

## Client Alert

# U.S. Sentencing Commission Proposes Amendments to Guidelines on Organization Compliance and Ethics Programs

### A. Introduction

Recently, the U.S. Sentencing Commission submitted to Congress amendments to the federal sentencing guidelines, including significant changes to the criteria an organization must follow to establish an “effective compliance and ethics program” that would mitigate the organization’s punishment for a criminal offense. The amendments require directors and executives of corporations, partnerships, trusts, pension funds and other organizations to assume responsibility for oversight and management of compliance and ethics programs in order to receive consideration for a mitigated sentence, thereby potentially increasing the responsibilities of corporate directors and executives.<sup>1</sup>

The guidelines apply to corporations, partnerships, associations, joint-stock companies, unions, trusts, pension funds, unincorporated organizations, governments and non-profit organizations.

These amendments will become effective on November 1, 2004, unless Congress vetoes them, and were implemented pursuant to Section 805(a)(5) of the Sarbanes-Oxley Act of 2002, which directed the Sentencing Commission to review and amend the guidelines and related policy statements to ensure that the guidelines deter and punish organizational criminal misconduct.

Although compliance with these guidelines is not mandatory, they provide a strong incentive for implementing an effective compliance and ethics program. As discussed below, establishing an “effective compliance and ethics program” can:

- reduce the severity of an organization’s sentence (including fines and probation) if it is found to have engaged in criminal conduct;
- reduce an organization’s chances of being investigated and prosecuted by federal criminal authorities; and
- reduce directors’ civil liability.

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<sup>1</sup> Not surprisingly, the amendments echo the themes of the Sarbanes-Oxley Act, which “has adopted ethics as a guiding principle.” U.S. Sentencing Commission, Commission Tightens Requirements for Corporate Compliance and Ethics Programs, News Release, May 3, 2004.

B. Reducing the Severity of a Sentence

Under the amended sentencing guidelines there are six factors that the sentencing court must consider in sentencing an organization. Two of the six factors that weigh in favor of decreasing an organization's sentence are:

- the existence of an “effective compliance and ethics program;” and
- self-reporting, cooperation, or acceptance of responsibility.

The four factors that weigh in favor of increasing an organization's punishment are:

- level of involvement in or tolerance of criminal activity;
- prior history of the organization;
- violation of an order; and
- obstruction of justice.

These latter four factors, and the risk of increasing an organization's sentence, may be mitigated by establishing an effective compliance and ethics program; provided it had implemented the program before the criminal conduct occurred.

1. An “Effective Compliance and Ethics Program”

Under the amended guidelines, an organization that has an “effective compliance and ethics program” is one that:

- exercises due diligence to prevent and detect criminal conduct; and
- promotes an organizational culture that encourages ethical conduct and a commitment to compliance with the law.

To satisfy these criteria, the organization must be an organization that, at a minimum:

- establishes standards and procedures to prevent and detect criminal conduct;
- periodically communicates these standards and procedures to all members of the organization and its agents;
- has a board of directors that is knowledgeable about and oversees the program;
- gives compliance and ethics officers with day-to-day operational responsibility for the compliance and ethics programs direct access to directors, and sufficient authority and resources to carry out their responsibilities;
- requires compliance and ethics officers to monitor and report periodically (at least annually) on the effectiveness of the program to officers and directors;
- excludes persons from positions of substantial authority who have engaged in illegal activities or other conduct inconsistent with an effective program;

- establishes and publicizes a system for individuals to anonymously report violations or seek guidance “without fear of retaliation”;
- promotes and enforces the program consistently throughout the organization, with appropriate incentives for compliance, as well as disciplinary measures for criminal conduct or failure to prevent or detect criminal conduct;
- takes reasonable steps to respond appropriately to and prevent further similar criminal conduct; and
- conducts ongoing risk assessments of areas where criminal conduct may occur, and modifies its compliance and ethics program to reduce such risk.

There is no one compliance and ethics program that would be appropriate for all organizations. Nor will any organization's program remain appropriate indefinitely. The risk of different types of criminal conduct may vary between industries, organizations, locations, and over time. Also, once an appropriate program is set up, it should be periodically reviewed and modified to reduce changing risks of criminal conduct. Accordingly, each organization should establish its own program and continually review and modify it to address changing risks.

The guidelines require that directors be directly and substantively involved in the oversight of their organization's compliance and ethics program. It is not enough for directors to establish a program and delegate its implementation to subordinates. They must understand the program and directly oversee it. To the extent that day-to-day functions of monitoring the program are delegated to subordinates, these individuals must periodically report to the organization's officers and directors, and have sufficient authority and resources to make the program effective. All directors, executives, and employees must be trained periodically in the relevant legal standards and procedures.

## 2. Self-Reporting and Cooperation

The amended guidelines strongly encourage prompt reporting of illegal conduct and cooperation with law enforcement authorities. Under the amendments, a mitigation of sentence is not available to an organization if: (1) it unreasonably delayed reporting the offense to the appropriate governmental authorities; or (2) its officers, directors, or similar high level management officials participated in, condoned, or were willfully ignorant of the illegal conduct.

One of the more controversial aspects of the amendments concerns the waiver of attorney-client and work-product privileges as part of an organization's cooperation. The amendments state that a privilege waiver is not necessary to receive a reduction in an organization's culpability score, unless the waiver “is necessary in order to provide timely and thorough disclosure of all pertinent information known to the organization.”

This provision is controversial because almost any situation could be perceived as one in which a waiver is necessary to provide “timely and thorough disclosure of all pertinent information known to the organization.” Assertion of attorney-client and work-product privileges almost always result in a delay of disclosure and a withholding of some pertinent information. Accordingly, even though the amended guidelines explicitly state that a privilege waiver is not a prerequisite to obtaining a sentence mitigation, in practice they may be interpreted as requiring waiver.

C. Reducing Risk of Criminal Investigation and Prosecution

The existence of an effective compliance and ethics program may also reduce the risk of being investigated for criminal activity. The U.S. Department of Justice's Principles of Prosecution of Business Organizations (the "DOJ Principles") (also known among federal prosecutors as the "Thompson Memo") state that the existence of a compliance program is a factor that weighs against the prosecution of a corporation. The DOJ Principles instruct prosecutors to "make an informed decision as to whether the corporation has adopted and implemented a truly effective compliance program that . . . may result in a decision to charge only the corporation's employees and agents."<sup>2</sup> Under these principles, prosecutors determine whether an organization has an effective compliance and ethics program by looking for the same characteristics that the sentencing guidelines require for mitigation of an organization's sentence.

Under the DOJ Principles, the nature and "seriousness of the offense" is another factor for prosecutors to consider in determining whether to charge a corporation. The more serious cases warranting prosecution are typically those that carry the heavier sentences. On a practical level, many federal prosecutors prioritize their cases by devoting more of their resources to the more serious cases on their docket, *i.e.*, the cases that would result in the harshest sentences. Accordingly, an organization's risk of prosecution can be reduced by implementing an effective compliance and ethics program that warrants a reduced sentence under the sentencing guidelines.

D. Reducing Officer and Director Liability

Establishing and maintaining an effective compliance and ethics program can reduce directors' risk of liability. In a leading case from the Delaware Chancery Court concerning directors' liability, the court concluded that a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system exists, and that failure to do so under some circumstances may render a director liable for losses caused by non-compliance with applicable legal standards.<sup>3</sup> The court noted the importance of the federal organizational sentencing guidelines and stated: "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 it offers." In other words, officers and directors should seriously consider implementing the type of compliance and ethics programs outlined in the U.S. Sentencing Commission guidelines.

E. Congress Likely Will Approve the Amendments

The amendments will take effect November 1, 2004, unless Congress vetoes them during its 180-day review period. Given its heightened sensitivity to corporate malfeasance, and given that this is an election year, it is likely that Congress will approve the proposed amendments. Accordingly, organizations should not delay in instituting an effective compliance and ethics program.

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<sup>2</sup> See *U.S. Department of Justice Memorandum, Principles of Federal Prosecution of Business Organizations*, at Sections II and VII, January 20, 2003.

<sup>3</sup> See, *In re Caremark, International Inc. Derivative Litigation*, Del. Chancery C.A. 13670, 698 A.2d 959, 970 (September 25, 1996).

#### Conclusion

Instituting an effective compliance and ethics program can result in reducing the severity of a sentence (including fines and probation), and in turn, reduce the organization's risk of investigation, prosecution, and reduce individual directors' liability. However, the amendments to the sentencing guidelines may potentially increase the responsibilities of directors and officers of organizations seeking to take advantage of the benefits of such a program.

For Additional Information

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