

Staying Alive:

Creating an effective compliance and ethics program to prevent and detect employee misconduct.

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INTRODUCTION

In recent years, corporate America has experienced scandals ranging from white collar crime and fraud to unfair and corrupt business practices. Recent scandals at WorldCom, Enron and Tyco illustrate the damage that can result from employee misconduct. Through the miracle of vicarious liability, the misdeeds of a few employees may expose an entire organization to criminal sanctions resulting in significant financial penalties, reputational damage and diminished shareholder value. With so much at stake, organizations should strive to mitigate their risks to the extent possible. This paper will outline how an organization can develop, implement and maintain a compliance and ethics program that will allow the organization to limit its exposure to criminal and civil liability.

I. Why a compliance and ethics program is important

In response to corporate scandals that have shaken shareholder confidence, Congress passed the Federal Organizational Sentencing Guidelines (“the Guidelines”) in 1991. Amendments to the Guidelines effective November 1, 2004 have strengthened and clarified the Guidelines. As explained by the U.S. Sentencing Commission, “[t]hese guidelines offer incentives to organizations to reduce and ultimately eliminate criminal conduct by providing a structural foundation from which an organization may self-police its own conduct through an effective compliance and ethics program. The prevention and detection of criminal conduct, as facilitated by an effective compliance and ethics program, will assist an organization in encouraging ethical conduct and in complying fully with all applicable laws.” (United States Sentencing Commission, *Guidelines Manual*, Ch. 8, Introductory Commentary at 468.) In addition, the Sarbanes-Oxley Act of 2002 and the listing requirements of the New York Stock Exchange and NASDAQ recommend or mandate that companies adopt and disclose codes of ethics.

Compliance and ethics programs may also mitigate civil liability. Three U.S. Supreme Court decisions, *Faragher v. City of Boca Raton*, 524 U.S. 775 (1998); *Burlington Industries, Inc.*

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v. Ellerth, 524 U.S. 742 (1998); and *Kolstad v. American Dental Association*, 527 U.S. 526 (1999), incentivized employers to create or supplement existing compliance and ethics programs to cover federal anti-discrimination laws. In the *Faragher* and *Ellerth* decisions, the Court held that, absent a tangible adverse employment action, an employer should be allowed “to show as an affirmative defense to [sexual harassment] liability that the employer exercised reasonable care to avoid harassment and to eliminate it when it might occur, and that the complaining employee had failed to act with like reasonable care to take advantage of the employer’s safeguards and otherwise to prevent harm that could have been avoided.” *Faragher*, 524 U.S. at 805. Such reasonable steps may include the development of an anti-harassment policy with a complaint mechanism. *Id.* In its *Kolstad* opinion, the Court held that “an employer may not be vicariously liable for the discriminatory employment decisions of managerial agents where these decisions are contrary to the employer’s ‘good faith efforts to comply with Title VII [of the Civil Rights Act of 1964].’” *Kolstad*, 527 U.S. at 545. Without providing direct guidance, the *Kolstad* decision cites to the importance of encouraging organizations to “implement[] programs or policies to prevent discrimination in the workplace....” *Id.* Subsequent lower court decisions, as well as EEOC guidance, underscore the importance to organizations of effective anti-harassment and anti-discrimination programs to/for organizations. See EEOC Enforcement Guidance: Vicarious Employer Liability for Unlawful Harassment by Supervisors, Section V, Parts C and D (“EEOC Guidance”).

The U.S. Supreme Court’s recent decision in *United States v. Booker* and *United States v. Fanfan*, U.S., 125 S. Ct. 738 (2005), holding that federal judges may now consider the Guidelines to be only “advisory” in nature, should not diminish the importance of compliance and ethics programs to organizations.¹ The Guidelines, as amended, reflect best practices for designing corporate compliance and ethics programs. Even without the benefit of a shortened criminal sentence, the development of an effective program offers organizations at least five benefits. First, in the best case, an ethics program will prevent misconduct from occurring in the first place. Second, if criminal conduct does occur, the program should facilitate early detection, which will allow an organization to mitigate its risks and manage its own internal investigation. Third, even if the program fails to provide early detection, it may still be useful in persuading the

¹ Although the Guidelines will no doubt be revised in response to the *Fanfan* and *Booker* decisions, the holdings in those cases involving individual criminal defendants may be distinguishable when an organizational defendant is involved.

government not to charge the company or to minimize the severity of any charges. Fourth, whether required to do so or not, federal judges remain likely to find an effective ethics program as a mitigating factor when making a sentencing decision. And finally, the existence of an ethics program provides tangible evidence that directors and officers are carrying out their fiduciary obligations to protect corporate assets, mitigating the risk of civil liability following a criminal investigation into employee misconduct.

II. Seven elements for developing and implementing an effective compliance and ethics program

The amended Guidelines, as well as EEOC guidance regarding anti-harassment claims, make it clear that organizations must have more than “paper” programs. Ethics programs must be embraced, applied and reinforced from the top down and must “promote an organizational culture that encourages ethical conduct and a commitment to compliance....” (USSG § 8B2.1(a)(2).) *See also* EEOC Guidance, Section V, Part C. Using the best practices summarized in the amended Guidelines as a reference point, this paper will outline the essential elements of an effective ethics program and those factors that organizations should consider when creating and implementing a program to meet the needs of a particular business.

The amended Guidelines outline seven essential elements that should be incorporated in developing and implementing an effective ethics program. These steps are consistent with the EEOC Guidance regarding effective anti-harassment programs. Although the Guidelines do not specify the exact steps to be taken for each element, the drafters indicate that in determining what specific actions are necessary, companies should take into account industry practice or standards, any applicable governmental regulations, and whether there has been previous misconduct. The Guidelines and the EEOC Guidance also advise that the size of an organization will impact the steps that should be taken. Larger organizations will be expected to invest more resources and to adopt more formal program compliance mechanisms than will smaller organizations.

Element One: Establish standards and procedures to prevent and detect violations of law.

The first step is the most basic – companies must establish standards and procedures to prevent and detect unethical conduct. According to the Guidelines, these standards of conduct and internal controls should be reasonably capable of reducing the likelihood of misconduct. The

standards should be incorporated into a written code of conduct that provides for audit systems and other procedures that have a reasonable chance of preventing and detecting wrongdoing.

The particulars of a written code should be tailored to each individual organization after considering a number of factors, including the size of the business, the relevant industry practice, any applicable regulatory requirements and other specific risks that the business faces. At a minimum, the standards should prohibit illegal on-the-job activities, including criminal conduct and unlawful employee harassment; many programs establish standards well beyond what is required by law. *See* EEOC Guidance, Section V, Part (C)(1). Industry groups have developed model codes of conduct that may serve as a starting point in the standards development process.

Element Two: Multiple layers of management should be involved in the ethics program.

The second element of an effective program is that multiple layers of management be involved in and knowledgeable about the program. The amended Guidelines impose specific duties on three classes of company management: the board of directors, senior management and one or more individuals with primary responsibility for the program.

- **Directors** must be “knowledgeable” about the program. This includes receiving periodic reports on the actual operation of the program from those with primary responsibility for operating it. The board must also exercise “reasonable oversight” concerning the implementation and effectiveness of the program. This second duty includes proactively seeking information about compliance problems, evaluating that information when received, and monitoring the implementation and effectiveness of remedial action taken when problems are detected.
- **Senior management** must ensure that an organization has an effective compliance and ethics program. One or more members of senior management must have overall responsibility and accountability for the compliance and ethics program.
- **Designated individuals** within an organization must be responsible for the day-to-day operation of the compliance and ethics program. These individuals must be given sufficient resources with which to operate the program and must report

directly to high level personnel and, as appropriate, to the board of directors, a committee of the board, the company's legal compliance committee, or a similar sub-group of the board.

Element Three: Avoid giving substantial authority to someone with a history of illegal or unethical behavior.

The third element of an effective program requires organizations to use reasonable efforts to avoid delegating substantial authority to individuals with a history of engaging in illegal activities or other behavior inconsistent with an effective compliance and ethics program. The Guidelines direct organizations to look at an individual's history as part of its reasonable efforts. *See also* EEOC Guidance, Section V, Part (C)(2). This may be achieved by conducting a background check once an individual accepts an offer of employment. Prior misconduct will not *per se* disqualify an individual from a management position. Organizations should consider how recently the misconduct occurred, the degree to which the person's managerial duties will relate to the area in which the misconduct occurred and the impact that information regarding the person's prior misconduct will have on the government, shareholders and the public should it become known.

Element Four: Communicate and train employees regarding the ethics program.

The fourth essential element of an effective ethics program is training and the regular dissemination of information about ethics and compliance to all levels of an organization, including senior management and the board of directors. An organization should determine what form of training and information dissemination is most appropriate. It may put ethics information in an employee handbook and on company intranets, make ethics training a part of orientation, and set up regular, periodic training and ethics program updates. *See also* EEOC Guidance, Section V, Part (C)(1). Training options include the dissemination of written materials, internally facilitated live training, externally facilitated live training, video and internet training products. Factors to be considered when selecting training options include the size of the workforce, the risks particular to the organization and the scope of responsibility of the individual being trained. Directors and senior managers should receive training appropriate to their unique roles and responsibilities.

Element Five: Create detection and reporting mechanisms for program violations and evaluate the effectiveness of those mechanisms.

The fifth essential element of an effective program is that the company must (1) ensure that the program is followed, (2) create and publicize a reporting mechanism, and (3) periodically evaluate the effectiveness of the program.

To ensure that the program is followed, organizations should monitor and audit to detect misconduct. The types of monitoring required will vary from organization to organization and be driven by the risks inherent in a particular line of business. Larger organizations should consider periodic auditing designed to detect weaknesses in the program. Audits should focus on compliance systems in areas where the company is at risk, such as environmental management systems, anti-money laundering programs, and government billing operations. These evaluations and audits should be summarized and shared with the board and those members of senior management accountable for the program. Where deficiencies are found, program controls should be enhanced.

In support of its detection efforts, the program should include a system by which employees can report actual and suspected program violations or request guidance. The reporting system should be designed to protect victims and whistleblowers from retaliation, typically through confidential or anonymous reporting mechanisms such as a program P.O. Box or an “Ethics Hotline.” As a practical matter, organizations cannot always investigate and/or address alleged code of ethics violations in a fully confidential manner. Therefore, program management should vigilantly protect employees who in good faith report potential ethics issues, even when those reports turn out to be unsubstantiated. In the case of a harassment claim, an individual should be given sufficient reporting options so that he or she is not required to report the harassment to the harasser or someone who works for him or her. *See* EEOC Guidance, Section V, Part (C)(1)(c). Likewise, multiple reporting options should exist for other types of allegations, to ensure that employees are not required to make a report to the individual engaged in the alleged wrongdoing.

Although not addressed expressly, implicit in the Guidelines is the duty of the program to thoroughly investigate each report to determine whether it can be substantiated; the EEOC Guidance expressly requires “prompt, thorough, and impartial investigation[s].” EEOC Guidance, Section V, Part (C)(1)(e). The way in which a matter is investigated will vary from organization to

organization. While it is optimum to have dedicated, trained investigators assigned to a program, some organizations may not have sufficient resources to do so. Human resources, security and auditing personnel may serve as investigators, depending on the nature of the allegation and the risks involved. In high risk situations, an organization may engage outside counsel to conduct or manage an investigation. Regardless of which resource is used, it is important to ensure that the person investigating the report is and appears to be objective. To promote impartiality, investigations must be conducted by someone outside the work group of the person being investigated.

Investigators should maintain records of their findings and any documentation they collect during the course of an investigation. An investigator should “close out” with reporting employees when their identities are known. While the investigator may not be able to provide details regarding his or her findings, it is important to the credibility of a program that reporting employees know their claims have been taken seriously and that a thorough investigation has been conducted.

In addition to detection and reporting mechanisms, the program’s effectiveness should be periodically evaluated. This can be done by monitoring and responding to trends in the numbers and types of matters reported, and/or surveying employees.

Element Six: Incentivize employees who comply with ethical guidance; discipline those who do not.

The sixth element of an effective ethics program requires organizations to take both a carrot and a stick approach. Although the Guidelines do not explain what kinds of incentives should be established, they clearly indicate that organizations should reward those whose actions demonstrate adherence to an ethical culture. Possible incentives include making ethical conduct part of the compensation, promotion and/or performance appraisal process.

By contrast, those who fail to adhere to an organization’s ethical standards should be disciplined appropriately. The Guidelines require discipline not only for those who actively engage in misconduct, but also for those who fail to take reasonable steps to prevent or detect violations of law. The EEOC Guidance directs employers who substantiate harassment claims to implement “remedial measures... designed to stop the harassment, correct its effects on the employee, and ensure that the harassment does not recur.” EEOC Guidance, Section V, Part

(C)(1)(f). The discipline should be proportional both to the severity of the offense and the discipline imposed on others for similar offenses. It is important that organizations maintain accurate records regarding discipline imposed for ethical violations to catch multiple offenses by a single individual and to ensure consistency in comparable situations.

Element Seven: Respond appropriately to substantiated misconduct to prevent future incidents.

The seventh and final element of an effective ethics program is to take appropriate action in response to a substantiated report. It is not enough to simply discipline the wrongdoer; in many cases, proactive measures should be taken. For example, if an organization were to substantiate that a group of employees was misreporting certain expenses, the organization could be expected to train all similarly situated employees regarding the proper accounting treatment. Similarly, if one or more employees in a workgroup have been engaged in harassing behavior, the organization probably should provide focused training on appropriate workplace behavior to the workgroup. *See* EEOC Guidance, Section V, Part (D)(2). In the event of significant ethical misconduct, or in response to an upward trend involving a specific kind of misconduct, an organization may examine whether the misconduct reveals any shortcomings in the program. In doing so, however, the organization should take steps to preserve the confidentiality of the investigation to avoid creating a discoverable record that could be exploited in litigation.

III. Maintaining a relevant compliance and ethics program

Compliance and ethics programs should evolve over time in response to organizational dynamics and changes in the legal landscape. The Guidelines require that after implementing a program, an organization must “periodically assess the risk of criminal conduct and shall take appropriate steps to design, implement, or modify each [element of the program] to reduce the risk of criminal conduct identified through this process.” (USSG § 8B2.1(c).)

These periodic assessments should consider (1) the nature and seriousness of the misconduct at risk, (2) the likelihood that misconduct will occur due to the nature of the organization’s business profile, and (3) the organization’s history. In response to this assessment, an organization should prioritize its compliance efforts based on relative risks, including the potential seriousness and likelihood of particular types of misconduct. The Guidelines direct organizations to prioritize risk and then modify appropriate program elements

“to reduce the risk of criminal conduct identified as most serious, and most likely, to occur.” (USSG § 8B2.1, Commentary at 480.) By regularly and periodically taking these steps, an organization can continuously maintain and improve its compliance and ethics program, ensuring its relevance and effectiveness as a risk management tool.

IV. Evaluating the effectiveness of current programs in light of the new Guidelines

Organizations that have already developed compliance and ethics programs should perform a gap analysis to identify deficiencies in their current programs. This analysis should compare current programs with the requirements set forth in the new Guidelines. Once areas of deficiency have been identified, a plan should be developed correct the weaknesses. The plan should assign specific tasks and responsibilities to ensure the revisions are made in an efficient manner and that they comply with the new Guidelines.

CONCLUSION

In view of the myriad of opportunities for organizational civil and criminal liability that exist today, a company, its officers and board of directors are putting themselves at risk if they do not develop, implement and continually monitor an effective compliance and ethics program. Organizations and those who operate and manage them should take advantage of this important risk management resource.