability to pay a fine, which is the case in a significant number of cases. In fiscal year 2001, for example, organizational defendants were unable to pay either a portion or the entire fine in 36% of the cases in which organizations were sentenced. As a result, the Commission receives information on a sentenced organization's culpability score factors in less than half the cases. Last year, for example, that information was available for 94 of the 238 organizations sentenced, which was 39% of the cases received.

Despite these limitations, a recent study concluded that "criminal fines and total sanctions are significantly higher in cases constrained by the Guidelines than they were prior to the Guidelines. Controlling for other factors, criminal fines in cases constrained by the Guidelines are almost five times their previous levels. Total sanctions are also significantly higher, with the percentage increase about half that for criminal fines."[99]

---

[96]The data for organizations sentenced under Chapter Eight begins in fiscal year 1993. *See* <http://www.ussc.gov/corp/organizsp.htm> for a collection of all the Sentencing Commission's data relevant to organizational sentencing from 1995 to the present.

[97]In recent years, Commission staff has supplemented its case collection by using information from the media and the U.S. Department of Justice press releases to identify and collect information on a substantial number of organizational cases that were not covered by data received from the sentencing courts.

[98]28 U.S.C. §§ 995(14) & (15) empower the Commission to "publish data concerning the sentencing process" and "collect systematically and disseminate information concerning sentences actually imposed . . . .". The PROTECT ACT recently amended the Sentencing Reform Act at 28 U.S.C. § 994(w) to require that the Chief Judge of each district ensure certain sentencing documents be submitted to the Commission: the judgment and commitment order; the statement of reasons for the sentence imposed (including the *written reason for any departure*); any plea agreement; the indictment or other charging document; and the presentence report). *See* Section 401(h) of Pub. L. No. 108-21 (April 30, 2003).

[99]Cindy R. Alexander, Jennifer H. Arlen & Mark Cohen, *The Effect of Federal Sentencing Guidelines on Penalties for Public Corporations*, 12 FED. SENTENCING REP. 20, 20 (July/Aug.1999); *see also* Cindy R. Alexander, Jennifer H. Arlen & Mark A. Cohen, *Regulating Corporate Criminal Sanctions: Federal Guidelines and the Sentencing of Public Firms*, 42 J. LAW & ECON. 393 (1999).

According to Commission data, the average organizational fine in fiscal year 1995 was $242,892, and the median fine was $30,000. In fiscal year 2001, the average fine was $2,154,929, and the median fine was $60,000.[100]

The Commission's data, along with information collected from outside sources, is helpful in identifying the kinds of organizations being sentenced and the relevant characteristics of sentenced organizations. A majority of the organizational defendants sentenced under the guidelines have been small, closely-held companies.[101] In FY 2001, for example, approximately 27.5% of the organizational defendants in the Commission's data file had 10 or fewer employees, 66.4% had 50 or fewer employees, 77.2% had 100 or fewer employees, and 7.4% had 1,000 or more employees.[102] This is not surprising because the overwhelming majority of business establishments in the United States have less than 1,000 employees.[103] In most organizational cases sentenced, high-level personnel or an individual with substantial authority participated in, condoned, or was willfully ignorant of the offense.[104]

For fiscal years 1993 through 2001, the Sentencing Commission received culpability score information for 812 organizational cases sentenced under the fine guidelines. According to that data, only three organizations (0.4%) have ever received credit at sentencing for having an effective program to prevent and detect violations of law. The information provided to the Commission does not contain enough information to discern why specific organizations did not qualify for a culpability score credit for having an effective program.[105]

Of the 812 cases with culpability score information for fiscal years 1993 through 2001, 222 (28%) organizational defendants accepted responsibility and received credit under §8C2.5(g)(3). In that same period, 444 (55%) organizational defendants obtained cooperation credit under

---

[100]*See* the Sentencing Commission's Annual Reports, collected at <http://www.ussc.gov/corp/organizsp.htm>.

[101]John R. Steer, *Changing Organizational Behavior – The Federal Sentencing Guidelines Experiment Begins to Bear Fruit*, 1291 PLI/CORP. 131,138 (Feb. 2002).

[102] Information about the size of the organization is not available for 37% of the organizations sentenced.

[103]U.S. Census Bureau, Statistical Abstract of the United States 2001, Section 15, Tables 710-727. This data reflects that in 1999 there were 7,008,000 establishments in the United States (establishment is defined as a single physical location where business is conducted or services or industrial operations are performed). Of those, only 7,000 establishments (.1%) had over 1,000 employees. *Id*. at Table 723.

[104]In the past several years, for example, between 65 and 70% of all organizations were given additional culpability score points on this basis. *See* Annual Reports for FY 1999, 2000 and 2001 at <http://www.ussc.gov/corp/organizsp.htm>.

[105]The guidelines provide that an organization cannot get credit for an effective program if high-level or substantial authority personnel participated in, condoned, or was willfully ignorant of the offense. The data does show that most of the organizations sentenced have been quite small, and it also indicates that a majority of organizations sentenced received culpability points for participation or willful ignorance by high-level personnel.

§8C2.5(g)(2). In only nine cases (7%) did the organizational defendant receive credit for self-reporting pursuant to §8C2.5(g)(1).

The extremely small number of organizations that received credit at sentencing for effective compliance programs and self-reporting, based on Commission data files, is potentially misleading because it seriously understates the value of an effective compliance program. A number of government programs offer leniency to organizations that self-report violations in a timely manner, such as the U.S. Department of Justice's Antitrust Division's Corporate Amnesty policy.[106] Current and former U.S. Department of Justice officials have stated to the Advisory Group that the U.S. Department of Justice has declined prosecutions based on the existence of an effective compliance program.[107] An effective compliance program enables organizations to detect violations at an earlier stage than might otherwise occur, and it may thus give them the opportunity to self-report and qualify for lenient treatment under government policies.[108]

For purposes of encouraging a better understanding of the types of compliance practices promoted by the organizational sentencing guidelines, the Advisory Group recommends that the Sentencing Commission's future data collection efforts include findings for each sentenced organization concerning the presence and quality of each of the seven steps specified in the guidelines as necessary features of an "effective program to prevent and detect violations of law." Also, the Advisory Group suggests that the Sentencing Commission encourage the U.S. Department of Justice and other federal agencies to provide more visibility and information on the frequency with which lenient treatment of organizations results from effective compliance efforts, whether it be in the criminal, civil, or administrative areas. The Advisory Group believes that an important part of preventing and deterring organizational violations of law resides in keeping the public informed in an appropriate way about how organizations are "rewarded" for being "good

---

[106] *See* the Department of Justice, Antitrust Division, Corporate Leniency Policy: <http//www.usdoj.gov/atr/public/guidelines/0091.htm>.

[107] For example, Carbide/Graphite Group of Pittsburgh received amnesty for self-reporting about a steelmaking conspiracy involving Showa Denko Carbon., and Showa Denko itself received a significantly lower fine because it cooperated with the government in a timely fashion. *See* Janet Novack, *Fix and Tell,* FORBES, May 4, 1998, at 46. In 1999, then Deputy Assistant Attorney General Gary R. Spratling (Antitrust Division, Department of Justice) observed that amnesty applications in the antitrust area for self-reporting companies had increased from one a year to two a month. The Bar Association of the District of Columbia's 35th Annual Symposium on Associations and Antitrust (Feb. 16, 1999) available at: <http://www.usdoj.gov/atr/public/speeches/2247.htm>.

[108] *See also* the announcement by U.S. Attorney's Office not to prosecute Coopers & Lybrand because of its cooperation in connection with the investigation of then-indicted (later convicted) former Arizona Governor Fyfe Symington. Andy Pasztor, *Coopers Settles in Symington Dealings,* WALL ST. J., Sept. 23, 1996, at B12. *See also* the Deferred Prosecution Agreement between PNC ICLC Corp and the Department of Justice entered into in part based on the company's cooperation with the government (W.D. Pa. June 2, 2003) available at: <http://www.usdoj.gov/opa/pr/2003/June/03_crm_329.htm>. Another example is illustrated by the fact that John Morrell & Company and several of Morrell's corporate officials were convicted of conspiracy and Clean Water Act felonies, but the government declined to prosecute the parent company based primarily on the company's voluntary disclosure and cooperation. *See The U.S. Department of Justice News Release,* February 21, 1996, 1996 WL 72865 (The U.S. Department of Justice).

corporate citizens" through compliance programs, self-reporting and cooperation with public authorities encouraged by the organizational sentencing guidelines.

E. SUCCESS OF ORGANIZATIONAL SENTENCING GUIDELINES IN FOCUSING ATTENTION ON COMPLIANCE PROGRAMS

Central to the "carrot and stick" philosophy underlying the organizational sentencing guidelines is the three-point credit an organization can obtain in the calculation of its culpability score under §8C2.5(g) for having an "effective program to prevent and detect violations of law" (effective program). The definition of such an effective program is contained in §8A1.2, Application Note 3(k), which states:

> 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.

The Commentary to §8A1.2 goes on to specify seven steps an organization must have taken "at a minimum" to demonstrate that the organization "exercised due diligence in seeking to prevent and detect criminal conduct by its employees and other agents."[109] The Sentencing Commission charged the Advisory Group with determining whether changes in the legal or business landscape or sentencing experience over the past ten years counsel that amendments be made to this fundamental provision of the organizational sentencing guidelines.

Various members of the Sentencing Commission have expressed the belief that the organizational sentencing guidelines "not only provide incentives for substantial changes in organizational behavior, but also further some of the main goals of the Sentencing Reform Act, namely, the prevention and deterrence of criminal conduct."[110] As one Commissioner has

---

[109]USSG §8A1.2, Application Note 3(k).

[110]Diana E. Murphy, *The Federal Sentencing Organizational Guidelines for Organizations: A Decade of Promoting Compliance and Ethics*, 87 IOWA L. REV. 697, 699 (2002); *see also* John R. Steer, *Changing Organizational Behavior–The Federal Sentencing Organizational Guidelines Experiment Begins to Bear Fruit*, 1291 PLI/CORP. 131, 148-49 (Feb. 2002).

recently recognized, it is difficult as yet to empirically test this belief.[111] Based on its comprehensive examination described in the Introduction, however, the Advisory Group concludes that there is abundant evidence that the organizational sentencing guidelines have, directly and indirectly, galvanized organizations to focus on their responsibility to detect and prevent violations of law and to institute compliance programs towards this goal.

The practice literature widely attributes a compliance boom to the mitigation credit offered by the organizational sentencing guidelines. As some commentators have noted, "[w]ithout question, the organizational sentencing guidelines' greatest practical effect thus far is to raise the business community's awareness of the need for effective compliance programs."[112] Although such programs are not generally legally mandated, continue to be legally irrelevant to the application of *respondent superior* liability, and are only relevant under the organizational sentencing guidelines to provide a reduction in criminal fines, some experts in this growing field have gone so far as to contend that "[f]or a general counsel to ignore [implementation of a compliance program under] these organizational sentencing guidelines is professional malpractice."[113] Further, other practitioners have recently observed that:

> Before 1991, when the [Federal Sentencing Guidelines for Organizations (FSGO)] were promulgated, no professional association of compliance and ethics officers existed, there was very little literature on the practicalities of managing compliance programs, few conferences focused on the topic, and, truth be told, too few companies outside the defense industry had sophisticated compliance

---

[111]*See, e.g.*, Steer, 1291 PLI/CORP. at 149 (noting that lack of empirical data means that it is not presently possible "to assess directly the success, or lack thereof, of the organizational sentencing guidelines in altering the rates at which organizations commit crimes," but noting studies that show companies are enhancing or instituting compliance programs in response to the organizational sentencing guidelines' incentives). *See also* Jeffrey S. Parker & Raymond A. Atkins, *Did the Corporate Criminal Sentencing Guidelines Matter? Some Preliminary Empirical Observations,* 42 J. LAW & ECON. 423, 443 (1999) (concluding that the data "are too few and ambiguous to draw even tentative conclusions" regarding changes effected by the organization sentencing guidelines on the incidence of compliance programs in the post-organizational sentencing guidelines world). It is worth noting the fact that the overwhelming majority of organizations sentenced since the institution of the organizational sentencing guidelines did not secure credit for having an effective program to detect and prevent violations of law does not mean that the organizational sentencing guidelines have been a failure in promoting such programs. The dearth of companies securing such credit may well reflect the fact that companies with effective programs commit few offenses or, when offenses do occur, the Department of Justice is declining to prosecute entities with effective programs. *See* discussion at Part VI. Further, it appears that most of the companies sentenced are disqualified from receiving such credit because senior officials in the company participated in, or at least tolerated, the misconduct, and thus the company was disqualified from receiving effective program credit regardless of whatever programs it had in place. *See* discussion at Part III, Section D.

[112]Dan K. Webb & Steven F. Molo, *Some Practical Considerations in Developing Effective Compliance Programs: A Framework for Meeting the Requirements of the Sentencing Guidelines*, 71 WASH. U.L. Q. 375, 375 (1993).

[113]Michele Galen, *Keeping the Long Arm of the Law at Arm's Length*, BUS. WK., Apr. 22, 1991, at 104 (quoting Professor John C. Coffee, Jr.).

programs. Most companies had policies, but the kind of comprehensive model for effective compliance prevention and detection outlined in the FSGO had yet to be widely adopted.

After 1991, this situation changed dramatically. The Ethics Officer Association ("EOA") was formed in 1992 with 12 members and, as a direct response to the FSGO, has ballooned to more than 800 in 2002 and to nearly 1,000 members in 2003. EOA's members regularly meet to share best practice information on how to implement and sustain compliance programs that meet the FSGO standards. Members include in-house compliance and ethics officers from about half of the Fortune 500. Other compliance associations specific to various industries, such as telecommunications and pharmaceutical, and compliance associations specific regions, such as New England Ethics Forum, Northwest Ethics Network, and Bay Area Compliance Association, also have sprung up to share best practices information.

The Practising Law Institute and the Conference Board began running annual conferences on corporate compliance in the 1990s, and the Sentencing Commission itself joined with EOA to run excellent regional programs on compliance. Periodicals focusing exclusively on compliance programs have sprung into existence, and treatises on compliance have been written.

All of this activity coincided with a rapid growth in the number of companies with compliance programs. And as more companies developed and shared compliance experiences, the sophistication of programs grew, as well . . . Companies also have developed a variety of ways to better build compliance into everyday decisionmaking, ranging from having compliance reflected in performance evaluations to having compliance officers directly involved in setting business strategy.[114]

---

[114]William B. Lytton & Winthrop M. Swenson, *The Effective Answer to Corporate Misconduct: Public Sector Encouragement of Private Sector Compliance Programs*, 20 No. 10 ACCA Docket 43, 47-48 (Nov./Dec. 2002) (footnotes omitted); *see also* Diana E. Murphy, *The Federal Sentencing Organizational Guidelines for Organizations: A Decade of Promoting Compliance and Ethics*, 87 IOWA L. REV. 697, 710 (2002) (noting that studies credit the organizational sentencing guidelines with "helping to create an entirely new job description: the Ethics and Compliance Officer" and that surveys further demonstrate that the organizational sentencing guidelines are having "a lot of influence" on many organizations' "commitment to ethics as manifested through the adoption of a compliance program"); *See* Ethics Officer Association, *1997 Member Survey* 9 (2000)(survey indicated that the organizational sentencing guidelines had spurred 50% of all the corporate survey respondents to make changes in their corporate compliance programs). The 2000 EOA Member Survey reflects that 85% of the corporate survey respondents created the position of ethics officers after 1992. Available at <http://www.eoa.org/EOA_Resources/Reports/MS2000_(PublicVersion).pdf>.

The organizational sentencing guidelines have had an influence far beyond criminal sentencing, and have even begun to influence the shape of corporate governance law.[115] The seminal decision of *In re Caremark International Inc. Derivative Litigation* by the Delaware Chancery Court marks this trend.[116] In 1995, Caremark pleaded guilty to a mail fraud charge for illegally paying physicians for patient referrals and then falsely billing the government. Caremark agreed to reimburse various private and public parties, ultimately paying $250 million in criminal and civil fines.

The important implication for the wider corporate community, however, came a year later when the Delaware Chancery Court was asked to approve the settlement of a shareholder derivative suit alleging that the Caremark directors had breached their duty of care by failing to supervise the conduct of Caremark's employees. The court approved the settlement, finding that "there [was] a very low probability that it would be determined that the directors of Caremark breached any duty to appropriately monitor and supervise the enterprise."[117] It went on, however, to underscore the importance of compliance efforts.

In considering the board's responsibility with respect to the organization and monitoring of the enterprise to assure that the corporation functions within the law to achieve its purposes, the Chancery Court stated that "[m]odernly this question has been given special importance by an increasing tendency, especially under federal law, to employ the criminal law to assure corporate compliance with external legal requirements" and by the organizational sentencing guidelines, "which impact importantly on the prospective effect these criminal sanctions might have on business corporations."[118] Most importantly, the Chancery Court observed that the organizational sentencing guidelines "*offer powerful incentives for corporations today to have in place compliance programs to detect violations of law, promptly to report violations to appropriate public officials when discovered, and to take prompt, voluntary remedial efforts*."[119] (emphasis added). In distinguishing a prior opinion (that arguably can be read to state that

---

[115]*See* Diana E. Murphy, *The Federal Sentencing Organizational Guidelines for Organizations: A Decade of Promoting Compliance and Ethics*, 87 IOWA L. REV. 697, 698 (2002).

[116]*In re Caremark International Inc. Derivative Litigation,* 698 A.2d 959 (Del. Ch. 1996).

[117]Id. at 961-968. The Chancery Court indicated that the case actually raised duty of care issues relating to the directors' alleged failure to monitor, not an alleged failure to make a "good" decision. Accordingly, the court examined the legal principles that apply where the alleged loss "eventuates not from a decision, but from unconsidered inaction. The court conceded that most decisions of a corporation are not the subject of director attention, pointing out that the board itself is only required to authorize the most significant corporate events. Nonetheless, the court noted, ordinary business decisions made as a matter of course by agents deeper within the organizational structure can drastically affect the interests of the corporation.

[118]*Id.* at 968.

[119]*Id.* at 968-969.

directors have no responsibility to assure adequate reporting systems are in place)[120], the Chancery Court reiterated the importance of the organizational sentencing guidelines: "Any rational person attempting in good faith to meet an organizational governance responsibility would be bound to take into account this development and the enhanced penalties and the opportunities for reduced sanctions that the federal sentencing guidelines offers."[121]

The court's observations in *Caremark* have raised the prospect, however attenuated, of directors' derivative liability for others' failures to ensure that adequate compliance programs are in place.[122] Consequently, the *Caremark* decision, "gave the movement toward corporate self-policing–known as compliance planning–a kick in the pants."[123] Other courts considering shareholder derivative suits have also focused on the principles embodied in the organizational sentencing guidelines.[124]

The federal judiciary has also developed standards for good faith compliance efforts that are parallel to the standards in the organizational sentencing guidelines. These standards have been used to determine when employers' good faith efforts to comply with equal employment opportunity laws will qualify the employers for defenses to sexual harassment and punitive damage liability.[125]

---

[120]*See Graham v. Allis–Chalmers*, 188 A.2d 125 (Del. 1963).

[121]*In re Caremark Int'l.,* 698 A.2d at 970.

[122]*See, e.g., Benjamin v. Kim*, 1999 WL 249706 (S.D.N.Y. 1999):

> * * * [W]hile it is true * * * that a director is not under a duty to "install and operate a corporate system of espionage to ferret out wrongdoing which they have no reason to suspect exists," *Graham v. Allis–Chalmers* (Del. 1963), a director does have a duty to be reasonably informed about the company and must make sure that appropriate information and reporting systems are in place so that the Board receives relevant and timely information necessary to satisfy its supervisory and monitoring role. (Citation omitted) Thus, a claim of directorial liability "predicated upon ignorance of liability creating activities within the corporation" will lie where the plaintiff shows a "sustained or systematic failure of a director to exercise reasonable oversight." (Citation omitted)

[123]John Gibeaut, *"For Any Lawyer Trying to Help Keep an Honest Company Straight, a Compliance Plan is the Best Way to Root Out Trouble Before it Happens and Limit Liability,"* 85 A.B.A.J. 64 (June 1999).

[124]*See for example*, *In re W.R. Grace & Co.*, 1997 WL597984 (September 30, 1997) ("an officer or director may rely upon the company's procedures for determining what disclosure is required only if he or she has a reasonable basis for believing that those procedures have resulted in full consideration of those issues"); *see also*, *In re Abbott Laboratories Derivative Shareholders Litigation*, 325 F.3d 795 (7th Cir. 2003).

[125]*See*, *e.g.*, *Godinet v. Management and Training Corp*., 56 Fed. Appx. 865 (10th Cir. 2003) (not selected for publication in the Federal Reporter); *Hatley v. Hilton Hotels Corp*., 308 F.3d 473 (5th Cir. 2002); *Marrero v. Goya of Puerto Rico, Inc*., 304 F.3d 7 (1st Cir. 2002); *Wyatt v. Hunt Plywood Co.,* 297 F.3d 405 (5th Cir. 2002); *Green v. Admin. of the Tulane Ed. Fund*., 284 F.3d 642 (5th Cir. 2002); *Anderson v. G.D.C., Inc*., 281 F.3d 452 (4th Cir.

The organizational sentencing guidelines have had an important indirect effect on compliance incentives through their influence on the policies of various federal regulators. These regulators now consider whether an organization has an effective compliance program in deciding whether to pursue enforcement actions or impose significant penalties, such as debarment from government contracting,[126] thereby reinforcing the organizational sentencing guidelines' "carrot and stick." For example, the Environmental Protection Agency (EPA) adopted an enforcement policy that owes much to the organizational sentencing guidelines.[127] EPA reported that it had received voluntary disclosures from over 6,000 facilities and 1,700 companies between 1998 and 2002, most of which resulted in penalty waivers or the substantial mitigation of civil penalties.[128]

A review of the model compliance programs for various sub-industry specialities issued by the Department of Health and Human Services typically reflects seven fundamental elements, whose genesis in the organizational sentencing guidelines is clear. For example, the guidance for the durable medical equipment sector contains the following fundamental principles:

- Implementing written policies, procedures and standards of conduct
- Designating a compliance officer and compliance committee
- Conducting effective training and education
- Developing lines of communication
- Enforcing standards through well-publicized disciplinary guidelines'
- Conducting internal monitor and auditing, and
- Responding promptly to detected offenses and developing correction action[129]

2002); *Idusuyi v. Tenn. Dept. of Children's Services*, 30 Fed. Appx. 398 (6th Cir. 2002)(not selected for publication in the Federal Reporter); *Golson v. Green Tree Financial Servicing Corp.*, 26 Fed. Appx. 209 (4th Cir. 2002)(not selected for publication in the Federal Reporter); *Romano v. U-Haul International*, 233 F.3d 655 (1st Cir. 2000); *Passantino v. Johnson & Johnson*, 212 F.3d 493 (9th Cir. 2000); *Lowery v. Circuit City Stores, Inc.*, 206 F.3d 431 (4th Cir. 2000); *Jaudon v. Elder Health, Inc.,* 125 F. Supp. 2d 153 (D. Md. 2000); Richard S. Gruner, *Developing Judicial Standards for Evaluating Compliance Programs: Insights from EEO Litigation*, in 1291 PLI/CORP. 155 (Feb. 2002) (describing developing standards for evaluating systematic efforts to comply with EEO laws and the relationship of these standards to tests for effective compliance programs under sentencing guideline standards).

[126] *See* Diana E. Murphy, *The Federal Sentencing Organizational Guidelines for Organizations: A Decade of Promoting Compliance and Ethics*, 87 IOWA L. REV. 697, 713 (2002).

[127] *See* Environmental Protection Agency, Incentives for Self-Policing: Discovery, Disclosure, Correction and Prevention, 65 Fed. Reg. 19618 (April 11, 2000).

[128] <http://www.epa.gov/compliance/resources/reports/endofyear/eoy2002/5year.pdf>.

[129] *See* 64 Fed. Reg. 36368 (July 9, 1999), <http://www.oig.hhs.gov/authorities/docs/frdme.pdf>. For the standards created by the Department of Health and Human Services, *see generally,*<http://www.oig.hhs.gov/fraud/complianceguidance.html>.

The Department of Health and Human Services' development of 'model compliance plans' is explicitly based on the organizational sentencing guidelines in detailing expectations for compliance programs in various health care subsidiaries.

Recently, the State Department has relied on the organizational sentencing guidelines in enumerating compliance criteria for registered exporters and manufacturers of arms which closely track the seven steps of the organizational sentencing guidelines. For example, the Bureau of Political Military Affairs, Office of Defense Trade Controls, states that "important elements of effective [compliance] manuals and programs include: corporate commitment and policy with directives by senior company management; methodologies for compliance that are tailored to the corporate organization and functions; internal monitoring and audits to ensure the integrity of the compliance program; training; procedures for voluntary disclosure; confidential advice (including an optional ombudsman office) to employees; procedures to foster employee discipline such as keying certain types of advancement to compliance understanding and implementation, and the establishment of internal disciplinary measures."[130]

The U.S. Department of Justice has articulated a policy under which an effective compliance program may lead to a decision to decline criminal prosecution of an organization. In 1999, the U.S. Department of Justice issued a memorandum entitled "Guidance on Prosecution of Corporations" that stressed the importance of effective compliance programs in federal prosecutors' decisions to indict or decline prosecutions against organizations.[131] The 2003 iteration of this policy is entitled "Principles of Federal Prosecution of Business Organizations."[132]

In the 2003 Memo, the U.S. Department of Justice identified the following as two of nine important factors to be considered in deciding whether to indict an organization: "the existence

---

[130]*See* Guidelines for DTC Registered Exporters/Manufacturers Compliance Program, <http//www.pmdtc.org/docs/Compliance_Programs.pdf>. The compliance criteria are also referenced in recent civil and administrative settlement agreements for violations of the Arms Export Act and implementing regulations. In the Matter of: The Boeing Company, Delaware (U.S. Dept. Of State Bureau of Political - Military Affairs, March 30, 2000); In the Matter of: Lockheed Martin Corporation, Maryland (U.S. Dept. Of State Bureau of Political - Military Affairs, June 13, 2000); In the Matter of: Hughes Electronics Corporation Boeing Satellite Systems, Inc., Delaware (U.S. Dept. Of State Bureau of Political - Military Affairs, March 4, 2003); *United States v. Raytheon Co. & Raytheon Canada Ltd.*, Civ. 03-10382 (D. Mass. Feb. 27, 2003) (RCL). These settlement agreements are available to the public at the Department of State Freedom of Information Act Reading Room.

[131]*See* Office of the Deputy Attorney General, *Guidance on Prosecutions of Corporations* (June 16, 1999) ("Holder Memo") at 66 CRIM LAW REP. (BNA) 10 at 189 (Dec. 8, 1999). This became known as the "Holder Memo" because it was circulated by then–Deputy Attorney General Eric H. Holder Jr.

[132] Memorandum from Deputy Attorney General Larry Thompson, to Heads of Department Components, *Principles of Federal Prosecution of Business Organizations* (January 20, 2003). Available at: <http://www.usdoj.gov/dag/cftf/business_organizations.pdf>. This is often referred to as the "Thompson Memo" because it was circulated by Deputy Attorney General Larry D. Thompson.

and adequacy of the corporation's compliance program";[133] and "the corporation's remedial actions, including any efforts to implement an effective corporate compliance program or to improve an existing one, to replace responsible management, to discipline or terminate wrongdoers, to pay restitution, and to cooperate with the relevant government agencies."[134] Even state Attorneys General "informally provide incentives in connection with enforcement decisions to companies to implement compliance programs."[135]

F. RECENT CORPORATE SCANDALS AND LEGISLATIVE AND REGULATORY RESPONSES

The preceding discussion demonstrates that the organizational sentencing guidelines have been very successful in raising the visibility of compliance issues and galvanizing many organizations to put in place compliance programs. It has been difficult to empirically test whether the organizational sentencing guidelines' success in raising corporate America's consciousness about compliance programs has translated into the *actual prevention or deterrence* of organizational crime, however, and the Advisory Group is not aware of any empirical evidence that the widespread movement to adopt compliance programs has resulted in the institution of *effective* compliance programs.

Following the Sentencing Commission's decision to empanel the Ad Hoc Advisory Group,[136] a series of corporate scandals involving rampant misconduct at the highest reaches of some of the largest companies in the United States captured national attention. On December 2, 2001, Enron Corporation, then the seventh largest corporation in the United States, declared bankruptcy amid allegations that Enron artificially boosted profits and hid debts totaling over $1 billion.[137] A Senate Subcommittee held hearings and determined that Enron's Board had been negligent in six

---

[133]*Id*. § II(A)(5); *see also id.* § VII.

[134]*Id.* § II(A)(6); *see also id.* § VIII. The organizational sentencing guidelines have also influenced the factors identified by the Antitrust Division of the Department of Justice for assessing corporate investigations and disclosures of antitrust offenses as a potential basis for grants of corporate amnesty concerning the disclosed offenses. *See* U.S. Department of Justice, Corporate Leniency Program (Aug 10, 1993), reprinted in 4 Trade Reg. Rep. (CCH) ¶ 13,113; Gary R. Spratling, *Making Companies an Offer They Shouldn't Refuse*, 1177 PLI/CORP. 641, 643 (2000) (assessing the steps necessary for companies to qualify for the Antitrust Division's Amnesty Program); Richard S. Gruner, *Avoiding Fines Through Offense Monitoring, Detection, and Disclosure: The Race for Amnesty*, 1230 PLI/CORP. 77 (2001)(describing the background and goals of the Antitrust Division's Amnesty Program).

[135]Jeffrey M. Kaplan, *The Sentencing Organizational Guidelines: The First Ten Years*, 1317 PLI/CORP 105, 108-9 (June-July 2002) (citing Woo, *Self Policing Can Pay Off For Companies*, WALL ST. J., Sept. 8, 1993 B5).

[136]The Sentencing Commission solicited public comment on September 19, 2001, 66 Fed. Reg. 48306, and appointed the Advisory Group on February 21, 2002. <http://www.ussc.gov/press/rel0202.htm>.

[137]*See The Role of the Board of Directors in Enron's Collapse*, S. Rep. No. 107-70 (2002) available at: <http://news.findlaw.com/rdocs/docs/enron/senpsi70802rpt.pdf>; Preliminary Report of the American Bar Association Task Force on Corporate Responsibility (July 16, 2002), available at <http://www.abanet.org/buslaw/corporateresponsibility/preliminary_report.pdf>.

separate ways.[138] Former Enron executives Michael Kopper and Ben F. Glisan, Jr., have pled guilty to felony charges, and the criminal investigation of others within the company continues. Enron is in bankruptcy with creditors holding an aggregate of $100 billion in claims.[139] Enron's accounting firm, Arthur Andersen LLP, was accused of shredding documents relating to its auditing work for Enron after the SEC launched an inquiry into Enron. Andersen was convicted of obstruction of justice in June 2002, and ceased auditing public firms on August 31, 2002.[140] Additional charges continue to be filed by various regulators and jurisdictions.[141]

The Enron/Andersen scandal was followed by allegations of major financial fraud involving officers and directors at Adelphia Communications,[142] Tyco,[143] WorldCom,[144]Quest,[145] Xerox,[146]

---

[138]*Id*., at 3. The six areas are: fiduciary failure, high risk accounting, inappropriate conflicts of interest, extensive undisclosed off-the-books activity, excessive compensation and lack of independence.

[139]Carrie Johnson and Peter Behr, *Andersen Guilty Of Obstruction, Accounting Firm Will End Audit Work*, WASH. POST, June 16, 2002, Page A1.

[140]*Id.*

[141]*See, e.g.,* SEC Press Release 2003-58, May 1, 2003, SEC Files Amended Complaint Charging Five Enron Executives with Fraud and Insider Trading Relating to Enron's Board and Subsidiary.

[142]Adelphia subsequently filed suit against its founder John Rigas, his entire family and twenty companies controlled by the family alleging that "[t]he Rigas Family Directors ... are responsible for one of the largest cases of corporate looting and self dealing in American corporate history." Adelphia Communications Corporation, Press Release, July 24, 2002, posted at <http://www.adelphia.net/pdf/2002/7_24_02.pdf>.

[143]SEC Press Release 2002.135, Sept. 12, 2002, SEC Sues Former Tyco CEO Kozlowski, Two Others for Fraud. All Three Failed to Disclose Millions of Dollars in Secret Corporate Loans. SEC Press Release 2002-177, December 17, 2002, SEC Sues Former Tyco Director and Chairman of Compensation Committee Frank E. Walsh Jr. for Hiding $20 Million Payment From Shareholders. Walsh Had Secret Agreement With L. Dennis Kozlowski To Receive Payment for "Finder's Fee" in Tyco's Acquisition of The CIT Group Inc.

[144]SEC Litigation Release No. 18147, May 19, 2003, Accounting and Auditing Enforcement Release No. 1785, May 19, 2003, In WorldCom Case, SEC Files Proposed Settlement of Claim for Civil Penalty; Proposed Settlement is Subject to Approval of Both District Court and Bankruptcy Court *Securities and Exchange Sentencing Commission v. WorldCom Inc.*, Civil Action No. 02-CV-4963 (SDNY) (JSR).

[145]SEC Press Release 2003-25, Feb. 25, 2003 SEC Sues Former and Current Qwest Employees for Fraud. The SEC filed civil fraud charges against eight current and former officers and employees of Qwest Communications International Inc., alleging that they inflated the company's revenues by approximately $144 million in 2000 and 2001 in order to meet earnings projections and revenue expectations.

[146]SEC Press Release 2002-52, April 11, 2002. Xerox To Pay Largest Financial Fraud Penalty Ever Against Public Company. Subsequently, six former executives of Xerox Corp., including two chief executives, agreed to pay a total of $22 million to settle charges that they manipulated earnings in order to boost the company's share price. SEC Press Release 2003-16, January 29, 2003, SEC Charges KPMG and Four KPMG Partners With Fraud in Connection With Audits of Xerox. SEC Seeks Injunction, Disgorgement and Penalties.

Kmart,[147] McKesson HBOC[148] and HealthSouth.[149] At the same time, the conviction of ImClone founder Samuel Waksal for insider trading and the criminal charges of insider trading in ImClone shares brought against celebrity homemaker Martha Stewart made headline news.[150]

It is obviously unrealistic to expect that the organizational sentencing guidelines will deter *all* corporate crime. No set of sentencing incentives and penalties can, in every case, overcome the impact of corporate culture and individual greed, fear, or arrogance that drive corporate misfeasance. The fact of this misconduct, then, does not necessarily indicate that the organizational sentencing guidelines are deficient.

What should be troubling, however, is the fact that much of this misconduct was perpetuated by senior management and was only belatedly discovered *despite the existence of auditing and other internal reporting systems*. Congress and regulators who investigated recent revelations of corporate wrongdoing have responded with a variety of legal regulations that affect the minimum features of responsible compliance programs. Such diverse areas as financial accounting, anti-money laundering, and equal opportunity programs have also been affected by new legal requirements in the compliance arena. The Advisory Group relied on the lessons drawn by Congress and regulators to assist it in identifying additional features that federal policy makers consider essential for preventing and detecting violations of law.

While it is not within the scope of this Report to provide a comprehensive survey of the official response to the recent scandals, the following discussion highlights recent statutory and regulatory innovations relevant to the Advisory Group's mission.[151] The new emerging standards reflect three major departures from the organizational sentencing guidelines compliance paradigm in that they:

---

[147]SEC Litigation Release No. 18000, February 26, 2003, SEC Charges Two Former Kmart Executives With $42 Million Accounting Fraud *Securities and Exchange Sentencing Commission v. Enio A. Montini, Jr. and Joseph A. Hofmeister*, Civil Action No. 03-70808 (Borman, J.; Capel, M.J.) (E.D. Michigan, filed February 26, 2003).

[148]SEC, Litigation Release No. 18170, June 4, 2003, Accounting and Auditing Enforcement Release No. 1792, June 4, 2003, SEC Charges Former Chairman of the Board of Directors of McKesson HBOC for His Role in the Massive Accounting Fraud, *Securities and Exchange Sentencing Commission v. Charles W. McCall,* United States District Court for the Northern District of California, Civil Action No. CO3-2603-SC.

[149]SEC Press Release 2003-34, March 19, 2003 SEC Charges HealthSouth Corp. CEO Richard Scrushy With $1.4 Billion Accounting Fraud Trading in HealthSouth Securities Is Suspended; Sentencing Commission Action Seeks Injunction, Money Penalties, Officer and Director Bar.

[150]Christopher Roland, *Im Clone Founder Gets Over 7 Years in Jail, Fine Harsh Sentence Sends A Warning To Executives,* BOSTON GLOBE, June 11, 2003, Page D1.

[151]The following discussion of the standards promulgated by the Securities and Exchange Commission and the New York Stock Exchange in response to the Sarbanes-Oxley Act of 2002, and the new laws and regulations governing anti-money-laundering compliance is derived from Richard S. Gruner, *Refining Compliance Program Standards: New Compliance Targets and Methods,* 1378 PLI/CORP. 161 (2003). *See also* RICHARD S. GRUNER, CORPORATE CRIMINAL LIABILITY AND COLLATERAL CONSEQUENCES (Law Journal Press, forthcoming 2004).

> (1) Extend conduct codes and related compliance efforts beyond mere law compliance to the development of an organizational culture that encourages a more effective commitment to compliance with the law, including ethics-based standards and procedures;
>
> (2) Recognize the responsibilities and accountability of organizational leadership for compliance efforts; and
>
> (3) Explicitly require organizations to focus their compliance efforts by conducting careful risk assessments of probable types and sources of misconduct in company operations and then using the results of these assessments to target compliance efforts and tailor compliance program features.

These new standards also expand upon or lend additional emphasis to some of the criteria already embodied in the organizational sentencing guidelines. In particular, recent regulatory efforts focus on:

(1) Empowering compliance officers;

(2) Encouraging the reporting of wrongdoing up the chain of command, including the protection of whistle-blowers against retaliation;

(3) Conducting adequate training of organizational personnel;

(4) Testing the effectiveness of compliance efforts through auditing and monitoring; and

(5) Ensuring accountability for, and rededication of, compliance failures identified through auditing and monitoring.

1. SEC Code of Ethics Regulations

Under the Sarbanes-Oxley Act of 2002[152] and implementing regulations promulgated by the Securities and Exchange Commission (SEC),[153] every publicly traded company is required to either adopt and disclose a "code of ethics" addressing law compliance and ethical conduct by key corporate officers, or explain publicly why the company has not adopted such a code.[154] These

---

[152]Pub. L. No. 107-204, 116 Stat. 745.

[153]Securities and Exchange Commission, Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, 68 Fed. Reg. 5110 (January 31, 2003) (to be codified at 17 C.F.R. pts. 228, 229 and 249).

[154]*Id.* at 5118, 5129. These required disclosures must be made by publicly traded companies in all annual reports filed with the SEC after July 15, 2003. *See id.* at 5121.

standards are significant both because they recognize the importance of conduct codes for the organizational leadership and because the types of codes envisioned go substantially beyond mere law compliance to address diverse types of ethical conduct as well.

A "code of ethics" meeting the SEC's standards must apply to a company's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions.[155] The aim of such a code is to specify standards for law compliance and ethical conduct on the part of these key executives. The SEC's standards describe the necessary features of a code of ethics as follows:

> [T]he term "code of ethics" means written standards that are reasonably designed to deter wrongdoing and to promote:
>
> (1) Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
> (2) Full, fair, accurate, timely, and understandable disclosure in reports and documents that a registrant files with, or submits to, the [SEC] and in other public communications made by the registrant;
> (3) Compliance with applicable governmental laws, rules and regulations;
> (4) The prompt internal reporting of violations of the code to an appropriate person or persons identified in the code;[156] and
> (5) Accountability for adherence to the code."[157]

---

[155] *See id.* at 5118, 5129. The SEC's standards regarding codes of ethics do not require companies to adopt such codes, but rather create substantial pressures favoring the adoption and careful administration of these codes through a system of required disclosures. If a company has not adopted a code of ethics, it must disclose why it has not done so. *Id.* A company that has adopted a code of ethics must make the code available either as an exhibit in its annual report, as a document on the company's Internet site, or as a document supplied without charge upon request by any person. *Id.* at 5118.

In addition, if a company amends its code of ethics, or grants a waiver of that code (including an implicit waiver) concerning any particular covered person or practice, the company must disclose that amendment or waiver. These disclosures must briefly describe the nature of the amendment or waiver. Disclosures regarding waivers must also include the name of the person to whom the waiver was granted and the date of the waiver. *Id.* at 5119, 5128. For purposes of these requirements, a company grants a "waiver" of a provision of its code of ethics where the company approves a material departure from the provision. A company engages in an "implicit waiver" if the company fails to take action within a reasonable period of time regarding a material departure from a provision of a code of ethics that has been made known to an executive of the company. *See id.* at 5128.

[156] The SEC's standards indicate that a company has the discretion to determine the identity of the appropriate person or persons to receive reports of code violations. However, a company's standards should provide for reports of code violations to persons other than those parties who are involved in a matter giving rise to a violation. Furthermore, the person or persons identified as proper recipients of reports of code violations should have sufficient status within their company to engender respect for the company's code of ethics and the authority to adequately deal with the persons subject to the code regardless of their stature in the company. *See id.* at 5118.

[157] *Id.* at 5129.

This description of the necessary elements of a code of ethics differs from prior regulatory standards for compliance codes in several key respects. As the name of the new code implies, the SEC standards call for an ethics oriented code, not just one aimed at achieving law compliance. Indeed, law compliance is treated as a subset of the broader body of ethical behavior that should be required under codes of ethics. Law compliance is apparently not even the most important type of ethical conduct to be promoted by these codes, being addressed only third in the list of types of misconduct or unethical behavior a code must address and combat.

The SEC's standards for codes of ethics contain two valuable enforcement-related components. The standards specify that a code of ethics should promote prompt internal reporting of violations of the code.[158] In the upper echelons of a company where relatively few insiders may be in a position to witness key acts of misconduct, a generally applicable reporting requirement may help to break up what would otherwise be a system of norms emphasizing silence over the reporting of misconduct. Furthermore, if fellow executives' reporting of code violations is perceived as a meaningful threat by potential wrongdoers, there is an increased likelihood that the latter will be deterred from initiating misconduct.

The SEC's standards also recognize that ensuring accountability for adherence to a code of ethics is an important facet of promoting compliance with the code. The standards specify that a code of ethics should include provisions promoting accountability for compliance with the code. This suggests that the conduct of persons covered by such a code should be regularly tested for compliance with the code and, where that compliance is lacking, persons responsible for code violations should be held accountable for these errors.

This type of regular monitoring of code compliance should help to ensure that a company develops a culture promoting ethical conduct at the top. If carried out diligently by fellow executives, these accountability promoting actions will help to ensure that no top executive feels completely confident that his or her violation or disregard of ethics code requirements will simply go undetected or ignored. Rather, in such an environment, top executives will expect ongoing compliance pressures and accountability demands as the norm, leading to a healthy degree of attention to the ethical implications of contemplated actions.

While they are presently limited to certain key executives of publicly traded concerns, the SEC's standards regarding codes of ethics seem likely to be a signal of more ethics-based compliance program requirements in future government standards. Compliance programs that are aimed at ensuring only compliance with legal requirements may increasingly be viewed as partial measures.

2. NYSE Governance Standards

[158] *Id.* at 5129.

In another set of new standards extending the reach of required programs beyond mere law compliance, the New York Stock Exchange (NYSE) has proposed privately enforced corporate governance standards for all companies listed on the exchange that would, among other changes, require companies to adopt and disclose codes of business conduct and ethics.[159] The required codes would apply to corporate employees as well as corporate directors and officers. The chief executive officer of a listed company will be required to certify annually to the NYSE that he or she is not aware of any violation of the NYSE's listing standards, including the requirement that a listed company has a business conduct code. The provisions of the NYSE's proposal regarding business conduct codes will go into effect six months after the provisions are approved by the SEC.

The NYSE developed its proposed standards regarding business conduct codes to address weaknesses in corporate governance practices revealed by recent corporate scandals. In the view of what it described as "the 'meltdown' of significant companies due to failures of diligence, ethics, and controls," the NYSE recognized "the opportunity – and the responsibility – . . . to raise corporate governance and disclosure standards."[160]

The NYSE shaped its corporate governance reforms to increase the role of corporate boards in furthering the ethical pursuit of corporate activities and shareholder interests. According to the NYSE, its aim in advocating new governance processes for listed companies was "to strengthen checks and balances and give diligent directors better tools to empower them and encourage excellence."[161] As part of this overall effort to improve corporate governance mechanisms, the NYSE's particular aim in requiring companies to develop and implement codes of business conduct and ethics was to focus corporate directors and managers on areas of ethical risks, provide mechanisms to report unethical conduct, and help to foster a culture of honesty and accountability.

The NYSE described the codes required under its new standards in somewhat general terms, but it indicated that listed companies are expected to fill in the details themselves in light of the specific characteristics of each firm's business and operating environment. The NYSE emphasized that listed companies should be proactive and open in implementing codes of business conduct. It described the overall approach that companies should adopt as follows:

> While many of the requirements set forth in this new rule are relatively specific, the Exchange is articulating a philosophy and approach to corporate governance that companies are expected to

---

[159] The new governance standards are proposed to be implemented by adding a new section 303A to the NYSE's Listed Company Manual. *See* New York Stock Exchange Board of Directors, Corporate Governance Rule Proposals (August 1, 2002), <http://www.nyse.com/pdfs/corp_gov_pro_b.pdf>.

[160] *Id.*

[161] *Id.*

> carry out as they apply the requirements to the specific facts and circumstances that they confront from time to time. Companies and their boards are expected to apply the requirements carefully and in good faith, making reasonable interpretations as necessary, and disclosing the interpretations that they make.[162]

The NYSE's proposal requires that codes of business conduct and ethics for listed companies address the most important ethical issues facing those companies, including, at minimum, code provisions regarding: (1) conflicts of interest; (2) corporate opportunities; (3) confidentiality; (4) fair dealing; (5) protection and proper use of company assets; (6) compliance with laws, rules and regulations; and (7) the reporting of any illegal or unethical behavior. Hence, as with the SEC's required conduct codes for key executives, the codes contemplated by the NYSE go far beyond law compliance to encompass a variety of key ethical aspects of business conduct. Indeed, within the framework of the NYSE proposal, law compliance is treated as one aspect of ethical behavior that is but a small part of the ethical business conduct which is the overall target of the proposed conduct codes.

3. Sarbanes-Oxley Certification Requirement

Other legislative responses to the corporate scandals of the past few years also reflect congressional efforts to make corporate leadership more accountable.[163] Thus, for example, Congress mandated in the Sarbanes-Oxley Act of 2002[164] that each report containing financial statements that a public company is required to file with the SEC must be accompanied by a certification by the company's chief executive officer and chief financial officer to the effect that it "fully complies with the requirements of section 13(a) or 15(d) the Securities Exchange Act . . . and that information contained in the periodic report fairly presents, in all material respects, the financial condition and results of operations of the issuer."[165] Under the companion criminal provisions of the Sarbanes-Oxley Act, executives who certify these statements knowing that they

[162] *Id.* at n.2.

[163] The movement to hold governing authority members individually accountable for corporate action is not unprecedented. It actually began in the non-profit sector prior to the scandals of 2002. To enable the Internal Revenue Service (IRS) to impose sanctions less drastic than revocation of tax exempt status – which could destroy a charitable organization that provided a necessary community benefit – Congress gave the IRS authority to impose intermediate sanctions in 1996. *See* 26 U.S.C. § 4958. The final regulations implementing the law were issued in 2002, *see* 67 Fed. Reg. 3076 (Jan. 23, 2002); 26 C.F.R. §§ 53.4958-0 through 53.4958-8, and impose excise taxes upon officers and directors of tax exempt organizations who approve or benefit from transactions that might otherwise endanger the tax exempt status of the organization.

[164] Pub. L. No. 107-204, 116 Stat. 745.

[165] Pub. L. No. 107-204, 116 Stat. 745, §302.

do not comport with statutory certification requirements are subject to up 10 years' imprisonment and 20 years' imprisonment if the offense was willful.[166]

4. Sarbanes-Oxley Reporting Provisions and Whistleblower Protections

The Sarbanes-Oxley Act also includes a number of provisions designed to ensure that information regarding corporate wrongdoing will be reported all the way up the ladder to the governing authority of the organization if necessary until it is dealt with effectively. For example, Congress mandated that the SEC issue regulations setting forth:

> . . . minimum standards of professional conduct for attorneys appearing and practicing before the [Securities and Exchange] Commission in any way in the representation of issuers, including a rule . . . requiring an attorney to report evidence of material violation of securities law or breach of fiduciary duty . . . by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof). . . [I]f the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), the attorney [is required] to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.[167]

In response to this congressional directive, the SEC has issued regulations that mandate "up the ladder" reporting by attorneys; similar related provisions in recent regulations reflect what the SEC believes are important components of an effective reporting system.[168]

To further encourage reporting of the type of misconduct at issue in many of the cases it was investigating, Congress also directed the SEC to establish rules directing the national securities exchanges and associations to prohibit the listing of any security of an issuer who had not established an audit committee of the Board of Directors with "independent" members and also established procedures for the receipt of complaints by the Board's audit committee.[169] In particular, Congress decreed that:

---

[166] 18 U.S.C. § 1350(c).

[167] Pub. L. No. 107-204, 116 Stat. 784, § 307.

[168] *See* 17 C.F.R. §§205.1 through 205.7 (2003).

[169] *See* Pub. L. No. 107-204, 116 Stat. 775-76, § 301, amending section 10A of the Securities Exchange Act of 1934 (15 U.S.C. § 78f).

(4) Complaints. Each audit committee shall establish procedures for:

A. the receipt, retention, and treatment of complaints received by the issuer regarding accounting, internal accounting controls, or auditing matters; and

B. the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters.[170]

Finally, Congress provided two new types of whistleblower protections in an effort to encourage reporting of potential misconduct. First, in 18 U.S.C. § 1513(e), Congress made it a crime, punishable by up to 10 years' imprisonment, for anyone to "knowingly, with the intent to retaliate, take[] any action harmful to any person . . . for providing to a law enforcement officer any truthful information relating to the commission or possible commission of any Federal offense." Second, in 18 U.S.C. § 1514A, Congress created a cause of action for employees of publicly-traded companies who provide information or assist in the investigation of a fraud case and suffer retaliation as a result.

5. Anti- Money Laundering Compliance Standards

Under the USA Patriot Act of 2001, financial institutions are required to establish compliance programs aimed at ensuring adherence to federal anti-money laundering laws.[171] The USA Patriot Act requires every financial institution to establish an anti-money laundering program that includes, at a minimum: (I) the development of internal policies, procedures, and controls; (ii) the designation of a compliance officer; (iii) an ongoing employee training program; and, (iv) an independent audit function to test programs.[172] These programs are intended to serve as tools to prevent, detect, and prosecute international money laundering and the financing of terrorism. Congress also expanded the scope of institutions where anti-money laundering programs are required to include entities such as casinos and insurance companies because they are also vulnerable to money laundering. The USA Patriot Act specifies certain basic standards

[170] *Id.*

[171] Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act. Pub. L. No. 107-56, 115 Stat 322, § 352(a).

[172] *Id.*

for all such programs.[173] Regulations promulgated by the Department of the Treasury identify additional requirements for anti-money laundering programs in specific types of companies.[174]

Standards proposed by the Department of the Treasury for anti-money laundering programs in insurance companies represent a particularly detailed and well-constructed set of regulatory criteria for anti-money laundering compliance programs that are instructive for the Advisory Group's efforts and warrant elucidation here.[175] An anti-money laundering program must incorporate policies, procedures, and internal controls aimed at preventing illegal money laundering and at ensuring that company employees make the monetary transaction reports required by federal law.[176] The scope and nature of these policies, procedures, and internal controls should be reasonably designed to ensure compliance with an insurance company's obligations under federal anti-money laundering laws.[177]

The proposed Treasury regulations make clear that companies must undertake risk assessments as the basis for constructing and operating reasonable anti-money laundering programs. In this respect, a reasonable program is one that matches anti-money laundering actions to the nature of compliance risks faced by a firm. An insurance company must shape its compliance program "based upon the insurance company's assessment of the money laundering and terrorist financing risks associated with its products, customers, distribution channels, and geographic locations."[178]

A detailed risk assessment is required to appropriately tailor a compliance program to a company's business circumstances. For example, in determining whether the nature of a company's insurance product raises risks of money laundering, the proposed Treasury Department standards indicate that an insurance company should consider whether it permits customers to use

---

[173]These details were specified in provisions of the USA Patriot Act that amended § 5318(h) of the Bank Secrecy Act. This amendment became effective on April 24, 2002. *See id.*

[174]For a list of these regulations and links to the anti-money laundering program standards involved, see U.S. Dept. of the Treasury, Financial Crimes Enforcement Network, Regulatory/BSA Regulations, at <http://www.fincen.gov/reg_bsaregulations.html>.

[175]*See* Financial Crimes Enforcement Network, Department of the Treasury, "Anti-Money Laundering Programs for Insurance Companies," 67 Fed. Reg. 60625 (September 26, 2002).

[176]*See id.* at 60630.

[177]Under present regulations, these obligations for insurance companies extend primarily to the reporting of cash transactions and certain non-cash instruments totaling more than $10,000 in one transaction or in a set of related transactions. However, federal compliance program standards recognize that, should the obligations of insurance companies increase under later regulations, expanded compliance program features (including revised program policies, compliance procedures, employee training, and program testing) will be needed to match the enhanced compliance obligations under the new regulations. In short, companies have an ongoing duty to match the scope of their compliance programs with evolving legal demands.

[178]*Id.* at 60628.

cash or cash equivalents to purchase an insurance product with a single premium or lump-sum payment, or to take out a loan against the value of an insurance product.[179]

Beyond including program components that reasonably promote compliance with anti-money laundering laws, an insurance company's compliance program should include substantial monitoring and information gathering components. Overall, these components must be sufficient to "ensure that the insurance company obtains all the information necessary to make its anti-money laundering program effective."[180] This information includes, but is not limited to, customer information collected and maintained by the insurance company's agents and brokers.[181]

Under the proposed Treasury regulations, an insurance company is required to designate a compliance officer to be responsible for administering the company's anti-money laundering program. A company may appoint a single party or a committee to be in charge of this type of program. A designated compliance officer should be a competent manager and knowledgeable about the requirements of federal anti-money laundering statutes and regulations. Such a compliance officer should also be "empowered with full responsibility and authority to develop and enforce appropriate polices and procedures."[182]

The overall responsibility of a designated compliance officer for an anti-money laundering program should be to "ensure that (1) the program is being implemented effectively; (2) the program is updated as necessary; and, (3) appropriate persons are trained and educated in accordance with [federal regulations mandating anti-money laundering training]."[183] In sum, compliance officers must be competent managers with sufficient managerial clout to ensure that the compliance programs operated under their direction are effective, regularly updated, and carried out through adequate training and education.

A complete anti-money laundering program complying with proposed federal regulatory standards should include education and training for employees who must carry out anti-money laundering activities. This education and training should ensure that employees of an insurance company (and any agents or third-party service providers) understand their individual responsibilities under the company's compliance program. Training and education programs

---

[179]*Id.* Similarly, in assessing the risks associated with the environment surrounding company operations, an insurance company is encouraged to consider whether the company engages in transactions involving a jurisdiction whose government has been identified by the Department of State as a sponsor of international terrorism, has been designated as non-cooperative with international anti-money laundering principles, or has been designated by the Secretary of the Treasury as warranting special measures due to money laundering concerns. *Id.*

[180]*Id.*

[181]*Id.*

[182]*Id.* at 60628.

[183]*Id.*

should also ensure that employees understand money laundering risks generally so that "red flags" associated with existing or potential money laundering can be identified.[184]

Training and education as part of a corporate anti-money laundering program can be conducted by outside or in-house providers and can include computer-based training. The nature, scope, and frequency of the education and training needed for a given individual will depend on the functions the individual performs.[185] However, parties with distinct responsibilities under a company's compliance program must be sufficiently trained to carry out those responsibilities. In addition, these parties should receive periodic updates and refreshers regarding their company's anti-money laundering program.[186]

Compliance program monitoring is another required component of an anti-money laundering program under the proposed Treasury regulations. An insurance company is required to conduct independent testing of its anti-money laundering program to ensure that the program complies with federal regulatory standards and that the program functions as designed. This testing can be performed by an outside consultant or accountant, but need not be. An employee of the company involved can perform system testing provided that the tester is not the compliance officer in charge of the program or otherwise involved in administering the program.

The appropriate frequency of program testing will depend upon a company's assessment of the compliance risks it faces in its operations. Hence, a company's risk assessment will not only define the substantive law compliance matters that an anti-money laundering program should address, but also the risk assessment will dictate how and when the company should test the sufficiency of its compliance program activities. Finally, the proposed Treasury regulations specify that "[a]ny recommendations resulting from [compliance program] testing should be implemented promptly or reviewed by senior management."[187] Thus, recommendations arising out of adverse findings in program testing processes must not be bottled up in testing reports, but they should instead be treated as blueprints for corrective actions that receive substantial management attention.

G. THE NEED FOR AMENDMENT OF THE COMPLIANCE CRITERIA

The Advisory Group considered, in light of its analysis summarized above, that the organizational sentencing guidelines must be counted a great success to the extent that the objective was to induce many organizations to focus on compliance and to create programs to prevent and detect violations of law. The Advisory Group also concluded, however, that changes

---

[184] *Id.*

[185] *Id.* at 60629.

[186] *Id.*

[187] *Id.*

can and should be made to give greater guidance regarding the factors that are likely to result in truly effective programs. Two circumstances were particularly influential in shaping the Advisory Group's efforts in this respect.

First, the recent corporate scandals and the legislative and regulatory responses to them, as detailed above, prompted the Advisory Group to look even more closely at the role of organizational leadership in ensuring that compliance programs are valued, supported, periodically re-evaluated, and working to prevent organizational crime. The recent emphasis by Congress and regulators on organizational culture and codes of conduct, improved reporting, risk assessment, empowerment of compliance officers, adequate training, auditing and monitoring accountability, and rededication, also influenced the Group's decisionmaking.

Second, much has changed in the field of organizational compliance since the advent of the organizational sentencing guidelines in 1991. As discussed previously, legal standards in a remarkably diverse range of fields have recognized organizational compliance programs as an important feature of responsible organizational conduct. For example, since the organizational sentencing guidelines went into effect, the U.S. Department of Justice,[188] the Department of Health and Human Services,[189] the Environmental Protection Agency,[190] the Securities and Exchange Commission,[191] and the Occupational Safety and Health Administration[192] have issued guidelines and standards relevant to organizational compliance efforts. Most recently, Congress mandated the necessary features of anti-money laundering systems,[193] and the Department of the

---

[188]*See* U.S. Department of Justice, Principles of Federal Prosecution of Business Organizations (January 20, 2003) (memorandum from Larry D. Thompson, Deputy Attorney General, to Heads of Department Components and United States Attorneys); <http://www.usdoj.gov/dag/cftf/business_organizations.pdf>.

[189]For standards created by the Office of Inspector General, Department of Health and Human Services, for evaluating compliance programs in the health care industry, see, e.g., 65 Fed. Reg. 14289 (March 16, 2000) (compliance program guidelines for nursing facilities); 63 Fed. Reg. 45076 (August 24, 1998) (compliance program guidelines for clinical laboratories).

[190]For definitions of a "compliance management system" and an "environmental audit" in charging and penalty standards issued by the United States Environmental Protection Agency, *see* Environmental Protection Agency, Incentives for Self-Policing: Discovery, Disclosure, Correction and Prevention, 65 Fed. Reg. 19618 (April 11, 2000).

[191]For criteria for recognizing systematic efforts by corporations to prevent violations of federal securities laws as specified in charging discretion and penalty assessment standards of the Securities and Exchange Commission, *see* Securities and Exchange Commission, Securities Exchange Act of 1934 Release No. 44969 (October 23, 2001), <http://www.sec.gov/litigation/investreport/34-44969.htm>.

[192]For Occupational Safety and Health Administration (OSHA) standards describing the minimum features of employers' self-audits of compliance with workplace safety and health requirements and providing that reports and other information produced by such audits will generally be immune from OSHA scrutiny, *see* Occupational Safety and Health Administration, Final Policy Concerning the Occupational Safety and Health Administration's Treatment of Voluntary Employer Safety and Health Self-Audits, 65 Fed. Reg. 46498 (July 28, 2000).

[193]*See* Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act (USA Patriot Act), Pub. L. No. 107-56, § 352(a) (2001) (codified at 31 U.S.C. § 5318(h)).

Treasury issued detailed regulations describing the contents of minimally sufficient anti-money laundering systems for specific industries.[194] These legal standards are often built upon the organizational sentencing guidelines model. They have progressed further, however, articulating increasingly detailed and sophisticated criteria. Efforts by industry and private organizations have also redefined "best practices" over the last decade. Accordingly, the Advisory Group believes that the organizational sentencing guidelines should be updated to reflect the education and progress in the compliance field since 1991.

The Advisory Group therefore proposes for the Sentencing Commission's consideration specific changes in the organizational sentencing guidelines, including the creation of a new guideline at §8B2.1 that contains a revised definition of an "effective program to prevent and detect violations of law." The proposed changes are intended to eliminate ambiguities revealed by ten years' of sentencing experience and to define more precisely the essential attributes of successful compliance programs based on program development and testing during the same period. Finally, they are intended to be responsive to the lessons learned through the bitter experience of the last two years. These suggestions are discussed at length in Part IV.

[194] *See* U.S. Dept. of the Treasury, Financial Crimes Enforcement Network, Regulatory/BSA Regulations, at <http://www.fincen.gov/reg_bsaregulations.html> (describing types of businesses covered by program standards); Financial Crimes Enforcement Network, Department of the Treasury, "Anti-Money Laundering Programs for Insurance Companies," 67 Fed. Reg. 60625 (September 26, 2002)(example of proposed standards for anti-money laundering programs in the insurance industry).

IV. SPECIFIC PROPOSALS FOR AMENDMENTS TO THE DEFINITION OF AN "EFFECTIVE PROGRAM TO PREVENT AND DETECT VIOLATIONS OF LAW"

Given the significance of the "effective program" credit as part of the Sentencing Commission's measures to encourage compliance, as well as the impact that this credit has had as a practical matter, the Advisory Group believes that the definition of an "effective program" merits enhanced prominence through the promulgation of the definition as a separate sentencing guideline. Although the Advisory Group recommends retaining much of the existing definition, the Group concludes that a number of changes, additions, and refinements are warranted, as explained in the following section-by-section analysis of the proposed new sentencing guideline to be codified at §8B2.1. (See Appendix B).

The existing provisions of §8A1.2, Application Note 3, which are the predecessors to the provisions of the Advisory Group's proposed new guideline, begin as follows:

> (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 programs 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 . . .*

This introductory language describes several important features of an effective program to prevent and detect violations of law. To clarify and amplify these points, the Advisory Group believes that it will be helpful to address different aspects of the definition of an effective compliance program in separate sentencing guideline subsections. Consequently, the new guideline at §8B2.1 proposed by the Advisory Group contains separate subdivisions describing several important characteristics of an effective compliance program:

- the purpose of a compliance program and the importance of preventive due diligence and organizational culture in carrying out such a program (§8B2.1(a));

- the seven minimum attributes that should be present in all compliance programs (§8B2.1(b)); and

- the need for risk assessments and related compliance program adaptation as a basis for constructing and operating a generally effective program to prevent and detect violations of law (§8B2.1(c)).

A. CULTURE AND THE RESPONSIBILITIES OF ORGANIZATIONAL LEADERSHIP

1. Background to §8B2.1(a)

One of the objectives of the organizational sentencing guidelines is to create incentives, as well as consequences, that encourage organizations to comply with the law. Organizations achieve this goal by establishing, maintaining and enforcing compliance standards and procedures. There is evidence that the effectiveness of compliance efforts is enhanced when they are integrated into an organization's culture.

For several years, academics and others have advocated organizational culture as being a key contributor towards improving the effectiveness of corporate compliance. For example, in 1994, Professor Lynn Sharp Paine, described the important role organizational culture can play in supporting compliance efforts. The "task of management," she wrote, is to:

> Define and give life to an organization's guiding values, to create an environment that supports ethically sound behavior, and to instill a sense of shared accountability among employees. . . The need to obey the law is viewed as a positive aspect of organizational life, rather than an unwelcome constraint imposed by external authorities.[195]

Testimony presented to the Advisory Group indicates that during the 1990s, as organizations shared best practices, many came to a similar conclusion as Dr. Paine, namely that the effectiveness of compliance programs could be enhanced if, in addition to due diligence in maintaining compliance programs, organizations also took steps to build cultures that encouraged employee commitment to compliance.

An organizational culture that encourages a commitment to compliance with the law is one in which compliance with the law is the expected behavior. Rather than solely emphasizing conduct restrictions and information gathering activities aimed at preventing and detecting violations of law, an organizational culture that encourages a commitment to compliance with the law also includes positive actions which demonstrate that law compliance is a key value within

[195] Lynn Sharp Paine, *Managing for Organizational Integrity,* HARVARD BUSINESS REVIEW (March-April 1994).

the organization. In general, organizational culture, in this context, has come to be defined as the shared set of norms and beliefs that guide individual and organizational behavior. These norms and beliefs are shaped by the leadership of the organization, are often expressed as shared values or guiding principles, and are reinforced by various systems and procedures throughout the organization.

The Advisory Group learned that during the 1990s industry literature and conference proceedings commonly referred to efforts to develop organizational cultures as described above as values-based or integrity-based programs. The widespread acceptance of this approach is reflected in the results of the 2000 Ethics Officer Association member survey.[196] Eighty-six percent (86%) of the responding companies described their programs as a combination of compliance and values-based elements. Only six percent (6%) described their programs as entirely compliance based.[197]

This emphasis on ethics and values is also reflected in recent legislative and regulatory reforms. Several recent reforms encourage organizations to promote honest and ethical conduct through codes of ethics or business conduct. For example, the Sarbanes-Oxley Act of 2002 encourages companies to adopt "codes of ethics" which include "standards that are reasonably necessary to promote honest and ethical conduct."[198] Recent Securities and Exchange Commission regulations recognize that a "code of ethics" should include "written standards that are reasonably designed to deter wrongdoing and to promote honest and ethical conduct."[199] Furthermore, in this same vein, new listing requirements proposed by the New York Stock Exchange emphasize the importance of a commitment to ethics and culture as a means of improving law compliance.[200] Recently, in separate speeches, Securities and Exchange Commission Chair William Donaldson and Commissioner Cynthia Glassman emphasized the importance of organizational culture in ensuring effective compliance.[201]

Based on this growing consensus, the Advisory Group recommends adding to the organizational sentencing guidelines a specific requirement that organizations seek to develop a culture in which compliance with the law is the expected behavior. At a minimum, such cultures

---

[196] *See* <http:www.eoa.org> and <http://www.eoa.org/EOA_Resources/Reports/MS2000_(PublicVersion).pdf>.

[197] *Id.*

[198] Pub. L. No. 107-204, 116 Stat. 789, § 406.

[199] 68 Fed. Reg. 5110, 5118 (January 31, 2003).

[200] *See* <http://www.nyse.com/pdfs/corp_gov_pro_b.pdf>.

[201] *See, e.g.* Speech by Commissioner Cynthia A. Glassman, *Improving Corporate Disclosure – Improving Shareholder Value* (April 10, 2003). A list of additional speeches is available at <http://www.sec.gov/news/speech.shtml#chair>.

will promote compliance with the law. To the extent that they encourage further ethical conduct, the organization and the community will benefit in additional ways.

It is important to note, however, that this recommendation will not impose upon organizations anything more than the law requires, nor will it conflict with industry-specific regulatory requirements. It is also intended to avoid requiring prosecutors to litigate and judges to determine whether an organization has a good "set of values" or appropriate "ethical standards," subjects which are very difficult, if not impossible, to evaluate in an objective, consistent manner.

2. Section 8B2.1(a)

Accordingly, the Advisory Group recommends that the general definition of an "effective program to prevent and detect violations of law" be expanded to contain two essential components, as follows:

§8B2.1. Effective Program to Prevent and Detect Violations of Law

(a) To have an effective program to prevent and detect violations of law, for purposes of subsection (f) of §8C2.5 (Culpability Score) and subsection (c)(1) of §8D1.4 (Recommended Conditions of Probation - Organizations), an organization shall–

(1) exercise due diligence to prevent and detect violations of law; and

(2) otherwise promote an organizational culture that encourages a commitment to compliance with the law.

Such program shall be reasonably designed, implemented, and enforced so that the program is generally effective in preventing and detecting violations of law. The failure to prevent or detect the instant offense leading to sentencing does not necessarily mean that the program is not generally effective in preventing and detecting violations of law.

This subsection of the proposed guideline recognizes that there are two contexts in which the guideline's definition of an effective compliance program will be important in sentencing convicted organizations: (1) determining whether an organization has maintained an effective program to prevent and detect violations of law and is therefore entitled to a lowered culpability score and reduced fine under §8C2.5(f) of the organizational sentencing guidelines, and (2) specifying the types of compliance program features that sentencing courts are encouraged to require when imposing a sentence upon convicted organizations that have not voluntarily improved their compliance efforts prior to sentencing.

The Advisory Group proposes specifying that the purpose of an effective compliance program is to take reasonable steps to prevent illegal conduct in organizational activities. These steps need to be coordinated with the nature of the organization's activities and the frequency and seriousness of misconduct foreseeably risked by those activities. However, measures to prevent illegal conduct need not be perfectly successful in order for a program to prevent and detect violations of law to be considered generally effective and to meet the standards of §8B2.1. Indeed, the proposed language of this subsection as set forth below specifically states that the failure of an organization to prevent the offense leading to the organization's sentencing will not preclude a finding that the organization's compliance program was generally effective. Such a program should still be seen as generally effective if it was reasonable for the program to have failed to have detected or prevented the offense leading to sentencing. For example, this might be the case where the offense leading to sentencing was aberrational in that it was unusual or unpredictable in some respect and the program was usually successful in preventing and detecting the types of offenses typically encountered by the organization involved.

Finally, the Advisory Group emphasizes that an effective compliance program should be aimed at preventing not just criminal activities within organizations, but rather all "violations of law." To clarify this, the proposed guideline includes in §8B2.1, Application Note 1, a definition of the types of violations of law that an effective compliance program should seek to detect and prevent. The term "violations of law"as used in the proposed guideline (except for the special definition applied in §8B2.1(b)(3)) includes "violations of any law, whether criminal or noncriminal (including a regulation), for which the organization is, or would be, liable."

While the organizational sentencing guidelines do provide for the evaluation of an organization's compliance program when an organization has been convicted of criminal conduct and a sentencing court needs to determine the proper sentence for that criminal conduct, the Advisory Group believes that the past responsibility of an organization in addressing possible criminal conduct does not completely measure an organization's culpability in connection with a criminal offense. Rather, the full range of efforts undertaken by an organization to prevent all violations of law are relevant factors to determine organizational culpability. The prior diligence of an organization in seeking to detect and prevent violations of law, including, but not limited to, criminal offenses, has a direct bearing on the appropriate penalties and probationary terms for the organization if it is convicted and sentenced for a criminal offense.

The consideration of an organization's prior efforts and success in preventing violations of law beyond just criminal offenses is consistent with existing provisions of the organizational sentencing guidelines that treat prior civil and administrative offenses (§8C2.5(c)) and prior misconduct leading to restrictive court orders (§8C2.5(d)) as relevant sentencing considerations justifying elevated organizational fines.

The Advisory Group also considers it important for organizations to promote an organizational culture that encourages a commitment to compliance with the law. Experience has taught that such programs are normally driven by values that go beyond aiming for the lowest possible standards of compliance. Therefore, the Advisory Group recommends adding to the organizational sentencing guidelines a specific requirement that organizations seek to develop a culture in which compliance with the law is the expected behavior.

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.

The Advisory Group anticipates that organizations will carry out both of the key components of an effective program to prevent and detect violations of law – that is, the pursuit of due diligence in the prevention and detection of offenses and the creation of a positive culture valuing law compliance – by taking steps in the seven areas addressed in §8B1.2(b). By tailoring their efforts in these seven areas to achieve both reasonable violation prevention and positive internal support for law compliance, organizations can attain both the compliance with law and organizational culture called for under the proposed guideline.

Hence, it is not the Advisory Group's intention to require organizations to go beyond the seven types of steps addressed in §8B2.1(b) in order to operate an effective program to prevent and detect violations of the law. Rather, the Advisory Group anticipates that the dual objectives of reasonable prevention and positive culture will be taken into account by organizations as they shape and implement steps in the seven areas covered by §8B2.1(b).

Of course, in conjunction with these steps or through other measures, organizations will be free to go further to encourage ethical behaviors and cultures in accordance with organizational values beyond law compliance. By focusing only on aspects of organizational culture affecting affirmative support of an organization's compliance with the law, the proposed guideline is intended to limit the assessments of sentencing courts, prosecutors and other interested parties to evaluations of program elements aimed at building support for compliance with the law. The proposal avoids the need for determinations of whether a particular organization has adopted a good "set of values" or appropriate "ethical standards," subjects which may be very difficult, if not impossible, to evaluate in an objective, consistent manner.

3. Section 8B2.1(b)(1)

The existing definition of an "effective program" contained in §8A1.2, Application Note 3, provides:

> (k) . . . *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.*

The Advisory Group recommends that the above language be replaced with the following in proposed guideline §8B2.1:

(b) Due diligence and the promotion of an organizational culture that encourages a commitment to compliance with the law within the meaning of subsection (a) minimally require the following steps:

(1) The organization shall establish compliance standards and procedures to prevent and detect violations of law.

The types of compliance measures addressed by this provision are neither new nor controversial and are obviously the foundation of any compliance effort. The Advisory Group does not believe it is necessary to elaborate on the types of standards and procedures that are required. Some commentators suggested very specific standards and procedures that would not be practical or applicable for all organizations. Experience has shown that different standards and procedures are utilized by different industries and are influenced by the size of the organization, its complexity, and the nature of its business function. For these reasons, this provision was left very general.

The Advisory Group has, however, attempted to clarify the nature of sufficient measures under this portion of the proposed guideline by including a definition of "compliance standards and procedures" at §8B2.1, Application Note 1. Under this definition, **"compliance standards and procedures"** are described as **"standards of conduct and internal control systems that are reasonably capable of reducing the likelihood of violations of law."** This definition emphasizes that standards of conduct and internal controls are essential aspects of effective compliance programs and that these measures should be developed, implemented, and evaluated in terms of their impact on reducing the likelihood of violations of law.

4. Background to §8B2.1(b)(2)

In the existing definition of an "effective program" contained in §8A1.2, Application Note 3, only two of the seven steps even arguably deal with the responsibility of organizational personnel or leadership with respect to compliance:

(k) . . . *Due diligence requires at a minimum that the organization must have taken the following types of steps:*

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

(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 reasonable due diligence, had a propensity to engage in illegal activities.

The Advisory Group concluded that these sections are not minimally sufficient to identify the responsibilities of organizational actors for compliance. While the Advisory Group resisted efforts to make the definition of responsibilities too particular, the lessons of the corporate scandals of 2002 are clear: greater specification of the roles of organizational leadership in the organizational sentencing guidelines is essential.

As was discussed at greater length in Part III(F) of this Report, the corporate scandals that exploded shortly following the tenth anniversary of the adoption of the organizational sentencing guidelines demonstrated that the involvement of officers and directors in corporate crime was not confined to small businesses. The corporate scandals of 2002 greatly contributed to the public's lack of confidence in the capital markets.[202] In virtually all of the scandals, the alleged malfeasance occurred at the senior management and/or governing authority level. Where there was no actual malfeasance by members of the governing authority, there were often instances of negligence.[203] This situation led the Advisory Group to consider the particular role of the governing authority of the organization. Serious questions were raised about whether the organizational sentencing guidelines could more specifically address the role of the governing authority without unintended adverse consequences.[204]

The Advisory Group sought and reviewed information from a variety of sources, both in written statements and at the public hearing. There was a mixed response to questions relating to the role of governing authorities, but most commentary supported adding specific references to the compliance-related duties of a corporation's governing authority.[205] The central theme was to

---

[202] *Sentencing Commission on Public Trust and Private Enterprise, Findings and Recommendations, Part 2 Corporate Governance*, p. 2, The Conference Board, Jan. 9, 2003.

[203] *See The Role of the Board of Directors in Enron's Collapse*, S. Rep. No. 107-70 (2002); Preliminary Report of the American Bar Association Task Force on Corporate Responsibility (July 16, 2002), available at <http://www.abanet.org/buslaw/corporateresponsibility/preliminary_report.pdf>. About 80 officers and directors from some of the nation's largest corporations attended a "post-Enron boot camp" at the University of Chicago in September 2002 to learn how to better govern organizations. Steven N. Kaplan, a finance and management professor at the University of Chicago School of Business told the group "Look at this [pointing to a line on Enron's cash flow statement showing that 'changes in components of working capital' shifted from negative $1 billion to positive $1.7 billion in a year.] If you're a board member, there has to be a disconnect." Andrew R. Sorkin, *Back to School, but This One is for Top Corporate Officials,* N.Y. TIMES, Sept. 3, 2002, at A1.

[204] Transcript of Plenary Session I (Nov. 14, 2002), James Cowdery, p. 34 lines 1-11; Lynn Sharp Paine, p. 84 lines 18-21. This transcript is available at: <http://www.ussc.gov/corp/advgrp.htm>.

[205] *See*, *e.g.,* Transcript of Breakout Session I (Nov. 14, 2002), Joshua Hochberg, p. 48 lines 6-15; Gretchen Winter, p. 66 lines 5-17, p. 69 lines 8-21; David Greenberg, p. 119 lines 9-15, p. 120 lines 1-6. This transcript is available at: <http://www.ussc.gov/corp/advgrp.htm>. The Letter of Arnold & Porter and PricewaterhouseCoopers, LLP on behalf of 19 pharmaceutical companies, dated October 4, 2002 states: "For any organization, a strong compliance program requires active oversight by the board and appropriate board committees (or equivalent governing bodies

amplify the role of the governing authority, providing direct access between the governing authority(or one of its committees) and a company's compliance officer, ensuring prompt and unfiltered communications.[206] There was also concern that nothing be added to the organizational sentencing guidelines that might conflict with the requirements of the Sarbanes-Oxley Act of 2002 or any of the other laws and regulations recently adopted or that might be adopted in the foreseeable future.[207] One commentator cautioned that specifying the appropriate role of the governing authority in law compliance processes would be impossible because of the different size, nature, and complexity of organizations.[208]

After considering all the presented views, the Advisory Group concluded that the current total silence in the organizational sentencing guidelines relating to the role of the governing authority fails to state what may otherwise be obvious: ultimately the governing authority is responsible for the activities of the organization.[209] It can only perform this function if its members are actively involved in compliance reviews and reasonably educated about the business of the organization and the legal and fiduciary duties of governing authority members.

The Conference Board's Commission on Public Trust and Private Enterprise specifically states:

> In fulfilling its oversight function, boards must monitor management's operating performance as well as ethical and legal compliance. In approving strategies, boards need to understand, among other things, the corporation's capital allocation, debt levels, risks and vulnerabilities, compensation strategy and growth opportunities. Importantly, they must engage management on the central issues

---

and their committees), and reporting systems that provide all of the organization's top leadership with the information needed for effective oversight." This letter is available at: <http://www.ussc.gov/corp/pubcom_1002/pc10_02f.pdf>.

[206] Transcript of Plenary Session I (Nov. 14, 2002), Stuart Gilman, p. 67 lines 9-14; Lynn Sharp Paine, p. 83 lines 15-21; Steven Priest, p. 94 lines 14-20. Transcript of Plenary Session II (Nov. 14, 2002), Joshua Hochberg, p. 11 lines 7-12. Transcript of Breakout Session I (Nov. 14, 2002), David Greenberg, p. 39 lines 4-11; Joshua Hochberg, p. 53 line 16 through p. 54 line 11. These transcripts are available at: <http://www.ussc.gov/corp/advgrp.htm>. Letter of Redmond, Williams & Associates, dated October 3, 2002. This letter is available at: <http://www.ussc.gov/corp/pubcom_1002/pc10_02d.pdf>.

[207] Transcript of Plenary Session I (Nov. 14, 2002), Jamie Conrad, p. 30 lines 1-9. Transcript of Breakout Session I (Nov. 14, 2002), Jamie Conrad, p. 16 lines 4-10, p. 23 line 21 through p. 24 line 14.

[208] Letter of Epstein, Becker & Green, P.C. dated October 7, 2002. This letter is available at: <http://www.ussc.gov/corp/pubcome_1002/pc10_02j.pdf>.

[209] Transcript of Breakout Session I (Nov. 14, 2002), Gretchen Winter, p. 67 lines 15-21. *See also, In re Caremark Int'l, Inc. Derivative Litigation,* 698 A.2d 959, 969 (Del. Chan. 1996), *Dellastatious v. Williams,* 242 F.3d 191 (4th Cir. 2001), and *McCall v. Scott*, 239 F.3d 808, 819 (6th Cir. 2001).

> facing the company and have a firm grasp on the tradeoffs that lie at the heart of a corporate enterprise.[210]

Moreover, specifying the role of the governing authority in compliance program definitions was becoming standard practice even before the recent corporate scandals and plethora of new laws and regulations. A survey of the top 1,000 companies conducted by Deloitte & Touche LLP, Corporate Compliance Consulting Services in 2000 revealed that 77 percent specified the role of the governing authority or its audit committee in their compliance programs.[211] This development is certainly consistent with the views expressed in the *Caremark* case, namely that directors and officers have an obligation to become informed about the accuracy and timeliness of compliance reporting systems within their organizations in order to reach informed judgments about compliance with the law.[212]

5. Section 8B2.1(b)(2)

The Advisory Group therefore proposes that the new guideline at §8B2.1 contain the following:

(b) Due diligence and the promotion of an organizational culture that encourages a commitment to compliance with the law within the meaning of subsection (a) minimally require the following steps: . . .

2. The organizational leadership shall be knowledgeable about the content and operation of the program to prevent and detect violations of law.

The organization's governing authority shall be knowledgeable about the content and operation of the program to prevent and detect violations of law and shall exercise reasonable oversight with respect to the implementation and effectiveness of the program to prevent and detect violations of law.

Specific individual(s) within high-level personnel of the organization shall be assigned direct, overall responsibility to ensure the implementation and effectiveness of the program to prevent and detect violations of law. Such individual(s) shall be given adequate resources

---

[210] The Conference Board Commission on Public Trust and Private Enterprise, Findings and Recommendations, Part 2: Corporate Governance, (January 9, 2003) p. 9.

[211] The Top 1,000 Companies Corporate Compliance Assessment Survey Report, Deloitte & Touche, LLP, Corporate Compliance Consulting Service, December 31, 2000.

[212] *In re Caremark Int'l Inc. Derivative Litigation*, 698 A. 2d 959, 969 (Del. Ch. 1996).

and authority to carry out such responsibility and shall report on the implementation and effectiveness of the program to prevent and detect violations of law directly to the governing authority or an appropriate subgroup of the governing authority.

The proposed changes to this portion of the definition of an effective compliance program are aimed at clarifying the compliance responsibilities and activities of key organizational officials. The proposal gives separate attention to the roles of three types of organizational officials: members of an organization's governing authority, executives comprising an organization's managerial leadership, and one or more individuals having primary responsibility for the organization's program to prevent and detect violations of law. The proposal describes the factual inquiry, oversight, and management duties of these three types of officials in connection with an organization's program to prevent and detect violations of law.

Governing Authority

As defined in the commentary to this proposed guideline at Application Note 1, the "governing authority" of an organization is "(A) the Board of Directors, or (B) if the organization does not have a Board of Directors, the highest level governing body of the organization." The proposal specifies that members of this top level body in charge of organizational affairs should be knowledgeable about the content and operation of their organization's program to prevent and detect violations of law, and then should exercise reasonable oversight with respect to the implementation and effectiveness of the program.

The knowledge about program features and operations that members of a governing authority should gain includes: 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 problems with compliance that the organization and other parties with similar operations have encountered in recent activities. The proposal does not specify the fact finding procedures or methods that members of a governing authority should use in acquiring this type of information, leaving it to particular organizations to gather and deliver this sort of information to governing authority members in the ways that best fit the organization's overall operations.

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). The proposal anticipates that members of a governing body will update their information about program features and operations periodically. This update would occur at least annually, and more frequently when legal changes or shifts in organizational activities raise new compliance risks for the organization.

In addition to their obligation to keep informed about program features and operations, members of a governing authority are expected under the proposal to exercise reasonable oversight of the implementation and effectiveness of an organization's program to prevent and detect violations of law. This obligation recognizes that oversight of compliance programs to prevent and detect violations of law is a key part of the duties of top level organizational officials, who oversee the affairs of their organizations generally. Just as compliance with the law is a critical feature of organizational conduct, oversight of compliance practices and mechanisms within an organization is a critical part of organizational management. The provisions of the proposal describing the oversight duties of governing authority members recognize that effective management requires that governing authorities be proactive in seeking information about compliance problems, evaluating that information when received, and monitoring the implementation and effectiveness of responses when compliance problems are detected.

Organizational Leadership

Provisions of the commentary accompanying the proposed guideline define "organizational leadership" as "(A) high-level personnel of the organization; (B) high-level personnel of a unit of the organization; and (C) substantial authority personnel" within the organization. The terms "high-level personnel of the organization" and "substantial authority personnel" have the meaning given those terms in the existing Commentary to §8A1.2 (Application Instructions - Organizations). The term "high-level personnel of a unit of the organization" has the meaning given that term in the existing Commentary to §8C2.5 (Culpability Score). Collectively, these parties represent the key decision makers within organization management – the range of leaders who set directions for organizational actions and who determine when organizational performance is successful in attaining organizational goals.

The proposal specifies that these organizational leaders must be knowledgeable about the content and operation of programs to prevent and detect violations of law within their organizations. The expectation of the Advisory Group is that such organizational leaders will gain information about these programs on a regular basis, as well as act on this information to pursue constant improvement in the programs. Each organizational leader is expected to be attentive to matters relating to compliance with the law and appropriate responses within the bounds of his or her area of leadership.

The Advisory Group anticipates that organizational leaders will 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. In short, the Advisory Group recognizes that ongoing organizational compliance within the law is a task that must be pursued by organizational leaders, based on regular attention to compliance program features and operations and the pursuit of compliance excellence through ongoing program adjustments.

Specific Individual(s) Having Direct, Overall Program Responsibility

The proposal indicates that one or more specific individuals within the high-level personnel of an organization should be designated as the organizational official or officials with primary responsibility for the operation of the organization's program to prevent and detect violations of law. Such person or persons should be assigned direct, overall responsibility to ensure the implementation and effectiveness of the program to prevent and detect violations of law.

The proposal specifies that this person should be within the high-level personnel of the organization to ensure that the official charged with implementing an organization's compliance program has the formal authority, access to senior management, and the respect needed to manage and oversee the implementation of a program to prevent and detect violations of law. For purposes of these provisions, the "high-level personnel of the organization" means individuals who have substantial control over the organization or who have a substantial role in the making of policy within the organization. Members of the high-level personnel of an organization who would be proper parties to take charge of a program to prevent and detect violations of law include a director; an executive officer; an individual in charge of a major business or functional unit of the organization, such as law, sales, administration, or finance; and an individual with a substantial ownership interest.

The proposed guideline provisions also specify certain characteristics of the organizational executive who is given direct, overall responsibility for an organization's program to prevent and detect violations of law. 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. The allocation of these sorts of resources is needed to ensure that a company's compliance program is not just a paper program, but rather a substantial management effort with the resources needed to succeed.

Finally, the proposal specifies that the person or persons in high-level management with direct, overall responsibility for an organization's program to prevent and detect violations of law 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. The aim of this reporting is to bring two types of information directly from the head of the program to the members of the governing authority without the potential filtering or censuring influence of senior organization managers.

First, reports directly to the governing authority should be made periodically to update members of this body on the current features of the company's compliance program and the compliance problems that are being addressed. These reports will aid the members of the governing authority in meeting their responsibilities to keep knowledgeable about program features and operations. Second, in cases of actual or apparent involvement in, or support for, illegal conduct by top level organizational executives, the head of the organization's compliance program should take steps to ensure that reports of this behavior are made directly to the organization's governing authority, an appropriate subgroup of the governing authority, or the organization's qualified legal compliance committee.[213] These reports will help the governing authority fulfill its proper role in ensuring accountability on the part of senior organizational managers and preventing the initiation or continuation of misconduct at upper organizational levels.

The proposed guideline's requirement that the head of an organization's compliance program report to the governing authority is intended to ensure that the governing authority will have key information necessary to meaningfully exercise its oversight responsibilities. However, additional operational information may be required. To further assist the governing authority in obtaining an understanding of how a program operating under its oversight is actually working, the Advisory Group believes that the governing authority should typically receive the information described in the proposed new commentary at §8B2.1, Application Note 3(B):

> **In addition to receiving reports from the foregoing individual(s), the governing authority or an appropriate subgroup thereof typically should receive periodically information on the implementation and effectiveness of the program to detect and prevent violations of law from the individual(s) with day-to-day operational responsibility for the program.**

The reporting envisioned by this new commentary would periodically supplement, but not replace, regular reporting by the individual(s) with overall program responsibility. The Advisory Group believes that, by periodically receiving reports directly from the individual(s) with day-to-day responsibility for the program (when different from the individual(s) with overall responsibility), the governing authority will be able to form an even more practical and comprehensive understanding of how the program is functioning. Direct contact with those who have day-to-day responsibility might, for example, help the governing authority more effectively assess the adequacy of resources being made available to the program.

6. Background to §8B2.1(b)(3)

The existing definition of an "effective program to detect and prevent violations of law" contained in §8A1.2, Application Note 3 provides that:

(k) . . . Due diligence requires at a minimum that the organization must have taken the following types of steps: . . .

(3) The organization must have used due care not to delegate substantial discretionary authority to individuals whom the organization knew, or should have

---

[213] *See* Securities and Exchange Commission, Final Rule: Implementation Standards of Professional Conduct for Attorneys, <http://www.sec.gov/rules/final/33-8185.htm>.

known through the exercise of reasonable due diligence, had a propensity to engage in illegal activities.

Views presented to the Advisory Group indicate that experts in the ethics and compliance field believe that the general goal of this requirement is sound, but that the specific guideline language is unclear and unhelpful. Every ethics and compliance officer who testified on this issue, as well as those who represented industry groups, agreed that the language needed to be clarified. In testimony at the November 14, 2002, public hearing, the representative of the American Chemistry Council, for example, referred to this portion of the definition of an effective compliance program as the most inscrutable feature of the organizational sentencing guidelines and recommended some clarification to what this actually means.[214]

While each of the other elements of the guidelines' definition of an effective compliance program has generated significant commentary and the sharing of best practices through publications, conferences and ethics and compliance associations, this element related to the delegation of substantial discretionary authority has not. For example, since 1992, the Ethics Officer Association has held 52 conferences, forums and training programs that have included over 700 individual sessions on topics selected by its members. No session has been devoted in its entirety to sharing best practices regarding the guidelines' provisions on the delegation of authority. As one expert testified before the Advisory Group, ". . . of the existing aspect[s] of the organizational sentencing guidelines it is the one part that I think people to this day have not really wrestled to the ground."[215]

Difficulties with this requirement were evident as early as 1995. In an article written by two former Sentencing Commission staff members, it was noted that "[t]he organizational sentencing guidelines' admonition on delegating discretionary authority has, admittedly, created some anxiety."[216] The authors suggested that some organizations were questioning the practicality of the requirement and the difficulty of ascertaining an individual's "propensity." In an effort to meet this requirement, some were speculating that they were being asked to "become either "Big Brother, Inc." or mind readers.[217]

Along these same lines, others have noted that determining whether or not an individual has a "propensity" to engage in wrongdoing may lead organizations to take steps that have serious consequences: "[T]he means for implementing this requirement are particularly sensitive given

---

214 Transcript of Breakout Session I (Nov. 14, 2002), Jamie Conrad, p.126. This transcript is available at: <http://www.ussc.gov/corp/advgrp.htm>.

215 Transcript of Breakout Session I (Nov. 14, 2002), Jamie Conrad, p. 127. This transcript is available at: <http://www.ussc.gov/corp/advgrp.htm>.

216 *See* Didier & Swenson, Thou Shall Not Improperly Delegate Authority–Thoughts on the US Sentencing Commission's "Step Three," 14 PREVENTIVE L. REP. 9, 14 (Winter 1995).

217 *Id.*

the concerns that intrusive investigations of current or potential employees raise about individual privacy and other federal, state, and local employment law protections that may be implicated."[218] These include verifying job applicant information, conducting criminal background checks, using polygraphs, requiring written psychological examinations to test honesty, periodically reviewing and assessing existing employees, electronic surveillance, and searches.

Each of these practices, which are intended to assess current or potential employees' propensities, however, have practical and/or legal limitations. For example:

- Verification of job applicant information may expose organizations to defamation risks.

- Excluding applicants with criminal convictions may be a violation of Title VII of the Civil Rights Act since such action may have a disparate impact on groups that are disproportionately the subject of reported criminal conduct, and further, it may be difficult to show the relevance of the past convictions.

- Use of polygraphs for employee screening may violate the Employee Polygraph Protection Act of 1988.

- Written psychological examinations to test honesty may violate state laws.

In addition, the Fair Credit Reporting Act may limit an organization's ability to conduct background checks of current or potential employees.[219]

Finally, in addition to the practical and legal risks and limitations associated with these efforts, implementing them may harm a company's reputation, impair employee morale, and have a chilling effect on internal communications. This is especially true of periodic reviews and assessments designed to uncover existing employees' "propensities," as well as electronic surveillance and employee searches. As has been noted elsewhere in this Report, internal communications and the willingness of employees to seek guidance and report possible violations are key elements of an organizational culture that encourages a commitment to compliance. It is therefore inconsistent for the organizational sentencing guidelines to suggest that organizations

---

[218] *See* Freyer, Hessinger, and Klubes, Chapter 9 – *Delegating Authority*, COMPLIANCE PROGRAMS AND THE CORPORATE SENTENCING ORGANIZATIONAL SENTENCING GUIDELINES; PREVENTING CRIMINAL AND CIVIL LIABILITY, Kaplan, et. al., West Group (1999).

[219] 15 U.S.C. § 1681 *et seq.*. In 1999, the staff of the Federal Trade Commission issued an informal advisory opinion suggesting that internal investigations of alleged misconduct may violate the Fair Credit Reporting Act. *See* <http://www.ftc.gov/os/statutes/fcra/vail.htm>. For a discussion of how organizations and courts are reacting to this development, *see* James A Huizinga and Patrick O'Keefe, *Recent Developments Under the Fair Credit Reporting Act,* 58 BUS. LAW. 1137 (May 2003); *see also* Mark J. Biros and Christine D. Bachman, *The Fair Credit Reporting Act: Courts Seek to Remedy The "Catch 22" - Part II,* THE METROPOLITAN CORP. COUNS. (March 2002); *see also Internal Investigators: Testimony Heard on FCRA's Effect on Employer Probes*, 11 PREVENTION OF CORP. LIABILITY 6, at 63 (BNA) (July 21, 2003).

take actions to ascertain the "propensities" of employees when doing so may undermine the overall effectiveness of their compliance efforts.

7. Section 8B2.1(b)(3)

The Advisory Group therefore proposes that the existing guideline language be deleted and the following language included in the new §8B2.1:

> **(b) Due diligence and the promotion of an organizational culture that encourages a commitment to compliance with the law, within the meaning of subsection (a) minimally require the following steps: . . .**
>
> > **(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 a history of engaging in violations of law or other conduct inconsistent with an effective program to prevent and detect violations of law.**

The Advisory Group believes that this provision describes objective criteria which will appropriately guide organizations when delegating significant discretionary authority. In general, the logic of this provision is clear. Even absent the incentives of the organizational sentencing guidelines, organizations would logically want to ensure that those with significant responsibilities are law abiding and likely to act in accordance with company policies. Difficulties arise, however, in determining exactly how this obligation should be met in accordance with the organizational sentencing guidelines.

In particular, the proposed changes are intended to address practical difficulties that organizations may have had in determining what constitutes a "propensity to engage in illegal activities" and in assessing if an individual has such a "propensity." To address these difficulties, the proposed change replaces the phrase "propensity to engage in illegal activities" with the more objective requirement of determining if there is a "history of engaging in violations of law." The phrase "other conduct inconsistent with an effective program . . ." is intended to address those circumstances where egregious behavior that is not a violation of law is nonetheless incompatible with an effective program.

In addition to the change from "propensity to engage" to "history of engaging," the Advisory Group also proposes clarifying to whom this criterion applies. It is proposed that the requirement apply to those persons being selected for inclusion "within the substantial authority personnel of the organization." The Advisory Group also proposes a change from "illegal activity" to "violations of law." The Advisory Group has indicated that a modified definition of "violations of law" should apply in this context. As set forth in Application Note 4 to proposed guideline §8B2.1, for purposes of the new guideline §8B2.1(b)(3) only, "violations of law" means "any official determination of a violation or violations of law, whether criminal or non-criminal (including a regulation)." This definition for purposes of proposed subsection (b)(3) differs in some respects from the definition used elsewhere in this proposed new guideline.

First, the phrase "for which the organization may be liable" is removed from the definition applied in this proposed subsection because it would be illogical for the organizational sentencing guidelines to implicitly sanction the inclusion within substantial authority personnel of a person with a history of engaging in violations of law, just because those violations were not ones for which the organization involve was liable. For example, absent the broader definition of violations of law applied here, the proposed guideline would appear to sanction the hiring of a person with control over an organization's funds if that person had previously been convicted of a crime of embezzlement, an offense for which the employing organization would not be liable. Second, this proposed Application Note specifies that, in determining whether a person has a history of engaging in violations of law, the violations of law that must be considered are those where there has been an official determination of a prior violation of law, so that an organization can reasonably limit its focus when screening persons for inclusion within substantial authority personnel.

To meet this new requirement, organizations may still choose to follow one or more of the employee screening practices summarized above. The Advisory Group believes, however, that the change will provide clearer guidance to organizations in choosing only the most effective means to ensure overall compliance. That is, this change will assist organizations in designing effective programs that balance the need for gathering employee information while at the same time avoiding intrusive policies that stifle vital internal communications. Compliance with this criterion, of course, must be consistent with federal and state or local employment law. An organization is not expected to use a method of determining whether a particular individual has a history of engaging in violations of law that would be prohibited under such laws.

In applying the "history of engaging in violations of law" standard, it should be kept in mind that many states have enacted statutes that restrict an employer's ability to request information concerning a job applicant's criminal history, or from considering such information in making employment decisions.[220] While federal anti-discrimination law does not expressly prohibit employers from basing employment decisions on the criminal history of an applicant or employee, as noted above, the consideration of criminal history may give rise to a disparate impact claim if a disappointed candidate can demonstrate that it operates to exclude those groups who are disproportionately the subject of reported criminal conduct.[221]

Although the law regarding an employer's consideration of criminal history may differ state by state, as a general rule, employers may only consider an applicant or employee's conviction record on a case-by-case basis when there is a compelling business justification and

---

[220] *See, e.g.,* N.Y. Exec. Law § 296(15), (16).

[221] *See Griggs v. Duke Power Co.,* 401 U.S. 424, 430-31 (1971) (adopting disparate impact theory in the context of an employer's use of written aptitude tests); *Green v. Missouri Pacific R.R. Co.,* 523 F.2d 1290, 1295 (8th Cir. 1975) (expanding the holding of *Griggs* to an employer's consideration of criminal conviction records).

when the offense is related to the requirements of the particular job at issue.[222] Moreover, a number of states expressly restrict the consideration of arrest records.[223] Certain legislative exceptions to these rules do exist, however, such as the Federal Deposit Insurance Act, which generally prohibits federally-insured depository institutions from employing persons who have been convicted of any criminal offense involving dishonesty or a breach of trust or money laundering,[224] and a number of states which permit law enforcement agencies to consider an applicant's criminal history.[225]

B. EFFECTIVE COMMUNICATION OF STANDARDS AND TRAINING

1. Background to §8B2.1(b)(4)

One of the existing seven minimum requirements of an effective program, reflected in §8A1.2 Application Note 3, deals with organizational communication. This subsection provides:

> (k) *. . . Due diligence requires at a minimum that the organization must have taken the following types of steps: . . .*
>
> *(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.*

In reviewing this language, the Advisory Group noted that the Application Note's use of "e.g." can be interpreted to mean that "training programs" and "disseminating publications" are illustrative examples, rather than necessary components, of "communicating effectively." The use of "or" can also be interpreted to mean that "training programs" and "disseminating publications" are alternative means for satisfying the "communicating effective" requirement. The Advisory Group therefore examined whether this language should be clarified to make clear that both training and other methods of communications are necessary components of "an effective" program and, if so, whether the term "disseminating publications" should be replaced by more flexible language such as "other forms of communications."

During the November 14, 2002, public hearing, Advisory Group Member Gregory Wallance posed the question: "Would anyone here regard as effective a compliance program that

---

[222] *See, e.g., New York City Transit Auth. v. Beazer,* 440 U.S. 568, 587 (1979); *see generally* EEOC Compliance Manual (CCH) ¶ 2088 (Jan. 1998).

[223] *See, e.g.,* Cal. Lab. Code § 432.7(a).

[224] 12 U.S.C. § 1829(a)(1).

[225] *See, e.g.,* N.Y. Exec. Law § 296(16).

has no training and simply relied on a fairly detailed employee code of ethical conduct?"[226] He continued by suggesting that the organizational sentencing guidelines state that an effective program should include a training component and then leave it to companies to decide what the detailed characteristics of that component should be.[227] There seemed to be general agreement with this suggestion; certainly no one objected to the inclusion of training as a required component of the "seven minimum requirements of an effective program to prevent and detect violations." Indeed, Eric Pressler, Director of Legal Compliance and Business Ethics for PG&E Corp., emphasized that "training is an essential component" of an effective compliance program.[228]

The consensus expressed at the public hearing was reinforced by the fact that legal compliance standards promulgated since the advent of the organizational sentencing guidelines put great emphasis on training. For example, the need for training in all businesses, including small ones, was addressed by the Office of Inspector General, Health and Human Services in its "OIG Compliance Program for Individual and Small Group Physician Practices."[229] Step four of the OIG's seven-part requirement states:

> Education is an important part of any compliance program and is the logical next step after problems have been identified and the practice has designated a person to oversee educational training. Ideally, education programs will be tailored to the physician practice's needs, specialty and size and will include both compliance and specific training.[230]

Most recently, in the USA Patriot Act, Congress mandated that every financial institution establish an anti-money laundering program whose minimal requirements include an ongoing employee training program.[231] Standards created by the Department of the Treasury for anti-

[226]Transcript of Breakout Session II (Nov. 14, 2002), Greg Wallance, pp. 67-68 lines 19-21, 1. This transcript is available at: <http://www.ussc.gov/corp/advgrp.htm>.

[227]*Id.*, p. 68 lines 9-13.

[228]"My perspective is that training is a very important component. We have tests that show that people learn things that they didn't know before they took the training." Transcript of Breakout Session II, Eric Pressler, p. 70 lines 11-16. "So something is going on that is either encouraging people to report things that are wrong that they now know are wrong because of the training or to ask questions about [it] in more detail about how things should be done. I think training is an essential component." *Id.,* p. 71 lines 5-10.

[229]<http://www.oig.hhs.gov/authorities/docs/physician.pdf>; 65 Fed. Reg. 59434 (Oct. 5, 2000).

[230]*Id. See also*, Environmental Protection Agency, Incentives for Self-Policing: Discovery, Disclosure, Correction and Prevention of Violations, 65 Fed. Reg. 19618, 19621 (April 11, 2000)(recognizing that "[c]ompliance management programs that train and motivate employees to prevent, detect and correct violations on a daily basis are a valuable complement to periodic auditing.").

[231]*See* Pub. L. No. 107-56, 115 Stat. 322, §352(a).

money laundering programs also stress training and education as part of anti-money laundering programs.[232]

2. Section 8B2.1(b)(4)

The Advisory Group therefore recommends that the following language be included in the proposed §8B2.1:

(b) Due diligence and the promotion of an organizational culture that encourages a commitment to compliance with the law within the meaning of subsection (a) minimally require the following steps: . . .

(4) (A) The organization shall take reasonable steps to communicate in a practical manner its compliance standards and procedures, and other aspects of the program to prevent and detect violations of law, 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, the organizational leadership, the organization's employees, and, as appropriate, the organization's agents.

This portion of the proposal has the twofold effect of eliminating existing confusion and strengthening the requirement that compliance standards be communicated to organizational agents. Training should not merely be considered as one of the many ways to "communicate effectively [organizational] standards and procedures." The Advisory Group believes that effective training has two components: (1) educating all employees about compliance requirements, *and* (2) motivating all employees to comply. Simply communicating standards and procedures through written documentation may satisfy the first, but it is unlikely to be effective in motivating employees to comply over time. As compliance expert Joseph Murphy has explained:

> Training involves more than the transfer of information to willing recipients. It is also about motivating employees to follow the rules. While there are certainly a large number of transgressions because of ignorance, the truly serious violations that reach the newspapers and incur multi-million dollar fines are typically the result of deliberate wrongdoing. They do not usually happen because a hapless employee lacked knowledge or needed to be told that the company valued ethical behavior. Regrettably, there are genuinely bad actors in

[232] *See* Financial Crimes Enforcement Network, Department of the Treasury, "Anti-Money Laundering Programs for Insurance Companies," 67 Fed. Reg. 60625, 60628-29 (Sept. 26, 2002) (31 C.F.R. pt. 103).

> corporate America (as in all parts of society), and there are others who may too readily yield to temptation or pressure to break the rules. These people are not necessarily helped or deterred by training that delivers only detailed information. Instead they need training that helps to motivate them and to deter misconduct.[233]

By requiring organizations to communicate compliance standards and procedures through both training and information dissemination, the Advisory Group wishes to emphasize that all organizations should engage in some form of active compliance training. The proposed language of §8B1.2(b)(4) also makes explicit that personnel at all levels of an organizational hierarchy should be made aware of their compliance responsibilities–from the governing authority right down, as appropriate, to organizational agents.

While the Advisory Group submits that clarifying language is desirable, it also believes that it would be unwise to be too prescriptive. Instead, the Advisory Group believes that organizations should have the flexibility to determine the types of compliance training and information dissemination that are appropriate given the size of their workforces, the types of misconduct that are of concern given the organizations' operations and fields of activity, and other factors such as the job responsibilities of the persons being trained.

Training does not need to be either formal or expensive in order to be effective. United States Attorney Debra Yang (C.D. Ca.) addressed this concept during the Advisory Group's public hearing, stating that "[w]hen you are a very small company, training could begin by just somebody starting that process during orientation."[234]

The language presently used in the guidelines which refers to "requiring participation in training programs" conjures up an image of very formal and possibly expensive training initiatives that small organizations might not be able to afford. By substituting the phrase "conducting effective training" for "requiring participation in training programs," the Advisory Group sought to ensure that small organizations would not be overly burdened in meeting the training obligations specified in the proposed guideline. For such small entities, effective training could occur during orientation sessions, monthly staff meetings, or even casual conversations between a manager and her subordinates. The larger the organization, the more appropriate it may be to have a more formal training program with appropriate documentation and dedicated resources and tools to measure the training program's impact.[235] The burden would thereby

---

[233] Joseph E. Murphy, Training "in a Practical Manner," Corporate Compliance 1999, at 559 (1999).

[234] Transcript of Breakout Session II (Nov. 14, 2002), Debra Yang, p. 58 lines 17-19. This transcript is available at: <http://www.ussc.gov/corp/advgrp.htm>.

[235] In the Advisory Group's November 14, 2002 hearing, Scott Gilbert, General Electric's Counsel of Litigation and Legal Policy, discussed the complexity of designing a program and training 300,000 people in nine languages, Transcript Breakout Session II, p. 61 lines 14-18, and there was a great deal of general discussion about the effectiveness of web-based training versus small-group training.

remain on the organization to explain what training occurred and why the organization considered it effective.[236]

C. MONITORING, AUDITING, AND EVALUATION

1. Background to §§8B2.1(b)(5)(A) & (B)

One of the existing seven minimum requirements of an effective program, reflected in §8A1.2, Application Note 3, addresses auditing and monitoring as follows:

> (k) . . . Due diligence requires at a minimum that the organization must have taken the following types of steps: . . .
>
> *(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*.

The use of an "*e.g.*" prior to the discussion of monitoring and auditing systems might be read to imply that such systems are not essential to effective compliance programs. The Advisory Group concluded that an increased emphasis on monitoring, auditing, and evaluation practices is justified on three independently sufficient grounds: (1) the recognition of the importance of compliance monitoring, auditing, and evaluation in recent legal standards; (2) practical evidence of the importance of these practices in revealing recent incidents of major corporate misconduct; and (3) privately developed standards and expert opinions identifying monitoring, auditing, and evaluation efforts as important components of effective compliance programs.

Several recently enacted statutory and regulatory standards from a variety of legal domains emphasize that compliance monitoring, auditing, and evaluation systems are essential parts of compliance programs. For example, provisions of the USA Patriot Act require financial institutions (including a wide range of businesses that engage in cash transactions) to implement anti-money laundering programs that include independent audit functions to test the programs.[237] Implementing regulations of the Department of the Treasury have elaborated on these requirements.[238]

---

[236]As United States Attorney Yang also stated during the November 14, 2002 hearing, training must be more than just a "paper program." She observed that in some organizations, "[training manuals] aren't used in any meaningful way. They were developed and then they were shelved." Transcript Breakout Session II, p. 58 lines 5-6.

[237]*See* Pub. L. No. 107-56, 115 Stat. 322, §352(a).

[238]*See* Financial Crimes Enforcement Network, Department of the Treasury, "Anti-Money Laundering Programs for Insurance Companies," 67 Fed. Reg. 60625 (Sept. 26, 2002) (31 C.F.R. pt. 103).

For example, the Treasury Department's proposed standards for anti-money laundering programs within insurance companies specify that an insurance company is required to conduct independent testing of its anti-money laundering program to ensure that the program complies with federal regulatory standards and that the program functions as designed. This testing can be performed by an outside consultant or accountant, but need not be. An employee of the company involved can perform system testing provided that the tester is not the compliance officer in charge of the program or otherwise involved in administering the program. The frequency of program testing is required to be based on a company's assessment of the compliance risks it faces in its operations.[239]

Similarly, the Environmental Protection Agency has stated that the following auditing and monitoring elements are critical components of compliance management systems aimed at preventing, detecting and correcting violations of environmental laws:

> Mechanisms for systematically assuring that compliance policies, standards, and procedures are being carried out, including monitoring and auditing systems reasonably designed to detect and correct violations [and] periodic evaluation of the overall performance of the compliance management system. . .[240]

In yet another very different compliance context, the Office of Inspector General (OIG) within the Department of Health and Human Services has also recognized that compliance monitoring and auditing activities are important means to prevent government billing fraud and regulatory violations in the health care field. For example, in its standards for hospitals, the OIG has specified that:

> An ongoing evaluation process is critical to a successful compliance program. The OIG believes that an effective program should incorporate thorough monitoring of its implementation and regular reporting to senior hospital or corporate offices. Compliance reports created by this ongoing monitoring, including reports of suspected noncompliance, should be maintained by the compliance officer and shared with the hospital's senior management and the compliance committee . . .
>
> An effective compliance program should also incorporate periodic (at least annual) reviews of whether the program's compliance elements have been satisfied, e.g., whether there has been appropriate

[239] *Id.* at 60629.

[240] Environmental Protection Agency, Incentives for Self-Policing: Discovery, Disclosure, Correction and Prevention of Violations, 65 Fed. Reg. 19618 (April 11, 2000).

> dissemination of the program's standards, training, ongoing educational programs and disciplinary actions, among others.[241]

The importance of independent compliance monitoring and auditing is further illustrated by the role of independent auditing practices in revealing and stopping recent incidents of corporate fraud. For example, internal audits of the company's payment and accounting practices, coupled with the reporting of detected misconduct to the corporation's board, were responsible for detecting and stopping one of the biggest corporate frauds in U.S. history -- Worldcom's multi-billion dollar misstatement of corporate expenses. Similar systematic monitoring of compliance in other areas should aid companies in detecting and stopping misconduct in a variety of contexts, provided that it is done by independent evaluators having the ability to invoke board access when compliance problems are found.

Expert opinion in the field of compliance programs, as reflected in several privately issued standards for such programs and in expert testimony provided to the Advisory Group, also emphasize that monitoring, auditing, and evaluation systems are key components of compliance programs. For example, standards developed by the International Standards Organization for an environmental management system (EMS), which are designed, in part, to ensure environmental law compliance, require that such a system include the following monitoring, auditing, and evaluation features:

(1) Establishing a program to periodically audit the operation of the EMS;

(2) Checking and taking corrective and preventive actions when deviations from the EMS occur, including periodically evaluating the organization's compliance with applicable regulatory requirements; and

(3) Undertaking periodic reviews of the EMS by top management to ensure its continuing performance and making adjustments to it, as necessary.[242]

Likewise, in the health care field, the Health Care Compliance Association has recently developed criteria for evaluating the quality of compliance programs in medical organizations. These criteria specify that:

> Effective compliance programs include proactive monitoring and auditing functions that are designed to test and confirm compliance

---

[241] Office of Inspector General, Department of Health and Human Services, Compliance Program Guidance for Hospitals, 63 Fed. Reg. 8987, 8996-7 (Feb. 23, 1998)(footnotes omitted).

[242] *See, e.g.*, <http://www.epa.gov/owm/iso14001/isofaq.htm>.

with legal requirements and the organization´s written compliance standards.[243]

These criteria recognize that high quality compliance programs incorporate the following monitoring and auditing features:

(1) The organization conducts a regular compliance auditing and monitoring program consistent with the organization's size, complexity and frequency of audits;

(2) The organization has auditors that are independent, to the extent possible, from the areas of the organizations they are auditing;

(3) A written compliance auditing and monitoring plan addresses the subject, method and frequency of audits;

(4) The organization gives notice to senior management and/or the board of directors of major audit findings;

(5) Corrective action plans are produced and followed in response to adverse findings;

(6) Features of audit plans respond to the organization's history of misconduct; and

(7) Audit results are disseminated to appropriate groups for corrective actions.[244]

Finally, expert views presented to the Advisory Group indicate that many compliance program managers and advisers consider that regular evaluations of program effectiveness are an essential means to ensure the completeness and success of a compliance program. These experts uniformly recognized the importance of compliance monitoring and auditing practices, provided that organizations retain some flexibility to establish performance baselines and evaluative standards for assessing the success of programs within the companies´ particular operating circumstances. Experts also generally agreed that the regular evaluation of the progress and success of a compliance program is a very important step in ensuring that the compliance programs are properly focused and adequately conducted so as to be generally effective in preventing and detecting illegal conduct.[245]

---

[243] Health Care Compliance Association, Evaluating and Improving a Compliance Program (2003) at <http://www.hcca-info.org/Content/NavigationMenu/Compliance_Resources/Evaluation_Improvement/Eval-Improve03.pdf>.

[244] *Id.*

[245] *See* Transcript of Breakout Session II (Nov. 14, 2002), Barbara Kipp, p. 127-8; Gale C. Andrews, p. 139; Nancy M. Higgins, p. 135-6; Scott Gilbert, p. 133. This transcript is available at: <http://www.ussc.gov/corp/advgrp.htm>.

2. Sections 8B2.1(b)(5)(A) & (B)

The Advisory Group therefore recommends that the following language be included in the proposed §8B2.1:

(b) Due diligence and the promotion of an organizational culture that encourages a commitment to compliance with the law within the meaning of subsection (a) minimally require the following steps: . . .

(5) The organization shall take reasonable steps–

(A) to ensure that the organization's program to prevent and detect violations of law is followed, including using monitoring and auditing systems that are designed to detect violations of law;

(B) to evaluate periodically the effectiveness of the organization's program to prevent and detect violations of law;

Through the addition of subsections (b)(5)(A) and (B) of guideline §8B2.1, the Advisory Group proposes that the organizational sentencing guidelines be amended to describe more fully the types of compliance monitoring, auditing, and evaluation that are essential features of an effective program to prevent and detect violations of law. The proposed changes primarily address three aspects of compliance monitoring, auditing, and evaluation.

First, the proposed changes remove the language ("*e.g.*") currently in §8A1.2 (Application Note 3(k)(5)) which may be understood to suggest that monitoring and auditing systems are examples of optional compliance program practices. This change is intended to recognize that regular compliance evaluations through auditing and monitoring practices are essential features of every compliance program.

Second, the proposed changes indicate that organizations should regularly scrutinize two separate organizational characteristics: (1) the adherence of organizational activities to applicable laws and compliance program requirements; and (2) the sufficiency of managerial practices comprising an organization's compliance program to ensure a reasonable likelihood of success in preventing and detecting violations of law. Except in the area of systems to detect violations of law, organizations will be free to choose their own reasonable means for ensuring that their compliance programs are being followed and for periodically evaluating the effectiveness of those programs. Compliance monitoring and auditing systems should be used to detect organizational violations of law. Differently focused monitoring and auditing practices may be used to assess the effectiveness of an organization's compliance program, although other periodic evaluation methods may be used as well.

Third, through additional provisions contained in §8B2.1(c), the proposed changes specify that compliance monitoring, auditing, and evaluation practices should be based on compliance risk assessments. This change clarifies that characteristics of monitoring, auditing, and evaluation efforts, such as the targeting and frequency of compliance assessments, should correspond to the likelihood of compliance problems in particular organizational activities.

The proposed changes do not specify the precise sorts of monitoring or auditing practices that will constitute adequate steps under these standards. Determinations of the sorts of periodic compliance assessments that will compose sufficient monitoring, auditing, and evaluation practices will depend on the characteristics and activities of specific organizations. In small organizations, periodic evaluations of compliance in the course of day-to-day business operating practices will often be adequate monitoring steps so that further auditing or evaluations will not be needed. In larger organizations, however, separate audits of compliance performance will usually be warranted, with such audits being conducted by internal or external parties who are independent of the managers overseeing the performance under scrutiny.

In general, a sufficient monitoring, auditing, and evaluation system will be one which provides organizational managers, on an ongoing basis, with sufficient information to determine if their organization's compliance program is generally effective in preventing and detecting violations of law. This degree of information, and the monitoring, auditing, and evaluation practices that are needed to obtain it, will depend on such features as an organization's compliance history, functional units, operating practices, and legal environment.

D. REPORTING SYSTEMS

1. Background to §8B2.1(b)(5)(C)

One of the existing seven minimum requirements of an effective program, reflected in §8A1.2 Application Note 3, addresses, in part, internal organizational reporting. This subsection provides:

> (k) . . . *Due diligence requires at a minimum that the organization must have taken the following types of steps: . . .*
>
> *(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*.

Organizations necessarily must depend in large part on information from employees and agents in order to correct potential or actual wrongdoing within the organization. It is axiomatic that organizations should have internal reporting mechanisms that actually encourage reporting of suspected wrongdoing. Both experience and research demonstrate that employees may be reluctant to make such reports unless there is a high level of confidence both that management will act on reports of misconduct and that there will be no retaliation for reports made in good faith.

An organization may validly promise that it will not officially retaliate against an individual within the organization. This promise generally consists of measures to protect the reporting individuals from harassment and punitive measures by management and supervisory level personnel over whom the organization exercises control within the workplace. Nonetheless, the organization cannot provide similar reassurances that hostility or ostracism will not occur by workplace colleagues and the broader community over which the organization does not exercise control. Even if the reporting individual does not fear losing his or her position within the organization, the fear of being labeled a "snitch" by peers remains a significant impediment to reporting potential or actual wrongdoing.[246]

The fear of retaliation, including retaliation by co-workers, is well documented. Recent scholarship suggests that an increasing number of identified whistleblowers suffered retaliation and a larger proportion chose to remain anonymous. The 2003 National Business Ethics survey by the Ethics Resource Center found that while there had been an overall increase in employee reporting of misconduct (compared to earlier surveys), "nearly half of all non-management employees (44%) still do not report the misconduct they observe."[247] Fifty-seven percent of those not reporting misconduct indicated that they feared that their report would not be kept confidential (up from 38% found in the 1994 survey); 41 percent feared retaliation from their manager (the same percentage reported in 1994); and 30 percent feared retaliation by their co-workers (up from 24% reported in 1994).[248]

Similar findings were made by the Conference Board Commission on Public Trust and Private Enterprise in January 2003 that cited recent studies in which the authors reported that of the 300 whistleblowers they had interviewed, 69 percent said that they had lost their jobs or were forced to retire as a result. [249] The same Conference Board report also cited a Time/CNN Survey/Harris Interactive poll from December 2002 on whether whistleblowers face negative consequences at work, such as being fired or treated poorly. The survey found that 57 percent of the public responding perceived that whistleblowers did face such consequences "most of the time" and another 30 percent responded that they did "some of the time."[250] There is thus powerful evidence that lack of confidentiality and fear of retaliation are major inhibitors to reporting.

---

[246]*See* studies compiled in M.P. MICELI & J.P. NEAR, BLOWING THE WHISTLE (Lexington Books, 1992).

[247]Ethics Resource Center, National Business Ethics Survey - 2003: How Employees View Ethics in Their Organization (2003), p. iii. Executive Summary available at: <http://www.ethics.org/nbes2003/2003_summary.html>.

[248]*Id*. at 43.

[249]Marcia Miceli, *et al.*, *Can Laws Protect Whistle-Blowers?*, 26 WORK & OCCUPATION 129, 131 (1999).

[250]The public perception of retaliation against whistleblowers is all the more significant in light of the fact that whistleblower protection laws have been enacted in each of the fifty states and in connection with various federal regulatory schemes. *See* Elletta Sangrey Callahan & Terry Morehead Dworkin, *The State of the Whistleblower Protections,* 38 AM. BUS. L. J. 99 (2002).

Concern about the need for confidential means of raising issues has been longstanding. Even before the organizational sentencing guidelines were first promulgated in 1991, major organizations in the defense industry came together in 1986 following the procurement fraud scandals of the 1980s to draft guiding principles for corporate conduct entitled the "Defense Industry Initiatives Business Ethics and Conduct." One of these principles, "Principle 3: Corporate Responsibility to Employees," provides: "To encourage the surfacing of problems, normal management channels should be supplemented by a confidential reporting mechanism."[251] A similar concern led to the original commentary provisions in §8A1.2, Application Note 3(k)(5), requiring a "reporting system whereby employees and other agents could report criminal conduct by others within the organization without fear of retribution." Likewise, Congress provided in § 301 of the Sarbanes-Oxley Act of 2002 that publically traded companies adopt procedures for the "confidential, anonymous submissions by employees of issues or concerns regarding questionable accounting for auditing practices."[252]

Although the Advisory Group received both written comment and testimony recommending that no change in the guidelines or related commentary should be made at all on

---

[251] "Principle 3: Corporate Responsibility to Employees

> Every company must ensure that employees have the opportunity to fulfill their responsibility to preserve the integrity of the code and their honor system. Employees should be free to report suspected violations of the code to the company without fear of retribution for such reporting. To encourage the surfacing of problems, normal management channels should be supplemented by a confidential reporting mechanism.
>
> It is critical that companies create and maintain an environment of openness where disclosures are accepted and expected. Employees must believe that to raise a concern or report misconduct is expected, accepted, and protected behavior, not the exception. This removes any legitimate rationale for employees to delay reporting alleged violations or for former employees to allege past offenses by former employers or associates.
>
> To receive and investigate employee allegations of violation of the corporate code of business ethics and conduct, defense contractors can use a contract review board, an ombudsman, a corporate ethics or compliance office, or other similar mechanism.
>
> In general, the companies accept the broadest responsibility to create an environment in which free, open, and timely reporting of any suspected violations becomes the felt responsibility of every employee."

[252] The Sarbanes-Oxley Act of 2002, § 301, provides that:

> "Each audit committee [of a publicly traded company] shall establish procedures for–
>
> ...
>
> (B) the confidential, anonymous submission by employees of the issuer of concerns regarding questionable accounting or auditing matters."

Pub. L. No. 107-204, § 301, 116 Stat. 745, 776.

the issue of confidentiality,[253] much of the written commentary and testimony supported some change to foster confidential reporting. Several of the responses spoke directly to the advantages of ombuds programs in encouraging confidential reporting,[254] while others expressed the view that some sort of source protection would be desirable, though such a provision is beyond the scope of changes that could be made to the guidelines or commentary.[255] Yet others were reluctant to urge adoption of any specific means or mechanism to encourage reporting while indicating that reporting should be encouraged.[256] Indeed, this latter position was taken by the U.S. Department of Justice in its written testimony.

> The inclusion of internal whistleblower protections is an important measure of an organization's commitment to have an "effective program." Similarly, the creation of an ombudsman or similar neutral office may also be an important measure (although, as we stated above, we think the guidelines should not dictate specifics), as would creation of other means of encouraging reporting without fear of retribution.

---

253 Letter of John T. Bentivoglio and Brent L. Saunders of Arnold & Porter and PricewaterhouseCoopers, LLP, October 4, 2002, on behalf of 19 pharmaceutical companies; letter of David E. Matyas and Carrie Valiant of Epstein, Becker & Green, PC, on behalf of that firm's health care and pharmaceutical clients; written statement of James W. Conrad for the American Chemistry Council, November 14, 2002, together with letters of May 16, 2002 and October 11, 2002 from David T. Buente of Sidley, Austin, Brown & Wood, LLP; letter of Roger Fine, Vice President and General Counsel of Johnson & Johnson, May 16, 2002; written and oral testimony of James Cowdery on concerns of small business. This information is available at: <http://www.ussc.gov/corp/advgrp.htm>.

254 Written testimony and letter of August 27, 2002 of Patrick Gnazzo, Vice President of Business Practices for United Technologies Corporation, and his oral testimony during Breakout Session III; letter of Redmond, Williams & Associates, October 3, 2002; letter of John Parauda, Managing Counsel of American Express Company, October 4, 2002; written comments from John S. Barkat, Ph.D., on behalf of The Ombudsman Association, October 2, 2002 and December 10, 2002; letters from A. Terry Van Houten, Assistant General Counsel, Employment Law & Personnel Relations Legal Staff, Eastman Kodak Company, October 5, 2002 and February 3, 2003; written testimony of Francis J. Daly, Corporate Director, Ethics and Business Conduct, Northrup Grumman Corporation, October 29, 2002; and comments of Lynne L. Dallas, Professor of Law, University of San Diego School of Law, October 5, 2002. This information is available at: <http://www.ussc.gov/corp/advgrp.htm>.

255 *See, e.g.*, written testimony of Joseph E. Murphy and his oral testimony during Breakout Session III; letter of David I. Greenberg, Senior Vice President and Chief Compliance Officer, Philip Morris Companies, Inc., October 11, 2002; letter of Nancy McCready Higgins, Vice President, Ethics and Business Conduct, Lockheed Martin Corporation, November 5, 2002; letter of Barbara H. Kipp, Partner and Global Leader, Ethics and Business Conduct, PricewaterhouseCoopers, LLP, October 29, 2002; Public Comment from the Ethics Resource Center with cover letter of October 4, 2002 from Patricia J. Harned, Ph.D., Managing Director of Programs. This information is available at: <http://www.ussc.gov/corp/advgrp.htm>. *See also* William B. Lytton and Winthrop M. Swenson, *Public Sector Encouragement of Private Sector Compliance Programs*, ACCA DOCKET, November/December 2002.

256 Letter of Nancy Thomas-Moore and Gretchen A. Winter, October 30, 2002 on behalf of the Ethics Officer Association; letter of Nancy McCready Higgins, Vice President, Ethics and Business Conduct, Lockheed Martin Corporation, November 5, 2002; letter of Barbara H. Kipp, Partner and Global Leader, Ethics and Business Conduct, PricewaterhouseCoopers, LLP, October 29, 2002; letter of Eric Pressler, Director, Legal Compliance and Business Ethics, PG&E Corporation, October 29, 2002; Public Comment from the Ethics Resource Center with cover letter of October 4, 2002 from Patricia J. Harned, Ph.D., Managing Director of Programs. This information is available at: <http://www.ussc.gov/corp/advgrp.htm>.

> Such "other means" could include a mechanism to *confidentially* report to the Board of Directors, or the Board Audit Committee where appropriate, without fear of retaliation. However, the guidelines should not incorporate any provisions which would encourage employees or organizations to think internal self assessment and correction would be subject to a privilege, since such a privilege may not exist in law.[257]

The concern over the lack of any privilege to protect confidentiality results from the fact that the current legal system does not totally shield confidential internal reports from litigation demands if the litigation demand is related to the subject matter of the confidential internal reports. Litigation demands typically consist of subpoenas issued by the government in enforcement and grand jury proceedings, as well as subpoenas and discovery requests by third party litigants who institute civil and administrative actions against the organization. Once documents and testimony are produced in response to such litigation demands, maintaining confidentiality as to the identity of the individual who reported certain information is no longer a viable possibility.[258]

Thus, organizations cannot in good faith promise total confidentiality to their employees and agents when asking them to report suspected wrongdoing. Instead, responsible organizations generally precede any disclosure that an individual wants to make in confidence with the caveat that both the information itself and the identity of the reporting individual may ultimately be made public through litigation demands beyond the organization's control.[259] This reality, of

[257] The U.S. Department of Justice's written testimony, p. 18, available at: <http://www.ussc.gov/corp/ph11_02/t_comey.pdf>.

[258] Even if information is collected under the auspices of the attorney-client privilege and protection of the work product doctrine, those privileges are most likely waived once any related information is disclosed pursuant to voluntary disclosures and self-reporting that the organizational sentencing guidelines encourage. *See* extensive discussion at Part V, below.

[259] The Advisory Group is aware that numerous corporations have responded to concerns over confidentiality by creating independent, neutral, and confidential ombuds offices where employees can seek assistance or express concerns. These offices are separate from compliance programs, yet assist them in facilitating employee reporting. By specifically providing that the ombuds offices do not conduct investigations and that they are not a reporting channel to place the organization on notice, these organizations promise confidentiality for employee communications with the ombuds. Although the Eighth Circuit did not recognize an "ombuds privilege" based on the inadequate record presented to it in *Carman v. McDonnell Douglas Corp.*, 114 F.3d 790 (8th Cir. 1997), two of the corporations that provided testimony to the Advisory Group, United Technologies Corporation and American Express Company, have successfully defended the confidentiality of such communications against legal challenges. *Roy v. UTC*, No. H-89-68P (JAC) (D. Conn. May 29, 1990); *Van Martin v. UTC*, No. 95-8389-CIV; *Ungaro-Benages* (S.D. Fla., July 16, 1996), affirmed without opinion 141 F.3d 1188 (11th Cir. 1998); *Leslie v. UTC*, 51 F. Supp. 2d 1332 (S.D. Fla. 1998); *Smith v. American Express Company*, Case No. 98-7206-CIV-Jordan (S.D. Fla., January 3, 2000). *See also* Charles L. Howard and George R. Wratney, *In the Aftermath of the Carman Decision, Ombuds 'Privilege' Still Has Validity*, ETHIKOS, May/June 1999, pp. 9-10; Transcript of Breakout Session III (Nov. 14, 2002), Patrick Gnazzo, pp. 88-98; and Patrick J. Gnazzo and George R. Wratney, *Are You Serious About Ethics? For Companies That Can't Guarantee Confidentiality, the Answer is No,* ACROSS THE BOARD (Conference Board Magazine), Vol. XL No. 4, July/August 2003, pp. 47-50.

course, may well serve to chill the reporting individual's willingness to come forward and prevent the organization from learning facts that would have assisted the organization in preventing and detecting wrongdoing at the earliest possible opportunity. This particular attempt to balance competing policy demands and legal realities, which comprises an important aspect of the "litigation dilemma" discussed more extensively at Part VI herein, was the subject of much concern and discussion during the Advisory Group's tenure.

As emphasized by some commentators to the Advisory Group, a self-reporting mechanism alone does not promote effective compliance with the law. More critical to achieving this ultimate objective is whether an organization acts promptly to terminate illegal conduct that is reported. The organization can do this most effectively by acting on verifiable reports and letting the reporting individual know the outcome of its efforts to investigate. Nonetheless, this exchange of information and dialogue is admittedly difficult to obtain through anonymous reporting mechanisms alone.[260]

As a result, some commentators encourage the establishment of ways in which to protect the identity of a reporting individual from discovery, both inside and outside an organization, but not necessarily shield from discovery the substance of the information if privileges are properly waived. The Advisory Group learned that one way in which this objective has been successfully accomplished is through the independent, neutral "ombudsman" office at United Technologies Corporation.[261] Other methods for protecting whistleblower reports and related information were extensively developed and explored at the public hearing and through the written testimony as well.[262]

The Department of Justice endorsed internal whistleblower protections as an important measure of an organization's commitment to having an effective compliance program.[263] Its

---

[260] "Whistle-blowers who are anonymous to everyone, including the complaint recipient, take less of a risk of retaliation than do other whistle-blowers. At the same time, they risk their effectiveness for at least [several] reasons . . . if whistle-blowers would be viewed as credible complainants because of their characteristics, remaining anonymous reduces their credibility, because the complaint recipient does not have the opportunity to assess it . . . [and] as implied earlier, if they do not provide sufficient evidence of wrongdoing, the complaint recipient is unable to contact them for additional information." MICELI & NEAR, BLOWING THE WHISTLE, 74 (Lexington Books, 1992).

[261] Through the unique structure of its ombudsman office, United Technologies has been successful in maintain the confidentiality of the information provided to the ombudsman against demands for external disclosures. Transcript Breakout Session III (Nov. 14, 2002), Patrick Gnazzo, pp. 88-98. This transcript is available at: <http://www.ussc.gov/corp/advgrp.htm>. *See also* Patrick J. Gnazzo and George R. Wratney, *Are You Serious about Ethics? For Companies That Can't Guarantee Confidentiality, the Answer Is No*, ACROSS THE BOARD (Conference Board Magazine) Vol. XL. No. 4 July/August 2003 pp. 47-50.

[262] For example, Joseph Murphy expounded on the advantages of permitting organizations to be protected from having such information used against it in third-party litigation once it is made public. Transcript of Breakout Session III (Nov. 14, 2002), pp. 16-21, 71. Former Sentencing Commissioner Michael Goldsmith proposed a modified self-evaluative privilege that might be adapted to this situation. *Id.*, pp. 46-50.

[263] Transcript of Plenary Session II (Nov. 14, 2002), Debra Yang, p. 17. This transcript is available at: <http://www.ussc.gov/corp/advgrp.htm>.

representatives acknowledged at the public hearing that the creation of an ombudsman or similar "neutral" office may work well as an internal reporting mechanism, but cautioned that the organizational sentencing guidelines should not suggest any provisions that go beyond the existing practical limitations of the current law on the existence and waiver of privileges.

Additional suggestions made to the Advisory Group were that the organizational sentencing guidelines should specifically state that there is an expectation of anonymous reporting, that the guidelines should design a method to encourage organizations to establish and demonstrate their anti-retaliation policy, and that organizations without such a policy should be exposed to enhanced penalties.

2. Section 8B2.1(b)(5)(C)

To address these concerns, the Advisory Group recommends that the following language be included in the proposed new guideline at §8B2.1(b)(5)(C):

(b) Due diligence and the promotion of an organizational culture that encourages a commitment to compliance with the law within the meaning of subsection (a) minimally require the following steps: . . .

(5) The organization shall take reasonable steps– . . .

(C) to have a system whereby the organization's employees and agents may report or seek guidance regarding potential or actual violations of law without fear of retaliation, including mechanisms to allow for anonymous reporting.

The Advisory Group considers it very important to encourage employees and agents to utilize an organization's internal reporting mechanism to seek guidance even when they are not sure that a violation of law has occurred. More frequent consultation in advance of problems may foster prevention as well as earlier detection of violations of law. Thus, the Advisory Group recommends that the phrase "seek guidance regarding potential or actual violations of law" be included in the proposed guideline.

The Advisory Group also recommends replacing the existing phrase "fear of retribution" with "fear of retaliation" in order to be consistent with recent federal legislation.[264] Further, the phrase "criminal conduct by others" should be replaced by "violations of law" for two reasons. First, it is important that employees and agents consult and report possible wrongdoing that they themselves may be involved in, and that there not be an implicit assumption in the language of the organizational sentencing guidelines that reporting is confined to the potential wrongdoing by "others." Language that suggests otherwise inherently contradicts the goal of self-reporting by an organization. Second, the objective of effective compliance programs is broader than preventing

[264] *See, e.g.,* Notification and Federal Antidiscrimination and Retaliation Act of 2002, Pub. L. No. 107-174, 116 Stat. 566 (May 15, 2002).

and detecting criminal conduct, so that the broader term "violations of law" should be used throughout the proposed new guideline, as discussed in Section IV(A)(2) above.

The Advisory Group decided not to recommend a further requirement that individual reports of wrongdoing be held in confidence. Although the Advisory Group received substantial and very persuasive testimony that assurances of confidentiality may well encourage more employees to report wrongdoing, the Advisory Group concluded that if an organization provides at least a mechanism for anonymous reporting (which by definition assures confidentiality), the organization otherwise should have the flexibility to choose whether to offer confidentiality assurances to employees who do not report anonymously.

An organization, for example, might legitimately choose not to assure an employee of confidentiality because, inter alia, the organization might be legally obligated to disclose the employee's report of wrongdoing or the organization might want to preserve the option to report voluntarily to law enforcement agencies the information provided by the individual employee or agent. The Advisory Group therefore concluded that the proper balance between fostering an organization's ability to provide a viable assurance of confidentiality to encourage employee and agent reports of wrongdoing and the organization's need for flexibility in disclosing such reports is best left to the judgment of the individual organization. As a result, the Advisory Group recommends that the proposed guideline specifically includes an anonymous reporting mechanism as a minimum requirement for an effective compliance program, but leave it up to individual organizations, at the present time, as to how best to handle the related issue of confidentiality.

Nonetheless, the Advisory Group is acutely aware of the limitations of anonymous reporting, particularly with respect to developing a solid internal investigation and promptly terminating violations of law or conditions which may foster such violations. It also considered persuasive much of the testimony on the need for confidential treatment of the identity of a reporting individual as a means to encourage organizations to develop more knowledge about law compliance problems in their own operations. The gathering of information on such problems may well be considerably restricted by the limited protections afforded to whistleblower reports under current laws on privileges and protection waivers. These competing tensions may constrain the development of more effective compliance programs, as well as the full implementation of legislative and regulatory mandates for companies to have internal reporting systems.[265] Perhaps the most significant of these is the recent requirement of reporting systems with whistleblower protections in the Sarbanes-Oxley Act of 2002, which specifies that a company should adopt

---

[265] *See*, *e.g.,* Securities and Exchange Commission, Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, 68 Fed. Reg. 5110, 5118, 5129 (January 31, 2003)(SEC rules encouraging companies to adopt codes of ethics that require corporate chief executive officers and chief financial officers to promptly report code violations to a designated person); New York Stock Exchange Board of Directors, Corporate Governance Rule Proposals (August 1, 2002), <http://www.nyse.com/pdfs/corp_gov_pro_b.pdf>. (New York Stock Exchange standards requiring listed corporations to adopt business conduct codes that obligate employees to report violations of laws, rules, or regulations to appropriate company personnel). *See also* 48 C.F.R.§ 203.7001(procurement regulations of the Defense Department); 48 C.F.R. §803.7000 (procurement regulations of the Department of Veterans Affairs); 48 C.F.R. § 1503.500-71 (procurement regulations of the Environmental Protection Agency).

procedures for “confidential, anonymous submission by employees . . . of concerns regarding questionable accounting or auditing matters.”[266]

The Advisory Group recognizes that a viable solution to these problems regarding the confidentiality of whistleblower reports is not presently feasible within the confines of the organizational sentencing guidelines. However, given the significant additional benefits that can occur if organizations are able to obtain more information to prevent violations of law, the Advisory Group recommends that the Sentencing Commission explore, together with The U.S. Department of Justice and other interested policy makers, how alternative methods, including legislation, as appropriate, may be developed to overcome these existing constraints on the fullest development of organizational information.

[266] Pub. L. No. 107-204, § 301, 116 Stat. 745, 776.

E. ACCOUNTABILITY AND REDEDICATION

1. Section 8B2.1(b)(6)

One of the existing seven minimum requirements of an effective program stresses accountability. This portion of the existing standards at Application Note 3 to §8A1.2 provides:

> *(k) Due diligence requires at a minimum that the organization must have taken the following types of steps: . . .*
>
> (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.*

While the Advisory Group concluded that few changes are needed to the provisions on accountability, in general, it concluded that language should be added to promote compliance standards through positive incentives as well as through disciplinary mechanisms. A culture of compliance can be promoted where organizational actors are judged by, and rewarded for, their positive compliance performance. Accordingly, the Advisory Group proposes the addition of language indicating that compliance standards should be promoted through incentives as well as enforced through disciplinary measures, giving both a "carrot and stick" to this component of the guidelines.

The Advisory Group therefore recommends that the preceding provision be replaced with the following language in the proposed §8B2.1:

> **(b) Due diligence and the promotion of an organizational culture that encourages a commitment to compliance with the law within the meaning of subsection (a) minimally require the following steps: . . .**
>
> **(6) The organization's program to prevent and detect violations of law shall be promoted and enforced consistently through appropriate incentives to perform in accordance with such program and disciplinary measures for engaging in violations of law and for failing to take reasonable steps to prevent or detect violations of law.**

Also, the Advisory Group recommends moving the final sentence of Application Note 3(k)(6) to §8A1.2 to the commentary of the proposed new guideline. The Advisory Group continues to believe that "[a]dequate 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."

2. Section 8B2.1(b)(7)

One of the existing seven minimum requirements of an effective program, reflected in §8A1.2 Application Note 3, deals with rededication. This portion of the existing standards provides:

(c) . . . *Due diligence requires at a minimum that the organization must have taken the following types of steps: . . .*

(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.

The Advisory Group believes that this language adequately reflects the need for rededication after an offense has occurred. It therefore recommends no substantive changes, but rather that the following language, conforming technically to the remainder of the proposed new guideline, be included in the new guideline §8B2.1:

(b) Due diligence and the promotion of an organizational culture that encourages a commitment to compliance with the law, within the meaning of subsection (a) minimally require the following steps: . . .

(7) After a violation of law has been detected, the organization shall take reasonable steps to respond appropriately to the violation of law and to prevent future similar violations of law, including making any necessary modifications to the organization's program to prevent and detect violations of law.

F. RISK ASSESSMENT

1. Section 8B2.1(c)

Although the existing definition of an effective compliance program contained in §8A1.2 Application Note 3(k) does not refer to risk assessment, the Advisory Group concluded that the need for risk assessment in designing and operating such a program is implicit in this definition. The Advisory Group determined that risk assessments need to be made at all stages of the development, testing, and implementation of a compliance program to ensure that compliance efforts are properly focused and effective. An explicit provision is warranted in the proposed guideline addressing risk assessment and its relationship to compliance program activities to emphasize both the importance of risk assessment and its relevance in connection with a wide variety of compliance program activities.

This emphasis on the importance of risk assessment in compliance program activities is consistent with the treatment that risk assessment has received in several recent government and private standards addressing effective programs for preventing and detecting violations of law. For example, under the USA Patriot Act, financial institutions are required to establish anti-money laundering programs.[267] Regulations promulgated by the Treasury Department specify additional requirements for anti-money laundering programs in specific types of companies.[268] Proposed standards for anti-money laundering programs in insurance companies represent a particularly detailed and well-constructed set of compliance program criteria that incorporate risk assessment requirements.[269]

The Treasury Department's proposed standards emphasize the importance of risk assessment as the basis for constructing and operating several facets of anti-money laundering law compliance programs. They indicate that an anti-money laundering program must incorporate policies, procedures, and internal controls aimed at preventing illegal money laundering and ensuring that insurance company employees make all monetary transaction reports required by federal law.[270] Insurance companies are expected to assess the changing legal risks that may arise as legal demands relating to anti-money laundering efforts shift and expand. Federal compliance program standards recognize that, should the anti-money laundering obligations of insurance companies increase under later regulations, expanded compliance program features (including revised program policies, compliance procedures, employee training, and program testing) will be needed to match the enhanced compliance obligations. In short, insurance companies will have an ongoing duty to match the scope of their compliance programs with evolving legal demands.[271]

These proposed regulations require insurance companies to undertake risk assessments as the basis for constructing and operating reasonable anti-money laundering programs. In this respect, a reasonable program is one that matches anti-money laundering actions to the nature of compliance risks faced by a firm. An insurance company must shape the features of its anti-money laundering program, including program policies, procedures, and internal controls, "based upon the insurance company's assessment of the money laundering and terrorist financing risks associated with its products, customers, distribution channels, and geographic locations."[272]

A detailed risk assessment is required to appropriately tailor a compliance program to a company's business circumstances. For example, in determining whether the nature of a company's insurance products raise risks of money laundering, the proposed Treasury Department standards indicate that an insurance company should consider whether it permits customers to use

---

[267] Pub. L. No. 107-56, 115 Stat. 322, §352(a).

[268] For a list of these regulations and links to the anti-money laundering program standards involved, see U.S. Department of the Treasury, Financial Crimes Enforcement Network, Regulatory/BSA Regulations, at <http://www.fincen.gov/reg_bsaregulations.html>.

[269] *See* Financial Crimes Enforcement Network, Department of the Treasury, "Anti-Money Laundering Programs for Insurance Companies," 67 Fed. Reg. 60625 (September 26, 2002) (31 C.F.R. pt. 103).

[270] *See Id.* at 60630.

[271] *See id.* at 60628.

[272] *Id.*

cash or cash equivalents to purchase an insurance product with a single premium or lump-sum payment, or to take out a loan against the value of an insurance product.[273]

Similarly, in assessing the risks associated with the environment surrounding company operations, an insurance company is encouraged to consider whether the company engages in transactions involving a jurisdiction whose government has been identified by the Department of State as a sponsor of international terrorism, has been designated as non-cooperative with international anti-money laundering principles, or has been designated by the Secretary of the Treasury as warranting special measures due to money laundering concerns.[274] Finally, in monitoring and testing the sufficiency of its anti-money laundering program, an insurance company is required by the proposed regulations to tailor the frequency and nature of its program testing activities to the risks of money laundering identified in the company's risk assessments.[275]

Risk assessment has received parallel attention in privately developed standards for evaluating compliance programs. For example, in the health care field, compliance program evaluation standards developed by the Health Care Compliance Association ("HCCA") recognize the central role of risk assessment in law compliance programs. The drafters of the standards concluded that "[c]reating an effective compliance program . . . requires a systematic effort (scaled to the size, resources, and complexity of the organization) to understand its principle legal obligations and risks and to make employees aware of how the relevant laws and risks impact the performance of their job functions."[276] To achieve this objective, the HCCA standards specify that well-constructed compliance programs should include:

(1) Steps to evaluate the compliance risks faced by a health care organization;

(2) Policies to address compliance risks identified by government officials in compliance guidance documents or enforcement actions;

(3) Further policies to address previously identified serious weaknesses in the organizations' compliance practices;

(4) Procedures under which organizations' monitor changes in laws and regulations; and

---

[273] *Id.*

[274] *Id.*

[275] *Id.* at 60629.

[276] Health Care Compliance Association, Evaluating and Improving a Compliance Program (2003) at <http://www.hcca-info.org/Content/NavigationMenu/Compliance_Resources/Evaluation_Improvement/Eval-Improve03.pdf>.

(5) Further mechanisms under which organizations' compliance policies and procedures are periodically reviewed and updated to reflect changes in laws and regulations.[277]

The HCCA standards also indicate that:

> The most effective compliance audit programs review operations in areas where the organization is at risk. The results of past internal reviews may help identify what risk areas an organization should focus on, or which areas may no longer require the same amount of attention.[278]

The standards also stress that valuable compliance risk information may be obtained from such sources as customer satisfaction surveys, complaint logs, adverse incident reports, and other indicators. Government reports describing enforcement agendas and incidents of illegal activities in the health care industry are identified as additional valuable sources of risk assessment information.[279]

In light of the increasing recognition afforded to risk assessment in both public and private standards governing compliance programs, the Advisory Group recommends that the following language be included as subsection (c) in the proposed new guideline at §8B2.1:

(c) In implementing subsection (b), the organization shall conduct ongoing risk assessment and take appropriate steps to design, implement, or modify each step set forth in subsection (b) to reduce the risk of violations of law identified by the risk assessment.

The proposed guideline provision addresses two aspects of risk assessment and its relationship to broader features of effective programs to prevent and detect violations of law. First, risk assessment to determine the scope and nature of risks of violations of law associated with an organization's activities should be ongoing. The nature of the legal obligations of an organization and the ways that specific organizational activities interact with those obligations may both change over time. Periodic reviews of compliance risks raised by organizational activities will be needed to ensure that a company's present efforts to prevent and detect violations of law are matched to the company's current business activities.

Second, the proposed guideline provision emphasizes that the results of risk assessments should influence the design and implementation of a broad range of features of an effective program to prevent and detect violations of law. For example, risk assessments identifying an

[277] *Id.*

[278] *Id.*

[279] *Id*.

organization's legal obligations and the types of practices that may cause an organization not to meet those obligations can provide valuable information for decisions on compliance program standards and procedures. These assessments may be able to specify actions that employees and other organizational agents should take to ensure compliance with legal requirements. Similarly, risk assessments that identify likely means of violating legal standards in an organization's operating context can help the organization develop training programs for preventing and detecting its most probable forms of unlawful conduct. Additionally, risk assessments identifying a company's law violation risks will help company auditors and compliance program evaluators target the frequency and content of program evaluations in order to make the most effective and efficient use of these studies.

The proposed guideline provisions on risk assessment are clarified through further commentary language identifying several specific topics that organizations should address in conducting risk assessments. However, the proposed guideline and commentary provisions do not mandate how risk assessment studies need to be performed in order to comply with the organizational sentencing guideline standards. Each organization will need to scrutinize its operating circumstances, legal surroundings, and industry history to gain a practical understanding of the types of unlawful practices that may arise in future organizational activities.[280]

G. CONCLUSION

The Advisory Group has proposed the preceding changes to the organizational sentencing guidelines in an effort to achieve reasonable prevention and detection of violations of law. In so doing, the Advisory Group has attempted to ensure that these proposals are "sufficient to deter and punish organizational criminal misconduct," as Congress directed the Sentencing Commission to provide in the Sarbanes-Oxley Act of 2002.[281] The Advisory Group expects that the proposed guideline changes and the organizational practices they will promote will also be of significance in preventing non-criminal violations of law. The Advisory Group trusts that its careful consideration of recent developments in corporate governance standards, business ethics, and regulatory laws will inform and assist the Sentencing Commission as it moves forward with its assessment of the organizational sentencing guidelines.

[280] For a thorough discussion of important considerations in risk assessments, see Jeffrey M. Kaplan, *Liability Inventory* in Compliance Programs and the Corporate Sentencing Guidelines ch. 6 (Jeffrey M. Kaplan, Joseph E. Murphy and Winthrop M. Swenson eds. 2002).

[281] Pub. L. No. 107-204, 116 Stat. 802, §805(a).

V. THE EFFECT OF PRIVILEGE WAIVERS ON COMPLIANCE INCENTIVES, COOPERATION, AND SELF-REPORTING

As part of its overall assessment of how the organizational sentencing guidelines are functioning, the Advisory Group examined whether the guidelines adequately define self-reporting and cooperation and whether they sufficiently encourage organizations to self-report their own illegal conduct and cooperate with federal law enforcement. In conjunction with this examination, the Advisory Group considered whether the organizational sentencing guidelines should provide commentary on the role of waiver of the attorney-client privilege and of the work product protection doctrine in assessing whether an organization should receive credit for cooperation under the organizational sentencing guidelines.

Both the U.S. Department of Justice and the defense bar are greatly interested in this issue. The U.S. Department of Justice explains that it measures cooperation, in the context of both its charging decisions and recommendations under the organizational sentencing guidelines, by assessing whether an organization thoroughly and completely discloses all pertinent facts about the full nature and extent of criminal activity and identifies the wrongdoing and wrongdoers. The U.S. Department of Justice maintains that waiver of privileges is not required, but where an organization cannot make a full disclosure of the facts without some waiver, the U.S. Department of Justice will consider its failure to waive in evaluating cooperation. Members of the defense bar repeatedly assert that requiring privilege waivers discourages organizations from reporting their offenses to the appropriate governmental authority, and it makes them less willing to cooperate with the government. According to the perspective of the defense bar, this situation could create disincentives for implementing and enforcing effective compliance programs.

A. BACKGROUND: RELEVANT PROVISIONS OF THE ORGANIZATIONAL SENTENCING GUIDELINES AND RELATED POLICIES

A central objective of the organizational sentencing guidelines is to deter criminal conduct by creating incentives for voluntary compliance and by rewarding organizations that help the government discover misconduct. Indeed, the Introductory Commentary to the organizational sentencing guidelines identifies such cooperation as a fundamental sentencing principle:

> *Culpability generally will be determined by the steps taken by the organization prior to the offense to prevent and detect criminal conduct, the level and extent of involvement in or tolerance of the offense by certain personnel, and the organization's actions after an offense has been committed.*

An organization's sentencing exposure may be significantly reduced as a result of mitigation credits awarded for compliance programs, self-reporting, cooperation at the investigative stage, and acceptance of responsibility.[282] While effective compliance programs may significantly reduce fines, the reduction that accrues from self-reporting, cooperation and acceptance of responsibility can be nearly twice as great. Further, if the U.S. Department of

[282] *See* USSG §8C2.5(f),(g)(1)-(3).

Justice concludes that the cooperation by an organizational defendant constitutes "substantial assistance," it may file a motion with the court requesting a "downward departure." This may result in the minimum fine prescribed by the organizational sentencing guidelines.[283] In some cases, voluntary compliance and cooperation may result in a decision by the U.S. Department of Justice not to bring charges at all.[284]

The organizational sentencing guidelines describe self-reporting and cooperation in general terms. The official commentary on self-reporting and cooperation states that they encompass the "disclosure of all pertinent information known by the organization" and that disclosed material should be "sufficient for law enforcement personnel to identify the nature and extent of the offense and the individual(s) responsible for the criminal conduct."[285] The guidelines are silent, however, on the extent to which, if at all, waiver of the attorney-client privilege or the work product protection doctrine is a factor in obtaining credit for cooperation and self-reporting at the sentencing phase.

The organizational sentencing guidelines rely in part upon the prosecutors' assessment of whether the organization has "an effective program to prevent and detect violations of law,"whether an organization has "fully cooperated" in the investigation, and whether the organization's cooperation constitutes "substantial assistance" to investigators.[286] These determinations then factor into the plea negotiations and settlement agreements, which directly affect the sentencing recommendations made to the court.

B. METHODOLOGY

The Advisory Group developed a three-part plan to determine how federal prosecutors assess cooperation and self-reporting, to measure the role that waiver of the attorney-client privilege and the work product protection doctrine plays in this assessment, and to evaluate whether amendments to this aspect of the organizational sentencing guidelines would be advisable. The plan included:

1. Reviewing policy statements and other explanatory materials from the U.S. Department of Justice and federal enforcement agencies that elaborate on what constitutes "cooperation" and "self-reporting" by an organization.

---

[283] *See id.* §§8C4.1, 5K1.1.

[284] *See* Deferred Prosecution Agreement in *United States v. PNC ICLC Corp.* (W.D. Pa. June 2, 2003), and The U.S. Department of Justice Press Release No. 329 (June 2, 2003) available at:<http://www.usdoj.gov/opa/pr/2003/June/03_crm_329.htm>.

[285] *See id.* §8C2.5, Commentary, Application Note 12.

[286] *See id.* §§8C2.5(f) & (g)(2)-(3), 8C4.1.

2. Conducting a survey of United States Attorneys to determine the extent to which waiver of the attorney-client privilege and the work product protection doctrine is being requested by prosecutors, and whether waiver is a factor in determining (a) the amount of credit to give to organizations that cooperate, and (b) whether to grant leniency to organizations that self-report; and

3. Reviewing public comments, periodicals and other secondary source materials (law review articles and general media publications) to determine whether practitioners, experts, and organizations themselves view cooperation and self-reporting as adequately defined at the sentencing stage and other phases of prosecution, and to assess the role that waiver of the attorney-client privilege and the work product protection doctrine has come to play in the implementation of the organizational sentencing guidelines.

C. THE U.S. DEPARTMENT OF JUSTICE POLICY ON THE ROLE OF PRIVILEGE WAIVERS IN COOPERATION

1. Criminal Division and United States Attorneys: The United States Attorneys Manual

The United States Attorneys Manual (USAM) is the primary policy document for federal prosecutors that controls in all cases where it conflicts with other Department of Justice policy statements, except statements directly made by the Attorney General. Title 9 of the USAM sets policy for Criminal Division prosecutors, who oversee the enforcement of all federal criminal laws except those specifically assigned to other Divisions.

a. The Principles of Federal Prosecution

The section in Title 9 entitled Principles of Federal Prosecution sets forth internal guidance for prosecutors with regard to initiating or declining prosecution, making charging decisions, negotiating plea agreements or settlements, and making sentencing recommendations. A party's "willingness to cooperate in the investigation or prosecution of others" is listed among seven key factors to be considered in determining whether prosecution should be initiated or declined.[287] Cooperation is also a factor in deciding whether to enter into plea agreements[288] and whether a defendant should be given a favorable sentencing recommendation.[289] The USAM does not specify what constitutes cooperation in these instances, however. With regard to sentencing recommendations, the USAM references a prosecutor's ability to move for a downward departure

---

[287] *See* USAM, § 9-27.230 (Initiating and Declining Charges – Substantial Federal Interest).

[288] *Id.* § 9-27.420.

[289] *Id.* § 9-27.730.

from the organizational sentencing guidelines based on the "nature and extent of the cooperation" of a defendant. The USAM also does not define cooperation in this context.[290]

b. The Holder and Thompson Memos

In 1999, then-Deputy Attorney General Eric Holder issued a memorandum entitled *Federal Prosecution of Corporations*,[291] which was recently revised by Deputy Attorney General Larry Thompson and renamed *Principles of Federal Prosecution of Business Organizations*.[292] The Holder Memo, as modified by the Thompson Memo, identifies criteria to be applied by the U.S. Department of Justice in making charging decisions with respect to organizations, including the criterion of cooperation.

The Holder Memo states that waiver of the attorney-client privilege and protection of the work product doctrine is one factor that either "should" or "may" be considered by United States Attorneys and other U.S. Department of Justice enforcement personnel in evaluating the adequacy of cooperation.[293] The more recent Thompson Memo states that prosecutors "may" request a waiver in "appropriate circumstances," and it "should ordinarily be limited to the factual internal investigation and any contemporaneous advice given to the corporation concerning the conduct at issue," as opposed to advice concerning the criminal investigation itself.[294]

The U.S. Department of Justice's policy statements clearly indicate that waiver is not necessarily a prerequisite for leniency in the prosecutor's charging decision.[295] While leniency is ultimately a matter of prosecutorial discretion, the express indication that prosecutors "should" or "may" consider waiver at all as a factor in evaluating cooperation has been examined by the Advisory Group to determine if it affects the incentives for a corporation to cooperate.

---

[290]*See Id.* § 9-27.740 (Considerations to be Weighed in Determining Sentencing Recommendations); USSC §5K1.1.

[291]*See* Memorandum from Deputy Attorney General Eric H. Holder, Jr., to Heads of Department Components and All United States Attorneys, *Federal Prosecution of Corporations* (June 16, 1999) ("Holder Memo") at 66 CRIM LAW REP. (BNA) 10 at 189(December 8, 1999).

[292]*See* Memorandum from Deputy Attorney General Larry Thompson, to Heads of Department Components, *Principles of Federal Prosecution of Business Organizations* (January 20, 2003) ("Thompson Memo"). Available at: <http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm>. The differences between the relevant portions of the two memos are discussed in further detail below.

[293]*Compare* p.3 with pp. 6 and 7 of Holder Memo.

[294]Thompson Memo at 7, footnote 3.

[295]*See* Transcript of Breakout Session IV (Nov. 14, 2002), James Comey, p. 15. This transcript is available at: <http://www.ussc.gov/corp/advgrp.htm>.

2. Other Relevant Enforcement Agencies

a. Securities and Exchange Commission

The Securities and Exchange Commission (SEC) has primary jurisdiction over enforcement of the federal securities laws. It must, however, refer cases for criminal prosecution to the U.S. Department of Justice.

In an October 23, 2001 report, the SEC formally announced the factors it would use in granting leniency to corporations in future enforcement actions, with self-reporting and cooperation figuring prominently on the list. The agency's definitions of self-reporting and cooperation do not expressly mention waiver of privileges, but the SEC did elaborate elsewhere on the role of privilege waivers.

> In some cases, the desire to provide information to the [SEC] staff may cause companies to consider choosing not to assert the attorney-client privilege, the work product protection and other privileges, protections and exemptions with respect to the [SEC]. The [SEC] recognizes that these privileges, protections and exemptions serve important social interests. In this regard, the [SEC] does not view a company's waiver of a privilege as an end in itself, but only as a means (where necessary) to provide relevant and sometimes critical information to the [SEC] staff. Thus, the [SEC] recently filed an amicus brief arguing that the provision of privileged information to the [SEC] staff pursuant to a confidentiality agreement did not necessarily waive the privilege as to third parties. [Citation omitted] Moreover, in certain circumstances, the [SEC] staff has agreed that a witness' production of privileged information would not constitute a subject matter waiver that would entitle the staff to receive further privileged information.[296]

Most recently, the SEC has supported federal legislation that will permit a selective waiver by persons who wish to make disclosures to the SEC, so that the disclosure to the SEC is not considered a waiver as to any other party.[297] The terms of this provision may provide some useful guidance in the ongoing discussion about waiver.

> Notwithstanding any other provision of law, whenever the [Securities and Exchange] Commission and any person agree in writing to terms

---

[296] *In the Matter of Gisela de Leon-Meredith,* Exchange Act Release No. 44969; Accounting and Auditing Enforcement Release No. 1470 (October 23, 2001). *But see* Memorandum from Fried Frank Harris Shriver & Jacobsen, *SEC Gives Details About When Cooperation Will Count*, 1324 PLI/CORP 797 (Aug. 2002)(suggesting that leniency will typically mean "waiving privileges and otherwise providing all available information.").

[297] Section 4 of the Securities Fraud Deterrence and Investor Restitution Act of 2003. H.R. 2179 (introduced May 21, 2003). *See* prepared testimony of Mr. Stephen M. Cutler, Director, Division of Enforcement, SEC, before the House Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises (June 5, 2003), <http://financialservices.house.gov/hearings.asp?formmode=detail&hearing=224&comm=1>.

> pursuant to which such person will produce or disclose to the Commission any document or information that is subject to any Federal or State law privilege, or to the protection provided by the work product doctrine, such production or disclosure shall not constitute a waiver of the privilege or protection as to any other person than the Commission.

b. Environmental Protection Agency and the Department of Health and Human Services

The offices of the Inspector General (OIG) of both the Environmental Protection Agency (EPA) and Department of Health and Human Services (HHS) have adopted cooperation and self-reporting policies patterned after the organizational sentencing guidelines.

The most recent EPA regulations on voluntary disclosure and cooperation do not explicitly require a target of an investigation to waive privileges to receive leniency (such leniency takes the form of nonreferral to the Department, or reduced sanctions).[298] HHS's leniency policies appear to rule out waiver as a factor in leniency as it pertains to Medicare and other civil fraud investigations. The Voluntary Disclosure Program "explicitly acknowledges the volunteer company's right to preserve the privilege," although it also excludes documents that are the subject of required disclosure.[299]

Nevertheless, since EPA and HHS lack independent prosecution authority and must defer to the U.S. Department of Justice if criminal prosecution is sought, their criteria for cooperation and self-reporting provide limited incentives.[300] Regardless of these enforcement agencies' internal policies on leniency, once a case against an organizational defendant has been referred for criminal prosecution, the U.S. Department of Justice’s criteria will govern, and waiver could become a factor in the granting of leniency.

[298] *See, e.g.,* Final Policy Statement on Incentives for Self-Policing, Discovery, Disclosure, Correction and Prevention of Crimes, 65 Fed. Reg. 19618, 19621-23 (April 11, 2000). However, recent scholarship indicates that this is an open question. *Compare* Channing J. Martin, *Voluntary Disclosure of Environmental Violations: Is Mea Culpa a Good Idea or a Bad Move?,*32 ENVTL. L. REP 10692 (2002) (stating that "there is a substantial question about whether cooperating to the degree EPA demands will result in waiving legal rights or privileges, e.g., attorney-client privilege. A better course of action may be to disclose potential criminal violations directly to the local U.S. Attorney since the U.S. Department of Justice (The Department), not EPA, will make the final call on whether to institute criminal proceedings."), *with* Judson W. Starr & Yvette W. Smallwood, *Environmental Crimes in Perspective*, THE ENVIRONMENTAL COUNSELOR (Jan. 15, 2003) (stating that full cooperation "in some cases requires waiving privileges"). Nevertheless, since the EPA provides the bulk of the criminal investigators, the EPA does indirectly influence prosecutorial action.

[299] *See* Leon Aussprung, *Fraud and Abuse*, 19 J. LEGAL MED. 1, 45 (1998).

[300] *See generally* John R. Steer, *Changing Organizational Behavior – The Federal Sentencing Organizational Guidelines Experiment Begins to Bear Fruit*, 1291 PLI/CORP 131 (Feb. 2002).

3. Survey of United States Attorneys

The Advisory Group also conducted a survey of certain United States Attorney's Offices,[301] inquiring into the policies and practices of those offices regarding their requests or demands for waiver of privileges from organizational defendants and the results thereof.

a. Methodology of the Survey

The survey was sent to the Criminal Chiefs and Civil Chiefs Working Groups of the Attorney General's Advisory Group of United States Attorneys (AGAC), as well as to those United States Attorneys who are members of the White Collar Crime Subcommittee and the Sentencing Subcommittee of the AGAC. The survey sent to the Civil Chiefs Working Group addressed only the compliance program issues, because the privilege waiver issue arises primarily in the criminal context.

The survey asked the U.S. Attorney's Offices to identify criminal and civil cases involving organizational defendants. On the criminal side, the survey sought a description of:

- the extent to which waivers of the attorney-client privilege and the protection of the work-product doctrine are requested;
- whether the practice regarding waivers is a matter of policy,
- whether waiver or non-waiver had an impact on the ability of the government to verify whether the defendant had provided full cooperation; and
- whether waiver is factor under the self-reporting, cooperation and acceptance of responsibility provision in §8C2.5 of the organizational sentencing guidelines or in preparing motions requesting a downward departure under §8C4.1.

b. Results of the Survey

The response rate for the Criminal Chiefs Working Group, the White Collar Working Group, and the organizational sentencing guidelines Working Group was 76 percent (46 surveys distributed, 35 returned). A majority of the U.S. Attorney's Offices responding to the survey have prosecuted fewer than a dozen corporate defendants in the past five years.

The responses indicate that the request for waiver of attorney-client privilege or the work product protection doctrine is the exception rather than the rule. Waivers were requested in only a very small number of instances – four cases in the Southern District of New York, six cases in the District of Massachusetts, six cases in the Eastern District of Pennsylvania, and two cases in the Eastern District of North Carolina. The Northern District of Mississippi indicated that it has a practice of negotiating informal, partial, unwritten waivers.

[301] There are 94 United States Attorney's Offices within the United States that handle the prosecution of federal criminal cases within their designated jurisdictions.

The purpose of obtaining the waivers varied. The Southern District of New York advised that "the purpose in seeking such waivers is to obtain evidence, which we believe may assist us in prosecuting appropriate individuals or entities." The Northern District of Mississippi stated that the purpose was "to obtain needed evidence either to charge or clear individuals and/or corporate defendants." The Eastern District of North Carolina indicated that "the purpose is to obtain information on corporate officers' state of mind." The District of Massachusetts indicated that the purpose was "to determine whether individuals who had asserted advice of counsel defenses were validly claiming the defenses so that appropriate charging decisions could be made on those individuals." The Eastern District of Pennsylvania advised that "[w]aivers are sought whenever the target company raises reliance on counsel or accountants as an argument in avoiding indictment."

Six of the respondents indicated that they obtained useful information in some instances from organizational defendants that had executed a waiver, whether the waiver was required or voluntary. Three of the responding districts--the District of Massachusetts, the Eastern District of Michigan, and the Northern District of Mississippi - indicated that their ability to verify full cooperation was hindered in situations in which no waivers were obtained. The Southern District of New York advised that "such waivers have proven to be important in evaluating the corporation's cooperation, and at other times such waivers have proven not to be necessary."

Seven of the responding districts indicated that waiver or non-waiver of the attorney-client privilege or protection of the work product doctrine was a factor both under the self-reporting, cooperation, and acceptance of responsibility provision found in §8C2.5(g) of the organizational sentencing guidelines and in preparing downward departure motions pursuant to §8C4.1. The Eastern District of Pennsylvania advised that although waiver or non-waiver was a factor it considered, the office has never agreed to such a downward departure, nor has one been granted in that district. At least one responding district indicated that waiver or non-waiver could be a factor under §8C2.5(g), but it is not likely to be a factor under §8C4.1.

4. Themes of Public Comment

a. The U.S. Department of Justice

The U.S. Department of Justice's position is that its policy, in making its charging decisions or in evaluating cooperation under the organizational sentencing guidelines as presently expressed in the Thompson Memo, does not require waiver of attorney-client privilege to obtain credit for cooperation.[302] Any divergence from this policy–that is, any "automatic" requirement of waiver–stems from miscommunication inside the United States Attorney's offices, which, the U.S. Department of Justice maintains, can be corrected through internal policies.[303]

[302]Transcript of Breakout Session IV (Nov. 14, 2002), James Comey, p. 15. This transcript is available at: <http://www.ussc.gov/corp/advgrp.htm>.

[303]*Id.*, James Comey, pp. 21, 62-64.

The U.S. Department of Justice also observed that in circumstances when a waiver is the only means by which a cooperating organization can disclose critical information about how the crime occurred, the organization may have to waive its privileges and protections in order to receive full credit for cooperation in the context of the charging decision. If a charged organization declines to waive its privileges or protections in such circumstances and consequently does not furnish the U.S. Department of Justice with all pertinent information in its possession about the criminal activity because some of the requested information is privileged, the U.S. Department of Justice would argue that the organization has not adequately cooperated under the requirements of the organizational sentencing guidelines to obtain the benefits of a reduced culpability score. In his testimony, United States Attorney Comey urged that "the organizational sentencing guidelines . . . not be amended to provide that in order to cooperate a waiver of privilege is not required precisely because in some situations the only way for a corporation to cooperate will be to waive either the work product protections or . . . the attorney-client privilege."[304]

United States Attorney Comey further explained the U.S. Department of Justice's view that a prohibition on requests for waiver would not serve the public interest in pursuing wrongdoing because it would allow organizations to raise the organizational sentencing guidelines as a shield when prosecutors believe they are not doing enough to cooperate.[305] The U.S. Department of Justice also opposes changes that would permit organizations to argue that they have cooperated as much as they can without waiver, and should therefore qualify for credit from a sentencing judge under other provisions in the guidelines. The U.S. Department of Justice is opposed to creating an opportunity for judges to give credit for partial cooperation, maintaining that it will undermine the very goals of full cooperation that the guidelines were designed to promote.[306]

In the U.S. Department of Justice's view as expressed to the Advisory Group, the organizational sentencing guidelines clearly define what cooperation is required--thoroughly disclosing all pertinent information that is sufficient for the government to identify the nature and extent of the offense and the individuals responsible for the criminal conduct. A corporation wishing to dispute the U.S. Department of Justice's assessment of its cooperation can do so fully under the guidelines as presently written, because it is ultimately the court and not the government that decides this issue.[307]

---

[304] Transcript of Plenary Session II (Nov. 14, 2002), James Comey, p. 32 lines 4-11. This transcript is available at: <http://www.ussc.gov/corp/advgrp.htm>.

[305] *See* Transcript of Plenary Session II and Breakout Session IV (Nov. 14, 2002), James Comey. These transcripts are available at: <http://www.ussc.gov/corp/advgrp.htm>.

[306] *See* Written Testimony submitted by the U.S. Department of Justice, p. 13. This written testimony is available at: <http://www.ussc.gov/corp/ph11_02/t_comey.pdf>.

[307] *See Id.* pp. 7-13; Transcript of Plenary Session II (Nov. 14, 2002), James Comey, p. 32.

In sum, the U.S. Department of Justice considers that its policies of evaluating cooperation, including its consideration of waiver, in making charging decisions and taking positions on cooperation under the organizational sentencing guidelines, are fair and appropriately reward organizations for full cooperation. The U.S. Department of Justice sees no need for mentioning privilege waivers in the organizational sentencing guidelines.[308]

b. The Defense Bar

Written submissions and testimony to the Advisory Group by members of the defense bar, many of them former prosecutors themselves, exhibit a continuing concern that prosecutors are increasingly requiring, or at least very strongly suggesting, waivers as a necessary part of the cooperation process.[309] This concern is echoed in a number of recent articles.[310] In particular, many defense attorneys report that the U.S. Attorney's Office for the Southern District of New York has for the last several years told organizations that failure to waive would be a factor in determining whether a given company has been cooperative enough to avoid prosecution or receive credit at sentencing.[311]

The defense bar's analysis of changes from the 1999 Holder Memo to the 2003 Thompson Memo has also raised concerns that the U.S. Department of Justice intends to place a greater emphasis on waiver as a condition of cooperation and lesser emphasis on the rights of defendants to claim long-established legal privileges. The Holder memo identified waiver as "*only* one factor" in evaluating cooperation.[312] The Thompson memo removed the word "only" and states that

---

[308]Transcript of Breakout Session IV, James Comey, p. 22.

[309]Transcript of Breakout Session IV (Nov. 14, 2002), Joseph Whitley, pp. 51-52; Gary Spratling, pp. 57-59.

[310]*See, e.g.*, Lance Cole, *Revoking Our Privileges: Federal Law Enforcement's Multi-Front Assault on the Attorney-Client Privilege (And Why It Is Misguided)*, 48 VILL. L. REV. 469 (2003); *The Erosion of the Attorney-Client Privilege and the Work Product Doctrine in Federal Criminal Investigations,* AM. C. TRIAL LAW. (March 2002); David M. Zornow & Keith D. Krakaur, *On the Brink of a Brave New World: The Death of Privilege in Corporate Criminal Investigations*, 37 AM. CRIM. L. REV. 147 (2000); Joseph F. Savage, Jr. & Melissa M. Long, *'Waive' Goodbye to Attorney-Client Privilege*, 7 BUS. CRIMES BULL. No. 9, at 1 (Oct. 2000); *Counsel Group Assails Prosecution Policy Compelling Corporations to Waive Privileges*, 67 CRIM. L. REP. (BNA) 391 (June 14, 2000); Breckinridge L. Wilcox, *Attorney/Client Privilege Waiver: Wrongheaded Practice?*, 6 BUS. CRIMES BULL. No. 12, at 1 (Jan. 2000).

[311]*See, e.g.*, John Gibeaut, *Junior G-Men*, ABA J. (June 2003); Thomas Brom, *Full Disclosure*, CALIFORNIA LAWYER (June 2003); Steve Seidenberg and Tamara Loomis, *The U.S. Department of Justice Gets Tougher on Corporations*, NAT'L LAW J. (Feb. 24, 2003); Tamara Loomis, *Justice Encourages Waiving Attorney-Client Privilege*, N.Y.L.J. (February 20, 2003); *Corporate Counsel: The U.S. Department of Justice Guideline on Corporations' Waiver of Attorney-Client Privilege Draws Criticism*, ABA/BNA Lawyers' Manual on Professional Conduct (Mar. 28, 2001); Tamara Loomis, *Privilege Waivers; Prosecutors Step Up Use of Bargaining Chips*, N.Y.L.J. (Sept. 7, 2000); Robert G. Morvillo, *The Decline of the Attorney-Client Privilege*, N.Y.L.J. (Dec. 2, 1997); Jed Rakoff, *Coerced Waiver of Corporate Privilege*, N.Y.L.J. (July 13, 1995).

[312]*See* Holder Memo, at 7 (emphasis added).

> . . . prosecutors should consider the willingness of a corporation to waive such protection when necessary to provide timely and complete information *as [only] one factor* in evaluating the corporation's cooperation.[313]

The Thompson Memo has also replaced the word "privileges," when referring to the attorney-client and the protection of the work product doctrine, with the word "protection."[314] For example, the Holder Memo states:

> The Department does not, however, consider waiver of a *corporation's privileges* an absolute requirement, and prosecutors should consider the willingness of a corporation to waive *the privileges* when necessary to provide timely and complete information as only one factor in evaluating the corporation's cooperation.[315]

The Thompson Memo was changed to:

> The Department does not, however, consider waiver of *a corporation's attorney-client and work product protection* an absolute requirement, and prosecutors should consider the willingness of a corporation to waive *such protection* when necessary to provide timely and complete information as one factor in evaluating the corporation's cooperation.[316]

In general, the defense bar contends that the specter of a waiver necessarily has a chilling effect on internal investigations. The possibility that the government may require a waiver, and the fear of both the criminal and civil consequences of such a waiver,[317] create strong disincentives for organizations to conduct thorough internal investigations, as well as for employees to cooperate in such investigations.[318] A waiver to the government is a waiver to potential civil plaintiffs and other adverse parties, and organizations are wary of providing a roadmap that will subject them to potentially crippling civil damages in addition to criminal penalties, as well as the burden of additional litigation.[319]

---

[313] *See* Thompson Memo, at 7 (emphasis added).

[314] *See* Holder Memo at 3, 6, and 7; Thompson Memo at 3, 6, and 7.

[315] *See* Holder Memo, at 7 (emphasis added).

[316] *See* Thompson Memo, at 7 (emphasis added).

[317] Transcript of Breakout Session IV (Nov. 14, 2002), Earl Silbert, pp. 29-31. This transcript is available at: <http://www.ussc.gov/corp/advgrp.htm>.

[318] Transcript of Breakout Session IV (Nov. 14, 2002), Donald Klawiter, pp. 38-41; Earl Silbert, p. 69.

[319] *See* Written Testimony submitted by David Greenberg. This testimony is available at: <http://www.ussc.gov/corp/ph11_02/t_greenberg.pdf>.

Furthermore, the attorney-client privilege and the work product protection doctrine are critical tools for the defense attorney in the criminal justice process. Required waivers diminish the value of those tools, creating an imbalance in the process that strongly favors the government.[320]

Several members of the defense bar testified that the organizational sentencing guidelines' silence on this issue permits, if not encourages, the practice of requiring waivers, especially when combined with the dictates of the Holder and Thompson memos and the various interpretations accorded the memos by the individual United States Attorneys' Offices.[321] They contend that this situation could create a danger that required waivers will become widespread and that organizations will be increasingly disinclined to self-police, self-report, and cooperate,[322] unless the organizational sentencing guidelines explicitly clarify the role of waivers in obtaining credit for cooperation.[323]

An explicit statement in the organizational sentencing guidelines that privilege waivers are not required in order to obtain credit for cooperation at sentencing appears to be a solution for the defense bar's concerns.[324] Nonetheless, the option should remain for organizations to voluntarily rather than under implicit compulsion–choose to waive the privileges to the extent necessary to permit the factual disclosure sufficient to satisfy the requirements for cooperation under the organizational sentencing guidelines.[325]

5. Proposal for Consideration

As is apparent from the preceding discussion of the Advisory Group's findings, there is a significant and increasingly entrenched divergence of opinion between the U.S. Department of Justice and the defense bar as to (1) the appropriate use of, or need for, waivers as a part of the cooperation process; and (2) the value of adding a statement in the organizational sentencing guidelines that would clarify the role of waivers in obtaining credit for cooperation. The U.S. Department of Justice maintains that there is no need for language to be added to the organizational sentencing guidelines, whereas the defense bar contends that there is a compelling need for clarification in this context. After considering all the information presented, the Advisory Group suggests a possible solution for further consideration by the Sentencing Commission.

---

[320] Transcript of Breakout Session IV (Nov. 14, 2002), Earl Silbert, pp. 23-31. This transcript is available at: <http://www.ussc.gov/corp/advgrp.htm>.

[321] *Id.*, Earl Silbert.

[322] *Id.*, Donald Klawiter, pp. 42-44.

[323] *Id.*, Introduction by Gary Spratling, pp. 5-9.

[324] *Id.*, Joseph Whitley, pp. 111-12; Earl Silbert, p. 118.

[325] *Id.*, Joseph Whitley, pp. 48-49.

- Amend the Commentary at Application Note 12 of existing Section 8C2.5 to read as follows:

  . . . If the defendant has satisfied the requirements for cooperation set forth in this note, waiver of the attorney-client privilege and of work product protections is not a prerequisite to a reduction in culpability score under subsection (g). However, in some circumstances, waiver of the attorney-client privilege and of work product protections may be required in order to satisfy the requirements of cooperation.

- Add a new Application Note to existing Section 8C4.1, to read as follows:

  2. <u>Waiver of Certain Privileges and Protections.</u>

  If the defendant has satisfied the requirements for substantial assistance set forth in subsection(b)(2), waiver of the attorney-client privilege and of work product protections is not a prerequisite to a motion for a downward departure by the government under this section. However, in some circumstances, the government may determine that waiver of the attorney-client privilege and of work product protections is necessary to ensure substantial assistance sufficient to warrant a motion for departure.

VI. THE LITIGATION DILEMMA: INFORMATION GENERATED BY ORGANIZATIONS TO STRENGTHEN COMPLIANCE PROGRAMS MAY BE USED AGAINST THEM IN NON-SENTENCING CONTEXTS

A. APPLICABLE GUIDELINE PROVISIONS

Of the existing seven minimum requirements of an "effective program to prevent and detect violations of law,"[326] the following are directly relevant to this discussion:

> *(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;*
>
> *(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;*
>
> *(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.*[327]

One of the caveats appended to the definition of this credit is also important for present purposes. Thus, "effective program" credit may not be given *"if, after becoming aware of an offense, the organization unreasonably delayed reporting the offense to appropriate governmental authorities."*[328]

In addition to implementing an effective compliance program, an organization can obtain a fine reduction through "self-reporting, cooperation and acceptance of responsibility."[329] A reduction is afforded if the organization, prior to an "imminent" threat of disclosure or government investigation, and "within a reasonably prompt time after becoming aware of the offense," reported the offense to appropriate governmental authorities, cooperated in the investigation, and demonstrated affirmative acceptance of responsibility for the conduct. In such an instance, five points are deducted from the culpability score.[330] But cooperation and a plea without self-

---

[326] USSG §8A1.2, Application Note 3(k).

[327] *Id.*

[328] *Id.* §8C2.5(f).

[329] *Id.* §8C2.5(g).

[330] *Id.* §8C2.5(g)(1).

reporting yield only a two-point reduction, while a plea of guilty alone, without cooperation or voluntary disclosure, merits only a one-point reduction.[331]

In short, the organizational sentencing guidelines state that an organization cannot obtain leniency credit for an effective compliance program unless it (I) effectively communicates its standards to employees through, for example, training; (ii) has utilized auditing and monitoring to detect employee wrongdoing; (iii) has encouraged employees to report such wrongdoing without fear of retribution; and (iv) makes full and timely disclosure of wrongdoing and takes steps to ensure that wrongdoing does not recur. An even more significant credit for self-reporting and cooperation cannot be secured absent reasonably prompt self-reporting *prior* to voluntary disclosure or government investigation, cooperation with the government, and a guilty plea.

Despite the incentives created by these provisions, *effective* compliance programs, with the attendant self-reporting and cooperation, may impose significant costs that cannot be measured simply by the dollars required to design and maintain programs. According to the practice and academic literature, as well as extensive commentary received by the Advisory Group, the most significant of these costs is what has been termed the "litigation dilemma," the threat that an organization's compliance efforts will be used against it by the government or in third-party litigation. Currently, implementation of a compliance program that follows the requirements in the organizational sentencing guidelines for monitoring, auditing, and self-reporting could result in an organization identifying or disclosing information that could be used against it in a subsequent lawsuit or a government investigation. This is considered by some to be a significant disadvantage to organizations that contemplate establishing a compliance program based on the organizational sentencing guidelines.[332]

The litigation dilemma affects organizational incentives with respect to training, auditing and monitoring, internal reporting, and cooperation and self-reporting. All of these critical aspects of a vigorous and effective compliance system can be compromised or rendered entirely worthless by entities more concerned about litigation exposure than the statistically less likely event of criminal prosecution.

B. CONSIDERATIONS THAT INFLUENCE COMPLIANCE DECISIONMAKING

To assess what steps might enhance organizational incentives to institute *effective* programs to prevent and detect violations of law, it is helpful to explore the merits and demerits of these programs from an organizational perspective. According to commentators, the advantages of compliance programs are many and ordinarily outweigh their disadvantages. "[A]n effective compliance program disseminates a positive, law-abiding corporate ethos throughout an

---

[331] *Id.* §8C2.5(g)(3). The question whether the "cooperation" standard should or should not require the corporation to waive the protection of the attorney-client privilege or work product doctrine is addressed separately in Part VI, *infra*.

[332] David Greenberg's written testimony at p. 6. This written testimony is available at: <http://www.ussc.gov/corp/ph11_02/t_greenberg.pdf>.

organization, and thereby creates an atmosphere that will discourage wrongdoing" in the first instance.[333] Even if it cannot always prevent illegal conduct, "an effective compliance program detects misconduct as it occurs so the organization can address problem situations quickly and minimize their adverse consequences,"[334] potentially obviating "intrusive government investigations."[335]

Compliance programs have some obvious litigation advantages in that they may allow an organization to assess more accurately its criminal or civil liability, "give a firm more control over the direction and scope of the investigation," and permit the organization to evaluate potential defenses.[336] Effective programs also may allow organizations to make more informed business decisions. "[R]egardless of whether a program uncovers misconduct, compliance reviews frequently assist the company economically by exposing inefficient employees or unprofitable departments."[337] Compliance audits may also permit organizations to meet any reporting responsibilities they have under applicable statutes and regulations.

If criminal acts have occurred despite an organization's compliance efforts, the existence of a compliance program instituted and pursued in good faith "serves as a significant mitigating factor to a prosecutor considering whether to indict a company; the organization can point to the program as evidence that it is a good corporate citizen and that the wrongdoing constituted aberrant behavior of rogue employees."[338] Finally, if an organization is prosecuted and convicted, the organizational sentencing guidelines obviously provide important sentencing advantages to organizations that have effective programs in place.[339]

Some of the disadvantages of an effective compliance program relate to the fact that organizations may incur costs in conducting their businesses in a legally appropriate way or in remedying the causes or effects of their wrongdoing.[340] Obviously, these are costs that the

---

[333]Dan K. Webb & Steven F. Molo, *Some Practical Considerations in Developing Effective Compliance Programs: A Framework for Meeting the Requirements of the Sentencing Guidelines*, 71 WASH. U. L.Q. 375, 376 (1993).

[334]*Id.*

[335]Michael Goldsmith & Chad W. King, *Policing Corporate Crime: The Dilemma of Internal Compliance Programs*, 50 VAND. L. REV. 1, 13 (1997).

[336]*Id.*

[337]*Id.* (footnotes omitted).

[338]Webb & Molo, 71 WASH. U. L.Q. at 376.

[339]*Id.* at 376.

[340]For example, Dan Webb and Steven Molo point out the following perceived disadvantages of an effective compliance program:

> [O]nce an organization establishes a compliance program, the company must abide by it. A sentencing court will deem a program "non-effective"--based on lack of enforcement--if the company fails to follow its compliance program. This

organizational sentencing guidelines can, and should, do nothing to abate.[341] Effective compliance also can be expensive.[342] Again, aside from the efforts the Sentencing Commission has already made to sponsor and participate in programs, thus providing free information to persons interested in organizational sentencing guidelines compliance, there would appear to be little the Sentencing Commission can do to lessen compliance costs.

All of these costs of compliance, however, pale in comparison to the principal disadvantage identified time and time again by organizations: the fact that, "by adhering to its compliance program, a company may generate evidence that ultimately may harm the organization" in litigation.[343] Indeed, audits and investigative reports may become litigation roadmaps for potential adversaries.

C. THE LIMITATIONS OF EXISTING PRIVILEGES AND PROTECTIONS

To understand how information generated by compliance efforts may ultimately be used by the government and third parties against the organization that is trying to be a "good citizen" under the organizational sentencing guidelines, the relationship of such information to the attorney-client, work product, and self-evaluative protections must be understood, as well as their scope and limitations. In order to advance the adversarial legal system that is used to resolve disputes within the United States, each party to a legal proceeding has the right to obtain evidence from the other party or parties. This occurs under particular rules of evidence that apply to criminal and civil litigation, depending on the nature of the legal proceeding.

> may force the organization to make difficult choices, such as changing an otherwise effective existing business practice, terminating a long-standing business relationship, or firing a longtime employee. *Id.* at 379.

[341] Another purported problem with an effective program is that "a plaintiff's lawyer or a prosecutor may try to use the company's compliance program as the standard by which employee conduct should be judged in a civil or criminal trial." *Id.* at 379. Presumably this should not be a problem if the company's program is adopted in good faith and is effectively enforced.

[342] Michael Goldsmith & Chad W. King, *Policing Corporate Crime: The Dilemma of Internal Compliance Programs*, 50 VAND. L. REV. 1, 16 (1997). ("[O]ngoing compliance programs can be expensive. Fees to outside professionals for compliance services can be costly. Businesses often hire an internal team of attorneys, auditors, and other professionals ('ethics officers,' for example) whose sole task is to manage the compliance process. Nor are expenses limited to professional fees. Internal investigations associated with compliance programs may increase costs due to lost time, lower productivity, and decreased morale when employee attention is unduly diverted from the ordinary course of business. Given these trade-offs, the profit motive alone will not always cause a business to establish a compliance program. Often, therefore, the decision to initiate such a program is induced by regulatory agencies who consider compliance programs to be utilitarian.").

[343] Dan K. Webb & Steven F. Molo, *Some Practical Considerations in Developing Effective Compliance Programs: A Framework for Meeting the Requirements of the Sentencing Guidelines*, 71 WASH. U. L.Q. 375, 380 (1993). *See also* David Greenberg's written testimony at p. 8. Written testimony available at: <http://www.ussc.gov/corp/ph11_02/t_greenberg.pdf>.

Generally, the law favors the disclosure of evidence in order to advance dispute resolution. The law protects from disclosure a very limited amount of information, and only when there are compelling social and policy interests in restricting the dissemination of that information.[344] For example, discussions between physician and patient about medical treatments are generally not discoverable in litigation unless the patient waives the privilege.

Effective compliance efforts are, by definition, epistemological, in that an organization must seek knowledge about its own operations by obtaining the information that resides within its employees and agents. Effective compliance efforts require that an organization learn from its employees about potential problems and take steps to rectify such problems. Even as early as the risk assessment stage, such communication is essential to effective compliance efforts.

However, the same information that an organization should use to improve its compliance and training efforts is also of potentially enormous value to those who may become involved in litigation with the organization, whether it be administrative, civil, or criminal litigation. This gives rise to the "litigation dilemma" and often a justifiable reluctance by many organizations to "dig deep" for fear of creating a roadmap for litigants against it. The role of certain evidentiary privileges, their scope and limitation, is fundamental to this discussion because they define the contours of the litigation dilemma. The litigation dilemma is at the nexus of the implementation of effective compliance programs, and thus it has direct and significant relevance to an assessment of the compliance criteria of the organizational sentencing guidelines.

1. The Attorney-Client Privilege and Work Product Protection Doctrine

"*Partial*" *Waiver*. "Partial" waiver issues arise when the privilege-holder discloses, publishes, or attempts to use selected portions of protected materials, or documents that are built on privileged information, while protecting the balance of the protected materials, or underlying documents, from disclosure. This issue comes up in a variety of situations, such as when an organization attempts to self-report or cooperate with government investigators by turning over the results of an internal investigation into alleged wrongdoing.[345]

Generally, the issue in "partial" waiver cases is not whether the protections attaching to the materials actually disclosed have been waived. For example, courts have found that the attorney-client privilege was waived when the results of internal investigations into corporate wrongdoing were revealed to: independent auditors verifying the organization's financial

[344] *See, e.g., University of Pennsylvania v. EEOC*, 493 U.S. 182, 189 (190). Justice Blackmun, writing for a unanimous court, stated "We do not create and apply an evidentiary privilege unless it 'promotes sufficiently important interests to outweigh the need for probative evidence . . . .' *Trammel v. United States*, 445 U.S. 40, 51 (1980). Inasmuch as 'testimonial exclusionary rules and privileges contravene the fundamental principle that 'the public . . . has a right to every man's evidence,' id., at 50, quoting *United States v. Bryan*, 339 U.S. 323, 331 (1950), any such privilege must 'be strictly construed.' 445 U.S., at 50.'"

[345] For example, "partial" waiver questions also frequently arise when the privilege holder relies, directly or indirectly, on a privileged communication or piece of work product in the course of litigation. *See, e.g.*, *Cox v. Administrator U.S. Steel & Carnegie*, 17 F.3d 1386, 1417–18 (11th Cir. 1994); *Weil v. Investment/Indicators, Research & Management, Inc.*, 647 F.2d 18, 24 (9th Cir. 1981).

statements;[346] counsel for underwriters;[347] government contract performance auditors;[348] government regulators, either to secure approval of a proposed corporate action[349] or to avert regulatory enforcement action;[350] and grand juries or prosecutors.[351] The more important issue in these cases is the *scope of any additional waiver*, that is, whether the privilege holder may argue for a finding of a "partial" waiver of only the materials previously disclosed.

With respect to the *attorney-client privilege*, the standard is generally said to be that the privilege is waived as to all communications concerning the same "subject matter" as the disclosed communications.[352] Courts generally employ a "fairness" analysis to determine how broadly or narrowly to define the "subject matter" of the waiver. For example, in the litigation context, most courts find a broad waiver appropriate where "a litigant places information protected by it in issue through some affirmative act for his own benefit, and to allow the privilege to protect against [further] disclosure of such information would be manifestly unfair to the opposing party."[353] Where, however, an extrajudicial disclosure of protected communications did not greatly prejudice the other party in litigation, a narrower waiver is deemed appropriate.[354]

The question often arises whether disclosure or use of the results of an organization's internal investigation waives the attorney-client privilege with respect to the notes and memoranda of counsel who prepared the report, even if privileged communications or work product are not expressly quoted in it. Although some courts have held that merely repeating non-privileged facts in a report does not waive the privilege as to the communications underlying those facts,[355] most courts to address the issue have ordered at least some disclosure of the underlying documentation

---

[346] *See, e.g.*, *In re John Doe Corp.*, 675 F.2d 482, 488 (2d Cir. 1982); *United States v. El Paso Co.*, 682 F.2d 530, 539–42 (5th Cir. 1982).

[347] *See, e.g.*, *In re John Doe Corp.*, 675 F.2d at 488–89.

[348] *See, e.g.*, *United States v. MIT*, 129 F.3d 681, 683 (1st Cir. 1997).

[349] *See, e.g.*, *Permian Corp. v. United States*, 665 F.2d 1214, 1216 (D.C. Cir. 1981).

[350] *See, e.g.*, *Westinghouse Electric Corp. v. Republic of the Philippines*, 951 F.2d 1414, 1417–18 (3d Cir. 1991); *In re Subpoenas Duces Tecum*, 738 F.2d 1367, 1369–75 (D.C. Cir. 1984).

[351] *See, e.g.*, *id.*; *In re Martin Marietta Corp.*, 856 F.2d 619, 623–24 (4th Cir. 1988), *cert. denied,* 490 U.S. 1011 (1989).

[352] *See, e.g., In re Martin Marietta*, 856 F.2d at 623–24; *In re Sealed Case*, 676 F.2d at 809; *Weil*, 647 F.2d at 24.

[353] *Cox*, 17 F.3d at 1417–18 (*quoting Conkling v. Turner*, 883 F.2d 431, 434 (5th Cir. 1989); *Westinghouse*, 951 F.2d at 1426; *Weil*, 647 F.2d at 25.

[354] *See, e.g.*, *In re Von Bulow*, 828 F.2d 94 (2d Cir. 1987).

[355] *See, e.g.*, *In re Woolworth Corp. Sec. Class Action Litig.*, 1996 WL 306576 (S.D.N.Y. 1996).

on a wider "fairness" waiver theory.[356] The dominant approach in determining the scope of waiver in the work product context again appears to be one of "fairness" in determining the appropriate scope of waiver. Courts look to whether the disclosing party is seeking to gain an advantage to the prejudice of others and ultimately to whether "a party seeks greater advantage from its control over work product than the law must provide to maintain a healthy adversary system."[357]

"Selective" Waiver. The issue in these cases is whether the waiver found--of whatever scope was determined above--may be limited to the party to whom disclosure was made or whether the waiver as to one person waives the protections of the attorney-client privilege or work product doctrine as to all other persons. Courts employ different analyses with respect to attorney-client, as opposed to work product, materials, but the result is often the same: a refusal to permit a "selective waiver."

With respect to the *attorney-client privilege*, all the circuits to consider the issue except the Eighth Circuit have rejected a "selective" waiver theory. They have ruled that where otherwise privileged materials are shown to third-parties, either in an attempt to head off regulatory or

---

[356]*See, e.g.*, *United States v. Billmyer*, 57 F.3d 31, 37 (1st Cir. 1995) (finding waiver where "counsel informed the client of detailed evidence and allegations concerning possible bribes of its employees, and the client chose to make this same information available to the government"); *In re Martin Marietta Corp*., 856 F.2d at 623–24 (disclosure of position paper to U.S. Attorney that described why the company should not face indictment and contained statements that characterized witnesses' likely testimony and other evidence waived the attorney-client privilege as to audit papers and witness statements upon which the assertions in the position paper were based); *In re John Doe Corp*., 675 F.2d at 488–90 (holding that disclosure of report of internal investigation of business practices to accountants conducting audit of financial statements and to counsel for underwriters waived attorney-client privilege as to report and memoranda and notes pertaining thereto); *In re Kidder Peabody Sec. Litig*., 168 F.R.D. 459, 469–70 (S.D.N.Y. 1996) (holding that public issuance of internal investigation report constitutes "a waiver of the privilege only for the communications or portions of communications disclosed in the report" but the balance of the interview memoranda underlying the report had to be disclosed because the privilege-holder had waived the privilege by "its repeated injection of the substance of the report into this and other litigations and into related investigative contexts"). *But see Diversified Indus., Inc. v. Meredith*, 572 F.2d 596, 611 (8th Cir. 1977) (en banc) (ruling that disclosure to SEC of report of investigation conducted (and, apparently, underlying documentation) did not constitute waiver of report and underlying memoranda and correspondence for all purposes).

[357]*In re Sealed Case*, 676 F.2d at 818; *see also, e.g.*, *In re Perrigo Co.*, 128 F.3d 430, 438–41 (6th Cir. 1997); *Westinghouse*, 951 F.2d at 1430; *In re Subpoenas Duces Tecum*, 738 F.2d at 1371–74; *In re Sealed Case*, 676 F.2d at 817–24; *Granite Partners, L.P. v. Bear, Stearns & Co.*, 184 F.R.D. 49 (S.D.N.Y. 1999) (finding that party waived any work product protection as to documents underlying report by putting the report's conclusions at issue through publication of the report and using it offensively); *cf. In re Grand Jury Investigation*, 599 F.2d 1224, 1229–33 (3d Cir. 1979) (holding materials underlying internal investigative report that was disclosed to the government to be protected by qualified work product immunity without considering waiver question); *In re Grand Jury Subpoena Dated Dec. 19, 1978*, 599 F.2d 504, 510 (2d Cir. 1979) (finding that employee questionnaires, interview notes and memoranda of outside counsel conducting internal corporate investigation (the results of which were "generally disclosed" in a report filed with the SEC) was protected work product without considering waiver issue). The Fourth Circuit has drawn a distinction between opinion and non-opinion work product, holding that the waiver extends to "all *non*-opinion work-product on the same subject matter as that disclosed" but is limited to only those opinion work product documents actually disclosed. *In re Martin Marietta*, 856 F.2d at 624–27; *see also Westinghouse*, 951 F.2d at 1430 n.17 (holding that a corporation that had shown the report of an internal corporate investigation to the SEC and, subject to a protective order, had produced the report (and, apparently, the documents accumulated in connection with that investigation) to a grand jury waived any attorney-client or work product protection even as to opinion work product).

criminal action against the corporation, in the conduct of the corporation's business, or in the conduct of litigation, the protections of the attorney-client privilege are waived *as to any other person*.[358] Only the Eighth Circuit has adopted a limited doctrine of "selective" waiver whereby voluntary disclosure to a government agency constitutes a waiver of the attorney-client privilege *only* as to that agency.[359] Unlike the "partial" waiver cases, these courts do not apply a "fairness" or "balancing" approach to "selective" waiver cases.[360] They simply hold that the disclosure to one third party requires a disclosure to all because the initial disclosure compromises any expectation of confidentiality.[361]

Under the *work product protection doctrine*, exposure of protected materials to third parties does not automatically waive the doctrine's protection.[362] "[A] party who discloses documents protected by the work-product protection doctrine may continue to assert the doctrine's protection only when the disclosure furthers the doctrine's underlying goal."[363] Generally, this inquiry turns on whether the disclosure was made to one deemed an "adversary," in which case work product protection is lost, or whether it is turned over to one with a "common interest" under circumstances that indicate a legitimate expectation of continued confidentiality, in which case the work product protections will be sustained.[364] "[T]he presence of an adversarial relationship does not depend on the existence of litigation."[365] Where the disclosing party knows that an investigation is ongoing by

---

[358] *See, e.g.*, *In re Columbia/HCA Healthcare Corp. Billing Practices Litig*., 293 F.3d 289 (6th Cir. 2002); *MIT*, 129 F.3d at 684–86 (finding that university waived attorney-client privilege and work product protection as to documents requested by the IRS where documents had been voluntarily disclosed to Department of Defense); *Genentech, Inc. v. U.S. Int'l Trade Comm'n*, 122 F.3d 1409, 1416 (Fed. Cir. 1997) (ruling that waiver of privilege by virtue of inadvertent production of privileged documents means that "privilege is generally lost for all purposes and in all forums"); *Westinghouse*, 951 F.2d at 1424–26 (holding attorney-client privilege and work product protection waived as to civil plaintiffs where documents had been voluntarily disclosed to SEC and The U.S. Department of Justice); *In re Martin Marietta Corp*., 856 F.2d at 624–25 (finding attorney-client privilege and work product protection waived as to criminal defendant where documents had been voluntarily disclosed to Department of Defense and U.S. Attorneys Office); *In re Subpoena Duces Tecum*, 738 F.2d at 1372 (ruling that attorney-client privilege and work product protection waived as to private plaintiffs where the protected documents had been furnished to SEC and to a grand jury); *Permian Corp*, 665 F.2d at 1220–21 (finding attorney-client privilege waived as to Department of Energy where documents had been voluntarily disclosed to SEC).

[359] *See Meredith*, 572 F.2d at 611 (en banc) (attorney-client privilege *not* waived as to civil plaintiff where documents had been voluntarily disclosed to SEC); *cf. also In re Perrigo Co.*, 128 F.3d at 441 n.9 (suggesting that the court might be open to a "selective" waiver argument in the future).

[360] *See Westinghouse Electric Corp v. Republic of the Philippines*, 951 F.2d 1414, 1430 (3d Cir. 1991).

[361] *See, e.g., Permian Corp. v. United States,* 665 F.2d 1214, 1220 (D.C. Cir. 1981).

[362] *See United States v. MIT*, 129 F.3d 681, 687 & n.6 (1st Cir. 1997).

[363] *Westinghouse*, 951 F.2d at 1429.

[364] *See, e.g.*, *United States v. MIT*, 129 F.3d 681, 687 (1st Cir. 1997); *In re Steinhardt Partners*, 9 F.3d 230, 234–36 (2d Cir. 1993).

[365] *In re Steinhardt Partners,* 9 F.3d at 234.

the recipient entity, that will certainly suffice to demonstrate an adversary relationship.[366] All the circuits to consider this issue have rejected a "selective" waiver theory on a "fairness" analysis, holding that disclosure of work product to one adversary is sufficient to waive the doctrine as to all adversaries.[367]

In most cases, the disclosing party does not necessarily increase its chances of maintaining attorney-client or work product protection by securing a confidentiality agreement or order prior to disclosure.[368] The recent situation of Columbia/HCA illustrates this dilemma. Columbia/HCA agreed to provide to the U.S. Department of Justice internal audits it had conducted as a part of its settlement of a fraud investigation (which ultimately resulted in Columbia/HCA paying a $840 million fine to the government in combined civil and criminal penalties).[369] The U.S. Department of Justice "agreed that certain stringent confidentiality provisions would govern its obtaining" of the audit documents.[370] Numerous lawsuits were then filed by private insurance companies and private individuals seeking discovery of the audit documents that Columbia/HCA disclosed to the government. The Sixth Circuit refused Columbia/HCA's argument for a selective waiver finding, and instead the court held that Columbia/HCA's provision of the audit papers to the government waived whatever attorney-client and work product protection privileges previously applied to those papers, *despite* the government's confidentiality agreement with Columbia/HCA.

2. The Federal Self-Evaluative Privilege

[366] *Id.*; *Westinghouse Electric Corp. v. Republic of the Philippines*, 951 F.2d 1414, 1428 (3d Cir. 1991).

[367] *See, e.g.*, *Westinghouse*, 951 F.2d at 1428–29.

[368] In those circuits that have rejected the "selective" waiver doctrine, the law is unsettled as to the significance of an express assurance of confidentiality by the government agency to which the original disclosure was made. The D.C. and Third Circuits have held that even an express agreement by the government agency to preserve the confidentiality of the disclosures offers no protection against waiver of the *attorney-client privilege*. *See Westinghouse*, 951 F.2d at 1426–27; *Permian Corp*, 665 F.2d at 1219–22. The D.C. Circuit, however, has upheld a disclosing party's claim of *work product protection* because an agreement with the SEC established a protective attitude of confidentiality which demonstrated the disclosing party's intent to preserve its work product as against another government "adversary." *See Permian Corp*, 665 F.2d at 1217–19; *see also In re Subpoenas Duces Tecum*, 738 F.2d at 1374 n.12. The Second Circuit has also indicated that an express assurance of confidentiality by the government agency would bar a finding of waiver in the work product context. *See In re Steinhardt*, 9 F.3d at 236; *In re Subpoena Duces Tecum*, 738 F.2d at 1375; *see also Billmyer*, 57 F.3d at 37. The Third Circuit, by contrast, has ruled that the existence of a confidentiality agreement between the disclosing party and the "adversary" agencies to whom the work product was disclosed would not change its determination that the disclosure effected a waiver. *Westinghouse*, 951 F.2d at 1430.

[369] *In re Columbia/HCA Healthcare Corp. Billing Practices Litig.*, 293 F.3d 289 (6th Cir. 2002).

[370] *Id.* at 292.

The federal "self-evaluative privilege" is a common law privilege[371] and is "premised on the public policy that frank and potentially damaging self-criticism should be protected from discovery in order to encourage this socially beneficial activity."[372] The policy underlying the privilege is that, if discovery of certain self-critical materials are permitted, there will be a "direct chilling effect on the institutional or individual self-analyst; and . . . this effect operates to discourage the analyst from investigating thoroughly and frankly or even from investigating at all."[373]

The self-evaluative privilege was first recognized in 1970 in *Bredice v. Doctors Hospital, Inc.,*[374] a medical malpractice action brought by the administratrix of a decedent's estate. The plaintiff moved for production of a variety of materials related to decedent's treatment, including the minutes of a hospital peer review meeting at which the care decedent received was critiqued. The U.S. District Court for the District of Columbia denied discovery, relying on the self-evaluative privilege and reasoning:

> Confidentiality is essential to effective functioning of these staff meetings; and these meetings are essential to the continued improvement in the care and treatment of patients. Candid and conscious evaluation of clinical practices is a *sine qua non* of adequate hospital care. To subject these discussions and deliberations to the discovery process, without a showing of exceptional necessity, would result in terminating such deliberations. Constructive professional criticism cannot occur in an atmosphere of apprehension that one doctor's suggestion will be used as a denunciation of a colleague's conduct in a malpractice suit.[375]

Following the initial judicial recognition of a privilege for self-critical analysis, it has been extended to numerous other areas including accounting records; securities losses; academic peer reviews; railroad accident investigations; product safety assessments; and products liability. The rationale for its application is to "allow individuals or businesses to candidly assess compliance with regulatory and legal requirements without creating evidence that may be used against them by their opponents in future litigation.'"[376]

---

[371]This privilege is also sometimes referred to as the "critical self-analysis privilege." *See* FED. R. EVID. 501.

[372]George S. Hodges, Karen A. Jockimo & Paul E. Svensson, *The Self-Critical Analysis Privilege in the Product Liability Context*, 70 DEF. COUNS. J. 40 (2003).

[373]Note, *The Privilege of Self-Critical Analysis*, 96 HARV. L. REV. 1083, 1091-92 (1983) (noting that the chilling effect may also cause the analyst to "temper his criticism out of a fear that reprisals will ensue" if the result is liability).

[374]*Bredice v. Doctors Hospital, Inc.,* 50 F.R.D. 249 (D.D.C. 1970), *aff'd mem*, 479 F.2d 920 (D.C. Cir. 1973).

[375]*Id.* at 250; *see also Banks v. Lockheed-Georgia Co.*, 53 F.R.D. 283 (N.D. Ga. 1971)(holding that company's self-analysis of employment practices and affirmative action compliance plans was shielded by privilege); *Laws v. Georgetown University Hospital*, 656 F. Supp. 824 (D.D.C. 1987).

[376]George S. Hodges, Karen A. Jockimo & Paul E. Svensson, *The Self-Critical Analysis Privilege in the Product Liability Context*, 70 DEF. COUNS. J. 40, 42 (2003).

The self-evaluative privilege is a qualified one and, although no single standard has emerged from the developing case law, the elements can be generally stated as follows:

> (1) The information sought to be protected must have resulted from self-critical analysis undertaken by the parties seeking protection;
>
> (2) The public must have a strong interest in preserving the free flow of the type of information sought;
>
> (3) The information must be of a type whose flow would be curtailed if discovery were allowed; and
>
> (4) (In some jurisdictions) The material sought must have been prepared with the expectation that it would be kept confidential, and it must in fact has been kept confidential.[377]

There are a number of exceptions that make this privilege less than certain in application. First, the privilege can be overcome by a showing of "extraordinary circumstances or special need."[378] Second, "[t]he privilege also has been limited to the extent that it has been held to apply only to subjective impressions and opinions exercised [in the critical self-evaluation] ... and not to statistical or objective facts. . . . Additionally, the privilege has been found inapplicable in circumstances where the document has been subpoenaed by a government agency as part of an administrative review."[379] Although it is often mentioned, the self-evaluative privilege has yet to truly take hold, either in judicial decisions or in generally applicable legislation.

> [T]he self-evaluative privilege has enjoyed limited acceptance by the courts. The courts that have applied the privilege have done so narrowly and inconsistently. The privilege has not been recognized by the United States Supreme Court, the federal circuits or federal agencies. Thus, if the provider is obligated to submit information to a federal agency. . . it is unlikely that the privilege will be applied. Moreover, the privilege generally is not applied in cases where the United States is the plaintiff.[380]

---

[377]*See id.*; Catherine L. Fornias, *The Fifth Circuit Reconsiders Application of the Work Product Doctrine and the Privilege of Self-Evaluation:* In re *Kaiser Aluminum & Chemical Co*., 76 TUL. L. REV. 247, 252 (2001).

[378]*See* Hodges, et al., 70 DEF. COUNS. J. at 43; *see also* Jason M. Healy, William M. Altman & Thomas C. Fox, *Confidentiality of Health Care Provider Quality of Care Information*, 40 BRANDEIS L.J. 595, 628-29 (2002).

[379]Hodges, et al., 70 DEF. COUNS. J. at 43; Healy, et al., 40 BRANDEIS L.J. at 630 ("in applying the privilege, courts may separate the evaluation from the facts ... These courts reason that the self-evaluative privilege should only protect evaluation and analysis, not the facts underlying evaluative reports or documents that contain only those facts").

[380]Jason M. Healy, William M. Altman & Thomas C. Fox, *Confidentiality of Health Care Provider Quality of Care Information*, 40 BRANDEIS L.J. 595, 630 (2002); *see also* Catherine L. Fornias, *The Fifth Circuit Reconsiders Application of the Work Product Doctrine and the Privilege of Self-Evaluation:* In re *Kaiser Aluminum & Chemical*

As a consequence of its limited and uncertain application, many commentators conclude that this privilege is "of little value" in promoting the "compelling" public policy underlying it.[381] They reason, to echo the Supreme Court in *Upjohn Co. v. United States*, that "[a]n uncertain privilege, or one which purports to be certain but results in widely varying applications by the courts, is little better than no privilege at all."[382]

D. THE LITIGATION DILEMMA

The limitations of these legal protections have very direct consequences on the incentive to create or administer compliance programs.[383] For example, training is potentially riddled with peril because of the litigation dilemma. It is arguable that the best training may occur when trainers and managers create a trusting environment in which participants can open up and discuss their real concerns in the workplace. Skilled trainers and managers can use these live scenarios in several ways. They may be able to dispel participants' perceptions by pointing out that their understanding of the situation may be either incomplete or inaccurate. If the information is true, it could provide a meaningful way of reporting problems or weaknesses, which, in turn, could be rectified by the appropriate people within the organization.

Unfortunately, companies that are the most effective in accomplishing this level of training are placed at the most risk of having the information used against them. Companies that create this environment of trust and get their participants to discuss their true workplace concerns risk having that information used against them by adversaries in other litigation.[384] In light of this substantial risk, organizations may well conclude that it may be safer to use "canned" training scenarios from outside the organization, or cases which have been so sanitized that they may lose their power and relevance to that particular organization. Effectiveness will be sacrificed to safety.

Co., 76 TUL. L. REV. 247, 252 (2001) ("courts have generally responded to invocations of the self-evaluation privilege by recognizing the existence of the privilege, but then rejecting its application in the case at hand"); Michael Goldsmith & Chad W. King, *Policing Corporate Crime: The Dilemma of Internal Compliance Programs*, 50 VAND. L. REV. 1, 32 (1997) ("The public policy concerns identified by *Bredice* are compelling, but the self-evaluative privilege has not enjoyed widespread application.").

[381]Goldsmith & King, 50 VAND. L. REV. at 32.

[382]*Upjohn Co. v. United States*, 449 U.S. 383, 393 (1981); *see also* Goldsmith & King, 50 VAND. L. REV. at 32.

[383]Joseph E. Murphy, *Examining the Legal and Business Risks of Compliance Programs,* 13 ETHIKOS 4 (Jan/Feb 2000).

[384]When organizations confront the "Lucky Stores" dilemma that an adversary is able to obtain notes taken by an employee during compliance training to prevent discrimination for ultimate use as evidence against the organization itself, a clear disincentive emerges. *See, Stender v. Lucky Stores Inc.* 803 F. Supp. 259 (N.D. Cal. 1992). Essentially Lucky Stores was forced to turn over notes taken during its training sessions that were intended to prevent discrimination. Those notes discussed the participants' feelings "that women do not want to work late shifts, that men do not want to compete with women or have a woman as their boss, that a woman's income is a second income in a household, that men resent the promotion of women, that black women are aggressive, that women who are promoted frequently step down, and that women do not have the drive to get ahead." *Id*. at 332. The notes were obtained for use in a subsequent discrimination lawsuit against the company.

Bearing on this issue is the fact that only 52% of the respondents to a recent 2003 survey found that the ethics training was "very useful" and 39% said that it was "somewhat useful,"[385] The question is legitimately raised as to whether this "lack of helpfulness" is constrained by the "litigation dilemma" in the training of employees.

Another area in which the litigation dilemma may affect compliance program efficacy is in the area of auditing and monitoring. Michael Goldsmith, former Vice-Chair and Member of the Sentencing Commission, and Chad King explained the problems that may flow from the type of auditing and monitoring required as part of an "effective program" as follows:

> [T]o qualify for mitigation under the organizational sentencing guidelines, responsible corporations must institute programs to assess their compliance with applicable laws and to prevent illegal conduct within the workplace. As part of such ongoing compliance programs, many companies periodically conduct comprehensive audits. These compliance programs and audits inevitably generate a variety of information and materials ranging from objective facts and photographs to subjective evaluations, reports, and opinions. Businesses use these materials to evaluate their compliance efforts and to construct new programs to help prevent future violations.

Under present law, however, compliance program and audit materials are rarely confidential. Consequently, they may be subject to discovery in criminal investigations and civil actions against the organization. Regulatory agencies, corporate shareholders, disgruntled employees, and third parties have all successfully accessed compliance materials in litigation against companies. Unless protected, these materials threaten to become a litigation road map for prosecutors and private plaintiffs. Ultimately, if such disclosures are routinely allowed, they will undermine the law enforcement policies upon which the organizational sentencing guidelines and comparable measures are premised: that corporate good citizenship can be induced through incentives that promote self-policing.[386]

Effective programs also often contemplate that where wrongdoing is reported, an internal investigation must follow. Such investigations will be conducted by organizational counsel, although large-scale or particularly sensitive investigations are often conducted by outside rather than in-house counsel. At the conclusion of the investigation, a report in some form is generally rendered to the organizational client. Assuming the appropriate steps have been taken to safeguard applicable protections, normally, the report of an internal corporate investigation, and the materials underlying it, will be protected by the attorney-client privilege and/or the work product doctrine.

---

[385] Ethics Resource Center, National Business Ethics Survey - 2003: How Employees View Ethics In Their Organization (2003). Executive Summary available at: <http://www.ethics.org/nbes2003/2003nbes_summary.html>.

[386] Michael Goldsmith & Chad W. King, *Policing Corporate Crime: The Dilemma of Internal Compliance Programs*, 50 VAND. L. REV. 1, 4-8 (1997); *see also* David A. Dana, *The Perverse Incentives of Environmental Audit Immunity*, 81 IOWA L. REV. 969, 970 (1996) ("[C]ommentators stress that corporations may forgo internal audits if they fear that they will be held liable for, and hence punished for, any violations that they may uncover.")

The protected nature of such reports is deemed critical by organizations and their counsel because, absent such protection, the reports may well provide prosecutors and regulators with a roadmap to corporate liability.[387] If, however, the organization decides to turn over to the government some or all of its internal investigation in order to argue for a declination or sentencing consideration, it will generally be deemed to have waived its attorney-client privilege and work product protections as to the subject-matter disclosed.[388] Further, because courts do not recognize "selective" waivers, when there is a waiver of otherwise protected information, it will be unprotected as to all comers.

Organizations claim that "such information will be welcome fodder for the use of plaintiffs' counsel in what surely will be endlessly ensuing civil litigation and massive attorneys' fees for a company. . . . There is a real danger that the release of privileged information could trigger a 'feeding frenzy' of civil litigation."[389] In sum, as experienced practitioners Dan Webb and Steven Molo explain:

> As part of its compliance efforts, a company may require that it conduct an internal investigation and prepare a report of the findings. These reports may receive protection under the attorney-client privilege and the work product doctrine. However, if the corporation discloses the report to regulators or others outside the organization, it may waive the privilege. Thus, through adherence to its compliance program, the company may collect and ultimately provide access to negative information that prosecutors, plaintiffs' lawyers, competitors, and the media may use against it.[390]

If this dynamic is present with respect to the implementation and day-to-day operation of a compliance program, it is considerably magnified when a corporation faces the question of whether it should, as the organizational sentencing organizational sentencing guidelines encourage, *self-report* any wrongdoing discovered and cooperate with the government in fully investigating it, instituting remedial measures, and taking whatever steps are necessary to assure that the wrongdoing will not recur.

Again, it may be helpful to explore the perceived advantages and disadvantages of self-reporting and cooperation from the perspective of an organization. At least in some industries the

[387]*See, e.g.,* Thomas R. Mulroy & Eric J. Munoz, *The Internal Corporate Investigation*, 1 DEPAUL BUS. & COMM. L.J. 49, 49 (2002).

[388]*See infra* Part V for a more extensive discussion.

[389]*Counsel Group Assails Prosecution Policy Compelling Corporations to Waive Privileges*, 67 CRIM. L. REP. (BNA) 391, 393 (June 14, 2000) (quoting letter of American Corporate Counsel Association).

[390]Dan K. Webb & Steven F. Molo, *Some Practical Considerations in Developing Effective Compliance Programs: A Framework for Meeting the Requirements of the Sentencing Guidelines*, 71 WASH. U. L.Q. 375, 379-380 (1993).

U.S. Department of Justice or regulators may reward with amnesty or least the prospect of amnesty those regulated corporations who self-report.[391] Even if no applicable voluntary disclosure program exists, the U.S. Department of Justice weighs, often heavily, the fact that a corporation self-reported or cooperated in deciding whether to bring a criminal case against the corporation.[392] Where a decision is made for other reasons to go forward with the case, the organizational sentencing guidelines provide significant sentencing advantages to corporations who have self-reported or cooperated. Finally, by voluntarily disclosing wrongdoing and cooperating in the rededication of the wrong, corporations may be able to place the misconduct in the best possible light, formulate a more effective defense to *any* type of liability, and mitigate the scope of collateral civil liability. Why, then, might corporations elect *not* to pursue these options?

Absent a specific statutory obligation to report corporate wrongdoing or a regulatory obligation to make disclosures to regulators (such as Suspicious Activity Reports to bank regulators) or in public filings (with the SEC or other regulators such as NASDAQ or the New

---

[391]For example, the Department of Defense (DOD) has a Voluntary Disclosure Program under which the overwhelming majority of contractors who have discovered criminal or civil fraud and have reported the matter to the DOD's Assistant Inspector General for Criminal Investigative Policy have avoided prosecution by the The U.S. Department of Justice. *See* Laurence A. Urgenson, *Voluntary Disclosure: Opportunities and Issues for the Mid–1990's*, 943 PLI/CORP. 225 (1996); Gary G. Lynch & Eric F. Grossman, *Responding to Bad News: How to Deal with the Board of Directors, Stockholders, the Press, Analysts, Regulators and the Plaintiff's Bar*, 1149 PLI/CORP 207 (1999); DOD Voluntary Disclosure Program, available at <http:www.dodig.osd.mil/Inspections/IPO/voldis.htm>.

The Office of Inspector General (OIG) of the Department of Health and Human Services (HHS), with the cooperation of the The U.S. Department of Justice, has established a voluntary disclosure program for health care providers, *see* HHS OIG, Provider Self–Disclosure Protocol, 63 Fed. Reg. 58399 (Oct. 30, 1998), as has the Environmental Protection Agency (EPA), *see* EPA, *Incentives for Self–Policing: Discovery, Disclosure, Correction, and Prevention of Violations*, Final Policy Statement, 60 Fed. Reg. 66706 (Dec. 22, 1995); 64 Fed. Reg. 26745, 26754 (May 17, 1999) (proposed revisions); Thomas J. Kelly, Jr. & Gregory S. Braker, *Navigating the Bermuda Triangle of Environmental Criminal Enforcement*, ALI–ABA Course of Study Materials on Criminal Enforcement of Environmental Laws (May 2000). The Antitrust Division of the Department of Justice has a number of voluntary disclosure programs which offer leniency to organizations and individuals under specified conditions. *See* Lynch & Grossman, *supra*.

The Antitrust Division's program is the farthest reaching of any agency's corporate leniency program as it is the only program that offers complete and automatic amnesty from criminal charges to the first corporation involved in the antitrust scheme to voluntarily come forward and cooperate.

[392]*See* Memorandum from Deputy Attorney General Larry Thompson, to Heads of Department Components, *Principles of Federal Prosecution of Business Organizations* (January 20, 2003). Available at: <http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm>.

York Stock Exchange),[393] many corporations have no legal obligation to self-report.[394] Self-reporting obviously raises the possibility that the corporation will, despite this heroic act, be criminally charged and sanctioned. As the preceding discussion illustrates, this eventuality may be very expensive and burdensome on an ongoing basis.

Voluntary disclosure also raises the risk that the government will uncover additional, perhaps unrelated, wrongdoing, thus exacerbating the corporation's difficulties. Corporations may accordingly choose to remain silent where the wrongdoing is uncertain or will be difficult to prove, when the chances that it will be detected by the government are small. The most effective way of altering an organization's deterrent calculation with respect to the above is to increase the likelihood that it will be apprehended. Obviously, the Sentencing Commission is not empowered to clarify prevailing legal rules or make the kind of resource allocation decisions necessary to affect the odds that an organization will be criminally punished. Self-reporting also creates business risks, including the probability of adverse publicity and deleterious consequences for the internal functioning of the corporation.[395] Again, these are not matters that the Sentencing Commission generally can, or should, address.

For present purposes, the most important factor that must be considered in decisions regarding voluntary disclosure are the important adverse consequences for the organizations's bottom line that may flow from self-reporting. A critical consideration for those organizations

[393]The contours of such requirements are beyond the scope of this report. For helpful guides, *see* Laurence A. Urgenson & Traci L. Jones, *Determining Whether to Disclose Uncharged Conduct in SEC Filings: A Three–Step Process*, 7 BUSINESS CRIMES 1 (Aug. 2000); Gary G. Lynch & Eric F. Grossman, *Responding to Bad News: How to Deal with the Board of Directors, Stockholders, the Press, Analysts, Regulators and the Plaintiff's Bar*, 1149 PLI/CORP 207, 241 (1999).

[394]Much has been made of the case of Daiwa Bank Ltd., in which Daiwa pleaded guilty to misprision of a felony for its attempt to cover up crimes committed by bank employees and paid a $340,000,000 fine. Generally, however, the misprision statute, 18 U.S.C. § 4, requires proof of more than a simple failure to volunteer information regarding wrongdoing. To prove misprision, the government must demonstrate that "(1) the principal committed and completed the felony alleged * * *; (2) the defendant had full knowledge of that fact; (3) the defendant failed to notify the authorities; and (4) the defendant took an affirmative step to conceal the crime." *United States v. Ciambrone*, 750 F.2d 1416, 1417 (9th Cir. 1984); *see also United States v. Vasquez–Chan*, 978 F.2d 546, 555 (9th Cir. 1992). " 'Mere silence, without some affirmative act, is insufficient evidence' of the crime of misprision of felony. Thus, a person who witnesses a crime does not violate 18 U.S.C. § 4 if he simply remains silent." *Id.* (quoting *Lancey v. United States,* 356 F.2d 407, 410 (9th Cir. 1966)); *see also United States v. Adams*, 961 F.2d 505, 508–09 (5th Cir. 1992) (same).

[395]"The incentives offered to corporations to report on themselves threaten to strain relations between employees and managers. Corporations conducting internal investigations of misconduct often plan on reporting investigative results to authorities. These reports will likely harm the individual employees who are the targets of the investigation and potentially lead to defamation claims by affected employees." Gary G. Lynch & Eric F. Grossman, *Responding to Bad News: How to Deal with the Board of Directors, Stockholders, the Press, Analysts, Regulators and the Plaintiff's Bar*, 1149 PLI/CORP 207, 241 (1999). The government's definition of full cooperation may require corporations to turn in or at least discipline valuable employees, revise or discontinue otherwise productive business plans or organizations, and will absorb the time and energies of many corporate employees.

whose success depends on business with the government is the possibility that the wrongdoing the organization itself reports may result in the corporation's suspension or debarment from government contracting[396] or non-procurement financial assistance or benefits.[397] No matter the organization's business, self-reporting may generate, or may assist a variety of litigators against the organization. Such actions may include regulatory action on the federal, state, or local level, shareholder derivative suits, treble damages suits, and *qui tam* suits.

As noted above, organizations often will seek to minimize this exposure by conducting compliance audits and investigations in ways that will secure for them the protections of the work product doctrine or the attorney-client privilege. Voluntary disclosure and cooperation ultimately risk waiver of these important protections. Such a waiver certainly will adversely affect the organization's ability to defend itself in collateral litigation. The collateral litigation may threaten financial liability far in excess of whatever criminal penalties might be exacted. Even where such liability may not outpace the potentially applicable criminal fines, an organization may conclude that it cannot survive if subjected to civil *and* criminal exposure and so may choose to gamble on silence. In short, an organization's decision whether to self-report and cooperate may, despite governmental incentives, be constrained by the litigation dilemma.

E. THE RECORD DEVELOPED BY THE ADVISORY GROUP

This litigation dilemma was described early on in the organizational sentencing guidelines' history. For example, in 1995, at the Sentencing Commission's groundbreaking symposium on corporate crime,[398] one of the chief sponsors of the Sentencing Reform Act, Senator Kennedy of Massachusetts, stated:

> In effect, the organizational sentencing guidelines make a basic promise to companies: "Act as good citizens and your penalty exposure will be reduced." But that promise is a false one if companies face non-

[396]*See, e.g.*, 48 C.F.R. §§ 9.400, *et seq.* (1998) (administrative suspension and debarment practices governed by the Federal Acquisition Regulations ("FAR") for procurement programs). "Suspension" is a temporary exclusion from contracting with, or receiving financial assistance from, the government while "debarment" is an exclusion from contracting with, or receiving financial assistance from, the government for a specified period of time. Almost all federal government departments and agencies have procurement debarment regulations. *See, e.g.*, 28 C.F.R. § 67.100, *et seq.* (1998) (Department of Justice regulations regarding procurement debarment following conviction); *see generally* SARAH N. WELLING, SARA SUN BEALE, PAMELA H. BUCY, FEDERAL CRIMINAL LAW AND RELATED ACTIONS: CRIMES, FORFEITURE, THE FALSE CLAIMS ACT AND RICO, (St. Paul, Minn.: West Group 1998) Chapter 33.

[397]*See, e.g.*, 41 C.F.R. § 105–68.100 *et seq.* (1999) (Non-procurement suspension and debarment).

[398]Corporate Crime in America: Strengthening the "Good Citizen" Corporation, September 7-8, 1995. The symposium drew approximately 450 attendees and was the largest conference of its kind as of that date.

> guideline penalties that take no account of [their] 'good citizenship' efforts. I'm pleased that [these] proceedings will consider these important coordination issues.[399]

The thrust of intervening developments and comments submitted to the Sentencing Commission and the Advisory Group indicate that these same issues, some eight years later, persist. The dilemma of compliance initiatives being used against companies continues to undermine the effectiveness of compliance programs, and thus this dilemma continues to threaten a key policy objective of the organizational sentencing guidelines that should be addressed in a coordinated and comprehensive fashion by policy makers.

In 1999, the Fellows Program of the Ethics Resource Center convened a panel of experts to explore ways to make compliance and ethics programs more effective. The ERC Fellows focused on the "litigation dilemma" and produced an outline of possible legislative solutions for discussion and evaluation purposes, although it did not endorse any particular approach.[400] In 2000, a coalition of prominent companies with active compliance programs and well known nonprofit organizations in the field[401] formed the Coalition for Ethics and Compliance Initiatives ("CECI"), which included within its agenda advancing the discussion of possible solutions to the litigation dilemma.

Even before the Sentencing Commission appointed the Advisory Group, it received public comment supporting the idea that the Sentencing Commission should play a role to advance the dialogue on the litigation dilemma issue. A May 2001 letter from the Ethics Resource Center voiced support for a "privilege" to shield the misuse of information generated by companies in good faith to evaluate the effectiveness of their compliance/ethics programs:

---

[399]Symposium proceedings at p.120. The proceedings to which Senator Kennedy referred included two panels in which presenters discussed the dilemma that many companies believed they were facing: the same rigorous compliance efforts they undertook to meet the organizational sentencing organizational guidelines' compliance program standards could, perversely, be used against them in other settings. William B. Lytton, then the General Counsel of Lockheed Martin Electronics and a prominent voice in the compliance field, put it this way during one of the panels:

> One of the things that results from the organizational sentencing organizational sentencing guidelines is the effort to find out if you have a problem. So we conduct internal audits and investigation just like the FBI not wanting raw FBI 302s to be out there, we don't want our investigative files to be out there. Why? Because there's another group of lawyers called the plaintiff's security firms. I used to be in one of those, and they are going to try [to use this information] and blackmail us to settle the case.

Symposium proceedings at p.282. Later that day, then - Sentencing Commissioner Michael Goldsmith elaborated on this same dilemma, stating that "compliance practices contemplated by the organizational sentencing organizational sentencing guidelines pose ... liability risks." He later put it, "[t]he problem that you folks [compliance practitioners] face is: how does one create and conduct an effective compliance program without producing a smoking gun for opponents to use in future litigation?" Symposium proceedings at pp. 351, 353.

[400]<http://www.ethics.org/fellows/index.html>.

[401]<http://www.ceci.ws/research_news.html>.

> At the present time, the threat of discovery or disclosure serves as a deterrent to organizations undertaking bona fide efforts to evaluate their behavior as an organization. Such a privilege could be designed to permit traditional discovery, while encouraging organizations to genuinely assess the effectiveness of their ethics/compliance programs.[402]

In response to the Advisory Group's requests for comment on this issue, a significant number of commentators expressed the view that the Sentencing Commission should play a leading role in advancing a solution to the litigation dilemma.[403] In particular, at the Advisory Group's November 14, 2002, hearing, several witnesses discussed the practical contours of this problem.[404] By design, witnesses assigned to Breakout Session III (alternatively titled "Externalities; Confidentiality, Internal Reporting and Whistleblowing"), addressed the question most directly. Of those, Joseph E. Murphy, of Compliance Systems Legal Group, and former Vice Chair and Sentencing Commissioner Michael Goldsmith, currently on the faculty of Brigham Young University Law School, particularly focused on this topic.

Mr. Murphy stated that the dilemma of compliance program information being used against an organization is having a "chilling impact" on important compliance practices and therefore is "interfer[ing] with the policy objectives of the organizational sentencing organizational sentencing guidelines."[405] He continued:

> Enron, Worldcom, Tyco, Adelphia, again remind us how important this is and that compliance programs are so key. But I think these cases show how only real, empowered compliance programs can make a difference. In, for example, Worldcom it was the aggressive internal auditors who uncovered what was going on . . . we need to do whatever it takes to make these compliance efforts real . . .
>
> [T]he risk of compliance materials being used against a company is, in practice, a weapon in the hands of ... for example, [in-house] litigation lawyers. They ... resist an expansive aggressive program ... things like helplines, audits, monitoring, surveys, focus groups, detailed [internal]

402 Available at USSC.

403 These include Arnold & Porter and PricewaterhouseCoopers (on behalf of 19 pharmaceutical companies); the Coalition for Ethics and Compliance Initiatives; the Ethics Resource Center; PricewaterhouseCoopers (on its own behalf); the Regence Group; and PG&E Corp. These comments are available at: <http://www.ussc.gov/corp/advgrp.htm>.

404 *See, e.g.*, Transcript of Plenary Session II (Nov. 14, 2002), William B. Lytton, pp. 42-44; Transcript of Breakout session III (Nov. 14, 2002), Patrick Gnazzo, p. 19 (robust compliance practices create a "road map" for litigants), in addition to the other witnesses noted. These transcripts are available at:<http://www.ussc.gov/corp/advgrp.htm>.

405 Transcript of Breakout Session III (Nov. 14, 2002), Joe Murphy, p .7.

> reporting [of compliance issues], but I believe it's those aggressive efforts that are the real difference between sham programs and real ones. It is, sadly, though, an ongoing battle to get these things accepted [within the company] ... from this fear of litigation. …[406]

Mr. Murphy noted that the litigation risks are real, and therefore in-house lawyers who discourage compliance practices because of these risks "are not being irresponsible." He stated, "[i]n fact, I would submit that the lawyer who fails to give that advice is engaging in malpractice because you have to warn your client of the litigation risk of what you're doing."[407] Mr. Murphy continued with examples of where, as an active compliance consultant and former in-house compliance lawyer, he has observed the "chilling effect" of litigation-related worries on effective compliance practices:

> And just to give you some examples . . . One that I run into on a routine basis is when I do compliance training. I will essentially say to employees, "Don't take notes. . . unless . . you feel confident reading them to a jury" [at] which [point] they all stop taking notes. This is very bad advice from a teaching point of view, but in my opinion really necessary as a result of . . . the *Lucky Stores* case where training notes were used against a company very effectively in litigation."[408]

Mr. Murphy then cited these additional examples of where he considers that effective compliance practices are undercut by litigation realities or fears:

(1) The inability of companies to promise confidentiality to internal whistleblowers, which may be necessary to foster robust internal reporting of compliance issues (litigation may compel disclosure, so a real promise of confidentiality can't be made);[409]

(2) Preparing a list of compliance "dos and don'ts" to explain a company's expectations (materials could be used against the company);[410]

(3) Not keeping initial scores of employees tested on compliance training when they can be useful to monitor individual improvement (same reason);[411]

---

[406] Transcript of Breakout Session III (Nov. 14, 2002), Joe Murphy, pp. 8-10. This transcript is available at: <http://www.ussc.gov/corp/advgrp.htm>.

[407] *Id.* at pp. 16-17.

[408] *Id.* at pp. 10-11; discussing *Stender v. Lucky Stores, Inc.,* 803 F.Supp. 259 (N.D. Cal. 1992).

[409] *Id.* at p. 11.

[410] *Id.* at p. 14.

[411] *Id.* at p. 14.

(4) Not internally publicizing discipline for code violations to demonstrate the program is real (same reason);[412] and

(5) Not sharing the results of compliance audits and investigations within the company so that all potentially affected parts of the business can fully grasp the compliance risks (same reason; also, risk of possible attorney-client or work product privileges being waived).[413]

Former Vice Chair and Sentencing Commissioner Michael Goldsmith broadly agreed with Mr. Murphy's testimony:

> This whole problem . . . brings to mind the adage, "no good deed goes unpunished." The Sentencing Commission essentially made internal compliance programs an essential aspect of federal sentencing policy and then, in turn, if it didn't create it, it certainly allowed to continue the existence of a dilemma faced by corporations that wanted to do the right thing . . . in effect, as [Pat Gnazzo, another panel witness from United Technologies Corporation] just pointed out a moment ago, a litigation road map to anyone who gets access to their compliance materials.[414]

A number of corporate representatives also testified at the November 14 hearings and reinforced the message delivered by the above compliance experts. A recurring sentiment was that "when companies undertake rigorous evaluations to understand how their compliance programs can be improved, there is no guarantee that the information generated will not be used against them in various legal proceedings, both criminal and civil."[415] These witnesses contended that companies who rigorously self-evaluate their programs are at greater risk of being exposed to such legal proceedings than companies that do not. Auditing and monitoring create a document that can be used by prosecutors against the company even though it exists only because of the company's voluntary efforts to protect and prevent legal violations.[416] A submission made on behalf of 19 pharmaceutical companies asserted that "self-policing activities such as auditing, monitoring and self-reporting can create serious risks for a company -- risks that, unfortunately, do diminish the likelihood of auditing, monitoring, and reporting."[417]

---

[412] Transcript of Breakout Session III (Nov. 14, 2002), Joe Murphy, pp. 14 –15. This transcript is available at: <http://www.ussc.gov/corp/adgrp.htm>.

[413] *Id.* at p. 15.

[414] *Id.* Michael Goldsmith, p. 46.

[415] Submission by David Greenberg on behalf of Phillip Morris & Company, Inc. (Oct. 11, 2002) at p. 8. This submission is available at: <http://www.ussc.gov/corp/adgrp.htm>.

[416] Transcript Breakout Session II (November 14, 2002), Eric Pressler, p. 36, lines 5-11. This transcript is available at http://www.ussc.gov/corp/adgrp.htm>.

[417] Submission by John T. Bentivoglio, Arnold & Porter, and Brent L. Saunders, PricewaterhouseCoopers LLP, on behalf of 19 pharmaceutical companies (Oct. 4, 2002) at p. 9. This submission is available at: <http://www.ussc.gov/corp/advgrp.htm>.

F. RECENT DEVELOPMENTS

Although Congress has not, to our knowledge, considered a comprehensive response to the litigation dilemma–for example, by codifying a self-evaluative privilege or a provision permitting selective waivers of the attorney-client and work product protections–it has recently demonstrated an awareness of the issue and a willingness to respond to it.

In the Sarbanes-Oxley Act of 2002, Congress created the Public Oversight Accounting Board "to oversee the audit of public companies that are subject to the securities laws, and related matters, in order to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports" for publicly-held companies.[418] In Section 105(b)(5) of the Act, Congress decreed that:

> **(A)** **Confidentiality**. Expect as provided in subparagraph (B), all documents and information prepared or received by or specifically for the [Public Oversight Accounting Board], and deliberations of the Board and its employees and agents, in connection with an inspection ... or with an investigation under this section, shall be confidential and privileged as an evidentiary matter (and shall not be subject to civil discovery or other legal process) in any proceeding in any Federal or State court or administrative agency, and shall be exempt from disclosure, in the hands of an agency or establishment of the Federal Government, under the Freedom of Information Act (5 U.S.C. 552a), or otherwise, unless and until presented in connection with a public proceeding or released in accordance with subsection (c).

Section 105(b)(5)(B) goes on to provide that the information protected in § 105(b)(5)(A) may, in the discretion of the Board, "when determined by the Board to be necessary to accomplish the purposes of this Act or to protect investors, and without the loss of its status as confidential and privileged in the hands of the Board," be disclosed by the Board to specified persons.

This confidentiality provision demonstrates a congressional understanding that the Board, by credibly promising confidentiality, will likely receive more "documents and information" than it otherwise would. Notably, however, it is unclear whether the assurance that documents and information submitted to the Board are "confidential and privileged as an evidentiary matter" applies when such materials are sought from the persons who submitted them, or only when they are sought through legal process from the Board itself. Whether Congress intended to provide that persons who submit documents and information may selectively waive any attorney-client or work product protections those materials may have only as to the Board, or may continue to assert those protections as to third parties, is not clarified in the legislation, and it may well give rise to litigation on these issues.

---

[418] Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 750, § 101.

A more unambiguous attempt to create a selective waiver doctrine as to documents submitted to the Securities and Exchange Commission is presently being considered by Congress in H.R. 2179, entitled "the Securities Fraud Deterrence and Investor Restitution Act." Section 4 of that bill seeks to amend Section 24 of the Securities Exchange Act of 1934[419] to include the following new subsection:

> **(e)** AUTHORITY TO ACCEPT PRIVILEGED AND PROTECTED INFORMATION. Notwithstanding any other provision of law, whenever the [Securities and Exchange] Commission and any person agree in writing to terms pursuant to which such person will produce or disclose to the Commission any document or information that is subject to any Federal or State law privilege, or to the protection provided by the work product doctrine, such production or disclosure shall not constitute a waiver of the privilege or protection as to any person other than the Commission.[420]

It is noteworthy that this provision was sought by the SEC, which has consistently recognized that a selective waiver provision may aid it in securing cooperation from organizations concerned about the litigation dilemma.[421]

The law of privileges is not static. As observed by the Supreme Court in discussing a particular rule of evidence, the law governing the privileges of witnesses in federal trials was not frozen at a particular point in our history, but rather federal courts can "continue the evolutionary development of testimonial privileges."[422] Recently, Congress itself has enacted several evidentiary privileges in order to promote various policies.

For example, in 1998 Congress provided protection for the self-testing of equal credit compliance to prevent "red-lining"as long as violations are identified and corrective measures taken.[423] Congress also extended the tax privilege of confidentiality for individuals who consult tax preparers who may not be attorneys and allows it to be asserted in non-criminal tax matters before the IRS or in federal district court.[424] In anticipation of technical problems that may have occurred in the transition to the new millennium, Congress provided that disclosures of "Year 2000 readiness" matters would not be able to be used in contract litigation against the party making the

---

[419] 15 U.S.C. §78x.

[420] This bill was forwarded by the Subcommittee on Capital Markets to the full House Committee on Financial Services as of July 10, 2003. As of this writing, no further action had occurred.

[421] *See* discussion at Part V, C above.

[422] *Trammel v. United States,* 445 U.S. 40, 47 (1980); *see also* FED. R. EVID. 501.

[423] *See* 15 U.S.C. § 1691c-1 (1998); The Equal Credit Opportunity Act, Pub. L. No. 104-208, 110 Stat. 3009-420 (1996).

[424] *See* 26 U.S.C. § 7525; Internal Revenue Reform Act, Pub. L. No. 105-206, 112 Stat. 750 (1998).

disclosure.[425] State legislatures also recognize periodically that certain types of privileges will serve the public interest, as the State of Illinois did by recently creating a compliance self-evaluative privilege for insurance companies "to conduct voluntary internal audits of their compliance programs."[426] These legislative mandates reflect a concern for the litigation dilemma facing law-abiding organizations.

G. RECOMMENDATION FOR FURTHER STUDY

Despite widespread agreement on the nature of the "litigation dilemma," there is no clear consensus on what, if anything, ought to be done to resolve it. Proposals have been made concerning creation of a partial and/or selective waiver doctrine, codification of a self-evaluative privilege, and a type of statutory "use immunity."[427] The Advisory Group determined that, given its limited mandate and term, it does not have sufficient information to make a recommendation regarding this issue. The Group could not explore fully the potential repercussions of a selective waiver doctrine. For example, were a selective waiver doctrine to be recognized, it is possible that the U.S. Department of Justice would increase its demands for organizational privilege waivers as a condition of declination or cooperation credit. As is discussed at greater length in Part VI of this Report, if such waivers were required in most cases, it may jeopardize the policy underlying the attorney-client privilege, namely, encouraging full and frank communication between client and counsel.

The Advisory Group also did not have the benefit of hearing from many of the constituencies that are likely interested in this issue but who did not necessarily focus on the Group's work. For example, the preceding discussion describes the dilemma from the perspective of the organizations whose conduct the organizational sentencing guidelines are designed to influence. The Advisory Group did not hear from the plaintiffs' bar, which may well have a different perspective. Despite widespread acknowledgment of the force of the litigation dilemma, other critics may emphasize that organizations continue to institute compliance programs because the incentives offered by the organizational sentencing guidelines are in themselves sufficient.

The U.S. Department of Justice's comments echoed this latter point. The U.S. Department of Justice acknowledged that "self-reporters will always bear the risk of third-party litigation or action by government enforcement personnel." In its view, however, this "dilemma" cannot be

---

[425] Year 2000 Information and Readiness Disclosure Act, 105 Pub. L. No. 271, 112 Stat. 2386 (1998). Enactment of S. 2392.

[426] *See* 215 Ill. Comp. Stat. 5/155.35 (1997). ("The General Assembly hereby finds and declares that protection of insurance consumers is enhanced by companies' voluntary compliance with this State's insurance and other laws and that the public will benefit from incentives to identify and remedy insurance and other compliance issues. It is further declared that limited expansion of the protection against disclosure will encourage voluntary compliance and improve insurance market conduct quality and that the voluntary provisions of this Section will not inhibit the exercise of the regulatory authority by those entrusted with protecting insurance consumers.")

[427] *See* Michael Goldsmith & Chad W. King, *Policing Corporate Crime: The Dilemma of Internal Compliance Programs*, 50 VAND. L. REV. 1, 39-44, 46-47 (1997).

resolved by changes to the organizational sentencing guidelines because they already appropriately encourage auditing, monitoring and self-reporting. Further, The U.S. Department of Justice representatives emphasized that management and boards of directors of organizations have an "inherent fiduciary duty to stockholders and investors to undertake such prophylactic activities."[428] The U.S. Department of Justice representatives also pointed to the new whistleblower provision in the Sarbanes-Oxley Act of 2002, which protects employees who report suspected misconduct and potential illegalities through the enactment of a new criminal offense for retaliating against whistleblowers.[429]

While the litigation dilemma can be resolved, if at all, only by Congress or the courts, so the potential importance of this issue for purposes of encouraging truly effective compliance programs suggests to the Advisory Group that the Sentencing Commission should, through its unique status and powers as an independent agency within the judiciary, serve as a fulcrum to advance the debate among policy makers. Up until this point, there has been no forum of government policy makers for discussion of this important issue despite its ramifications for the organizational sentencing guidelines and all its progeny, both within executive agencies and in the growing practice field of compliance and ethics. Accordingly, the Advisory Group recommends that the Sentencing Commission consider how, under its various statutory powers under 28 U.S.C. § 994 *et seq*., it can advance and further the dialogue among the branches of government and interested members of the public. The Advisory Group considers that a dialogue seeking to resolve the litigation dilemma is fundamental to the full and effective operation of the organizational sentencing guidelines and the public policies that they are intended to advance.

[428]Transcript of Plenary Session II (Nov. 14, 2002), Debra Yang, p. 19. This transcript is available at: <http://www.ussc.gov/corp/advgrp.htm>.

[429]*See* 18 U.S.C. § 1513(e); *see also* 18 U.S.C. § 1514A.

VII. RECOMMENDATIONS

A. GUIDELINE CHANGES

1. New Guideline Containing Compliance Criteria

The Advisory Group recommends (1) specific modifications to the existing criteria for an effective compliance program, (2) expansion of the existing guideline language to focus organizational efforts on the prevention and detection of all violations of law rather than solely criminal violations, and, (3) the relocation of the criteria for an effective compliance program to a separate stand-alone guideline. The proposed new guideline is set forth at Appendix B, and a section-by-section analysis of each change from the existing language, together with the Advisory Group's analysis and findings leading to each particular recommendation, is set forth at Part IV above.

2. Guideline Reference to Waiver of Privileges

The Advisory Group recommends that Chapter Eight mention the role that waivers of the attorney-client privilege and protections of the work product doctrine play in the context of obtaining credit for cooperation under §8C2.5(b) and the benefit of a motion by the government for substantial assistance under §8C4.1. As discussed in Section V above, the Advisory Group recommends that the following two sections be amended as follows:

- Amend the Commentary at Application Note 12 of §8C2.5 to read as follows:

  If the defendant has satisfied the requirements for cooperation set forth in this note, then waiver of the attorney-client privilege and of work product protections is not a prerequisite to a reduction in culpability score under subsection(g). However, in some circumstances waiver of the attorney-client privilege and of work protect protections may be required in order to satisfy the requirements of cooperation.

- Add a new Application Note to §8C4.1, to read as follows:

  <u>Waiver of Certain Privileges and Protections</u>. – If the defendant has satisfied the requirements for substantial assistance set forth in subsection (b)(2), then waiver of the attorney-client privilege and of work product protection is not a prerequisite to a motion for a downward departure by the government under this section. However, in some circumstances the government may determine that waiver of the attorney-client privilege and of work product protections is necessary to ensure substantial assistance sufficient to warrant a motion for departure.

Again, the Advisory Group would like to reiterate its intention that this proposal, which has the unanimous support of the diverse and broad- based membership of the Advisory Group may assist the Sentencing Commission in resolving the current misperceptions about privilege waivers in the context of cases covered by the organizational sentencing guidelines. The Advisory Group is confident that the Sentencing Commission can advance understanding in this area by making the recommended changes suggested above and encouraging further dialogue on the matter with other policy makers, as appropriate.

B. FAILURE TO IMPLEMENT A COMPLIANCE PROGRAM

Section 8C2.5(f) provides for a three-level reduction in the culpability score of an organization "if the offense occurred despite an effective program to prevent and detect violations of law." However, there is no corresponding increase in the culpability score if an organization fails to implement a compliance program or if its compliance program fails to meet the standards set out in the organizational sentencing guidelines. The Advisory Group evaluated whether a culpability *enhancement* for the *absence* of an effective program is necessary to create additional incentives for the institution of effective compliance programs, and concluded that it is not.

In considering this issue, the Advisory Group came to understand that the consequence of an amendment of this nature will most likely have a disproportionate impact upon small companies. Of the 1,089 cases sentenced under the organizational sentencing guidelines between 1991 and 1999, only three organizational defendants qualified for the credit for an effective compliance program. These statistics, of course, do not reveal the number of organizations that were *not indicted* in the first instance because they had an effective compliance program in place.[430]

Perhaps, more importantly, the principal reason that the overwhelming majority of convicted organizations do not receive sentencing credit for having an effective program is related to their size. Section 8C2.5(f), which provides for penalty increases whenever "high-level personnel"of an organization participated in, condoned, or was wilfully ignorant of the offense," makes no distinction between large and small corporations. As John Steer, a current member and Vice-Chair of the U.S. Sentencing Commission has explained,

> The overwhelming majority of organizations ultimately criminally convicted and sentenced in federal courts are small, closely-held companies. These small businesses are less likely to have become aware of the sentencing guidelines, or to have acted on any awareness they may have gained, by allocating resources to develop a sufficient compliance program. Moreover, because such organizational offenders often, by their nature, involve high level management participation in the offense, they are precluded under the terms of the guidelines from

[430] *See, e.g.*, Saul M. Pilchen, *When Corporations Commit Crimes: Sentencing Under the Federal Organizational Sentencing Guidelines*, 78 JUDICATURE 202-06 (January-February 1995). (Examining first 50 cases sentenced under the organizational sentencing guidelines and concluding that the cases generally involved significantly culpable corporations and suggesting that prosecutors may be declining to prosecute less culpable corporations).

> receiving sentencing credit for any compliance program that may have been developed.[431]

In recognition of this reality, and because the Advisory Group wished to explore the more general question of how the organizational sentencing guidelines affect small and medium-sized companies, the Advisory Group solicited comments on a number of questions that relate to the special circumstances that such companies may face.

With respect to the more specific issue of an *enhancement* for *failure* to put in place an effective program, the Advisory Group noted that current legislative and regulatory trends, as well as public opinion, demand stiffer consequences for corporate crimes. This opinion was echoed, in part, during the public hearing conducted by the Advisory Group. Most of the commentators recognized and endorsed the "carrot and stick" approach that the organizational sentencing guidelines employ, but the majority, including the U.S. Department of Justice, did not favor an increase in culpability score for companies that fail to implement an effective compliance program. The U.S. Department of Justice recommended "against a blanket rule for organizations of all sizes requiring an increase in the culpability score for failure to implement an effective program to prevent and detect violations of law. The existing guideline incentive is sufficient to encourage small companies to implement meaningful programs.'"[432]

Similarly, a submission on behalf of health care industry organizations, including hospital systems, physicians and managed care companies, opposed modification of this aspect of the organizational sentencing guidelines. The submission observed that organizations which have not adopted "effective" corporate compliance programs will already have increased culpability scores in relation to organizations having such compliance programs, because only those organizations with effective programs will be eligible for decreased culpability scores.[433]

The Ethics Resource Center, however, recommended that the organizational sentencing guidelines adopt a "negative score" for organizations that simply "go through the motions" of implementing a compliance program.[434] The U.S. Department of Justice representatives, while opposing changes to the culpability score, suggested that the Sentencing Commission consider adding commentary to §8C2.5(f) stating that the *"failure to have an effective program to prevent and detect violations of law could be weighed against larger organizations as evidence that 'an individual within high-level personnel of the organization . . . condoned, or was willfully ignorant'*

---

[431] John R. Steer, Changing Organizational Behavior - The Federal Sentencing Guidelines Experiment Begins to Bear Fruit, 1291 PLI/CORP 131, 149 (Feb. 2002).

[432] Transcript Breakout Session II (Nov. 14, 2002), Debra Yang, p.32 lines 3-16. This transcript is available at: <http://www.ussc.gov/corp/advgrp.htm>.

[433] Submission of Epstein, Becker & Green; *accord* Submission of American Chemistry Council. Available at: <http://www.ussc.gov/corp/advgrp.htm>.

[434] Letter of Patricia J. Harned, Managing Director of Programs, Ethics Resource Center, in response to Advisory Group's August 2000 Request for Comment available at <http://www.ussc.gov/corp/advgrp/htm>.

of the criminal conduct. See §8C2.5(b)(1)(A)(I).” [435] The U.S. Department of Justice representatives also recommended that the culpability score increase where the “absence of any compliance program will signal a significant deviation from recognized practice.”[436]

The Advisory Group received very little commentary in response to its questions regarding the wisdom or fairness of the organizational sentencing guidelines’ treatment of small- and medium-sized companies, despite the Advisory Group’s focus on issues affecting that constituency. Government officials and private practitioners agreed that there are many reasons why small organizations often do not receive a culpability score credit for their compliance efforts. Most commentators concurred that small organizations *should* get credit under the organizational sentencing guidelines for substantial compliance efforts but cannot because of their inability to implement sophisticated compliance programs. While the “carrot and stick” approach offers a balanced approach to the process, many of the “carrots” will not apply to the small organization.[437] The U.S. Department of Justice representatives stated that language is needed to address the issue of the effectiveness of compliance programs in small organizations[438] but they did not provide any specific suggestions.

In consideration of the disparate impact that an increase in culpability score for the absence of a compliance program would likely have on small businesses, the Advisory Group does not recommend such a change to the organizational sentencing guidelines. The Advisory Group, does recommend, however, that the Sentencing Commission devote resources to reaching and training this target audience, perhaps through coordinating with the Small Business Administration and other appropriate policy makers.

C. PROBATION

Section 3261(c) of Title 18 provides that the authorized terms of probation for an organization are “for a felony, not less than one nor more than five years,” for a misdemeanor, not more than five years, and “for an infraction, not more than one year.”[439] The U.S. Department of Justice representatives suggested that the Advisory Group and the Sentencing Commission “consider recommending to Congress an increase in the maximum period of probation for

---

[435] Transcript Breakout Session II (Nov. 14, 2002), Greg Wallance, p. 157, lines 4-10. Transcript available at: <http://www.ussc.gov/corp/advgrp.htm>.

[436] The U.S. Department of Justice’s Written Testimony, p. 19, available at <http://www.usscgov/corp/ph11_02/t_comey.pdf>.

[437] Summary of Testimony, James T. Cowdery, Nov. 4, 2002., available at <http://www.ussc.gov/corp/ph11_02lt_cowdery.pdf>.

[438] The U.S. Department of Justice’s Written Testimony, p. 19, available at <http://www.usscgov/corp/ph11_02/t_comey.pdf>.

[439] In fiscal years 2000 and 2001, 70% and 71% of defendant organizations were sentenced to terms of probation. Annual Reports, USSC, Table 53, available at: <http://www.ussc.gov/corp/organizsp.htm>.

organizational offenders," noting that in their experience "the maximum available period of probation has been inadequate to bring about the needed change in corporate culture."[440]

The Advisory Group agrees that the current five-year maximum term of organizational probation may be insufficient in many instances to ensure that the organization has developed and implemented under court order an effective compliance program, which is, in fact, a required condition of probation under §8D1.1(a)(3).[441] When organizations are large, global, and decentralized, this may be particularly difficult for the court to monitor. Five years may also be an insufficient period for the government to collect large financial restitution and fine obligations from particular defendants. It may also be inadequate if the government needs to extend an organization's term of probation to ensure compliance with all the terms ordered by the court, such as a remedial order, or completion of community service, pursuant to §8D1.1(a)(1).

The Advisory Group recommends that this important area of Chapter Eight be studied further and that the Commission ultimately make appropriate recommendations to Congress for statutory changes, if necessary. In addition, the Advisory Group suggests that the Sentencing Commission review current organizational probationary practices and problems in consultation with judges, probation officers, the U.S. Department of Justice, representatives of the defense bar, and other interested parties. The Advisory Group recommends that studies in this area include assessments of how probation is being used to promote organizational law compliance, the range of conditions being used in probationary terms for organizations, means of supervising organizations on probation, and potential problems related to the resentencing of organizations for violations of probation.

D. FINE PROVISIONS

Under the alternative fine provision of 18 U.S.C. § 3571, the statutory maximum for a given count is the *greatest* of (1) the amount (if any) specified in the law setting forth the offense; (2) for an organization convicted of a felony, $500,000; or (3) "[i]f any person derives pecuniary gain from the offense, or if the offense results in pecuniary loss to a person other than the defendant, the defendant may be fined not more than the greater of twice the gross gain or twice the gross loss, unless the imposition of a fine under this subsection would unduly complicate or prolong the sentencing process."[442] This last provision, known as the"twice gross gain or loss" provision, is likely to be the applicable maximum fine amount in many cases, especially where the dollar amount of the gain or loss is substantial. The Advisory Group has identified potential problems with the application of the fine provisions to organizations, and it recommends that the Sentencing Commission assess how this maximum fine provision interacts with the fine guidelines of Chapter Eight.

[440]The U.S. Department of Justice's Written Testimony, p. 8 available at <http://www.ussc.gov/corp/ph11_02/t_comey.pdf>.

[441]In fiscal years 2000 and 2001, 14% and 17% of organizations sentenced were ordered to implement a compliance program. USSC Annual Reports, Table 53, available at: <http://www.ussc.gov/corp/organizsp.htm>.

[442]*See* 18 U.S.C. § 3571 (Sentence of Fine).

The fine range calculation is based on the interaction of the culpability score at §8C2.5, the minimum and maximum multipliers at §8C2.6, and the base fine table at §8C2.4. Essential to the basic calculation is the zero to ten point scale. All organizations begin with five points. This number is then adjusted upwards or downwards for aggravating or mitigating circumstances, reflecting greater or lesser culpability. The maximum culpability score of ten leads to a fine range of between two times and four times the pecuniary gain or loss. This is in effect capped by the statutory maximum of twice the gain or loss in 18 U.S.C. § 3571. An altered statutory maximum of four times the gain or loss would be needed to avoid this conflict between the statutory maximum and the upper ranges of fines recommended under the guidelines for high culpability organizational offenders. The Advisory Group recommends that the Sentencing Commission, together with other interested parties, examine whether § 3571's cap of twice the gross gain or loss creates disproportional, unfair, and counterproductive sentencing results where organizations' culpability scores are in the upper ranges.

E. LOSS DEFINITION

The Advisory Group also wishes to call to the Sentencing Commission's attention the fact that the very expansive definition of "loss" in Chapter Two may not be consistent with the Alternative Fine Provision at 18 U.S.C. § 3571 as it applies to organizational sentencing. The Sentencing Commission has revised the definition of "loss" with respect to fraud and theft definitions many times, and comprehensively so in connection with the Economic Crimes Package of 2001.[443] The Advisory Group is not aware that commentators to the Economic Crimes Package focused on the effect that such revisions would have on applications under Chapter Eight, and recommends that the Commission undertake such a review.

The Advisory Group also wishes to draw attention to the fact that the recent amendment to the "loss" definition for corporate fraud,[444] in conjunction with the directives to Congress of the Sarbanes Oxley Act, may be particularly problematic for organizational defendants. In particular, the Sentencing Commission amended the Commentary at Application Note 2(C)(iv) to §2B1.1 to include the following example in the context of making an "estimation of loss" for sentencing purposes - "The reduction that resulted from the offense in the value of equity securities or other corporate assets."

The concern is that this measure of loss can yield an unrealistically high number, potentially reaching into the billions of dollars for some publicly traded companies. When companies sustain a publicized incident of misconduct, market capitalization (loss of share value in the securities markets where the company's stock is traded) can be 25, 50 or an even greater percent of the company's overall value. Such a number could lead to disproportionately high fines, especially given the fact that market capitalization can be driven by such things as public misperceptions, unconfirmed rumors, and other unrelated factors. All told, the loss of equity value, without further definition as to what that means, can constitute an unreliable measure of the harm caused by an

[443] Amendment 617. Appendix C. For a comprehensive discussion of the definition of "loss," see Frank O. Bowman, III *The 2001 Federal Economic Crime sentencing Reforms: An Analysis and Legislative History*, 35 IND. L. REV. 5 (2001).
[444] Amendments 637, 638, and 646. Appendix C.

offense, and the Advisory Group encourages the Commission to revisit this matter in the course of its review of Chapter Eight.

F. DATA COLLECTION

The Advisory Group recommends that the Commission begin to collect data on whether sentenced organizations have some or all of the characteristics of "effective programs to prevent and detect violations of law" specified in the organizational sentencing guidelines. It would also be of great benefit if more information could be made available about the positive assessment of compliance programs by The U.S. Department of Justice and other federal law enforcement agencies in their consideration of charging decisions and sentencing recommendations. The Advisory Group recommends that the Sentencing Commission foster a dialogue among federal policy makers in an effort to encourage greater awareness of the need to "reward" organizations for diligent compliance efforts by giving them public credit and recognition when possible.

G. CONCLUSION

The Advisory Group recommends specific changes to the criteria for an effective compliance program that reflects contemporary developments in legislation and the implementation of compliance programs. It also recommends the addition of clarifying language on the role of waivers in connection with credit for cooperation, and further study of the litigation dilemma, and probation and fine issues for organizational defendants. The Advisory Group also recommends that attention be devoted to educating small businesses about the organizational sentencing guidelines, to the extent practicable.