The Business Case for Compliance Programs

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“Good governance matters, if for no other reason than bad governance is so costly.”

Buy the Board
Morgan Stanley US Investment Strategy

There is much confusion among counsel and other officials of companies in heavily regulated industries about what it means to have a compliance and ethics program. There is also much confusion about the costs and benefits of such programs. This chapter provides an overview of what a compliance and ethics program really is and why companies in heavily regulated industries need them. It also provides empirical evidence demonstrating that compliance programs are not just a cost center but can provide measurable financial returns on the investment.

* The authors wish to acknowledge Suzanne M. Foster for her contributions to this chapter.
CORPORATE COMPLIANCE ANSWER BOOK

Compliance and Ethics Programs Overview..................................................3
Definitions ..........................................................................................3
“Effective” Compliance Programs .........................................................5
The Role of a Compliance and Ethics Program.......................................7
Ethical Conduct and the Corporate Culture .............................................7
Why Businesses Need Compliance and Ethics Programs ..........................8
Compliance and the Law.........................................................................10
Your Compliance Program......................................................................14
The Costs ............................................................................................14
The Benefits.........................................................................................18
Identifying Whether You Already Have One .........................................26
Compliance and Ethics Programs
Overview

Definitions

Q 1.1 What is a compliance program?

The most commonly used definition of a compliance program comes from chapter eight of the *U.S. Sentencing Guidelines Manual*, dealing with the sentencing of organizations.

§ 8B2.1. Effective Compliance and Ethics Program

(a) To have an effective compliance and ethics program, ... an organization shall—

(1) exercise due diligence to prevent and detect criminal conduct; and

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

Such compliance and ethics program shall be reasonably designed, implemented, and enforced so that the program is generally effective in preventing and detecting criminal conduct. The failure to prevent or detect the instant offense does not necessarily mean that the program is not generally effective in preventing and detecting criminal conduct.

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Q 1.1.1  CORPORATE COMPLIANCE ANSWER BOOK

The Society of Corporate Compliance and Ethics has a very practical definition of “compliance program” that you may find very useful in communications with management and the board:

On a very basic level it is about education, definition, prevention, detection, collaboration, and enforcement. It is a system of individuals, processes, and policies and procedures developed to ensure compliance with all applicable federal and state laws, industry regulations, and private contracts governing the actions of the organization. A compliance program is not merely a piece of paper or a binder on a shelf; it is not a quick fix to the latest hot problem; it is not a collection of hollow words. A compliance program—an effective compliance program—must be a living, ongoing process that is part of the fabric of the organization. A compliance program must be a commitment to an ethical way of conducting business and a system for helping individuals to do the right thing.1

Q 1.1.1  What does the Sentencing Guidelines’ definition mean by “due diligence”?

The Sentencing Commission’s definition cited above goes on to define what it means by “due diligence” and to describe what promoting “an organizational culture that encourages ethical conduct and a commitment to compliance with the law” requires. (The Sentencing Guidelines are discussed in detail in chapter 2.) One of the key components of an effective program as defined by the Guidelines is the requirement of a periodic compliance risk assessment and designing and implementing compliance procedures to address the risks identified.2 (The risk assessment process is discussed in detail in chapter 3.)

Q 1.1.2  Should the primary focus of a compliance program be on criminal conduct?

Because of the nature of its mission (criminal sentencing), the Sentencing Commission guidance speaks to a compliance and ethics program preventing and detecting criminal conduct. In
commentary and in other communications, however, the Commis-

sion made clear that the better practice would be for the program
to address all legal, regulatory, and ethical risks facing the organiza-
tion, not just the risk of criminal conduct.

Thus, most organizations at the forefront of thinking about

compliance and ethics programs use them in the context of compre-

hensive enterprise risk management programs. In this way, organi-

zations can address their commitment to compliance with laws and

regulations, their commitment to ethical business practices, and

fixing problems internally before they fester and expose the organi-

zation to legal, regulatory, or reputational damage.

“Effective” Compliance Programs

Q 1.2 What makes a compliance program “effective”?

The qualifying word almost always seen in the context of compli-

ance programs is “effective”: Does the organization have an effective

compliance and ethics program? This issue is key.

Enron had a “compliance program” in the sense that, when the

FBI went into company offices after the investigation had begun,

they found a written compliance manual on a bookshelf. Unfortu-

nately for Enron, its compliance program had never been imple-

mented. Its written procedures were not followed. In the view of
government investigators it was a “paper program”; it was not an
“effective” program.

An effective compliance and ethics program should:

• communicate to employees, customers, and the govern-

ment that your company is committed to compliance with
laws and regulations and ethical business conduct;

• provide an outlet, an internal place, to report possible
problems or violations and to ask questions;

• provide guidance to help well-intentioned employees
understand proper procedures and how to conform their
behavior to the regulatory requirements;
• provide an internal mechanism for appropriately investigating potential wrongdoing;
• identify problems early and provide a process for correcting them before they fester or cause unhappiness in employees that can result in reports to the government;
• provide central oversight and organization of compliance procedures throughout the company, allowing for more effective oversight by both senior management and the board;
• provide a process for and source of documentation of compliance-related activities;
• provide effective compliance training for employees;
• be integrated into customer service and quality control activities to provide better service to customers;
• properly implement the growing number of state and federal regulations that have made compliance program components mandatory in certain areas such as healthcare and government contracts;

COMPLIANCE FACT

Studies have shown that most employees would rather have a problem dealt with internally than report it to the government. If a company’s program demonstrates a commitment to compliance, employees normally will feel comfortable reporting issues through the internal mechanism.

An effective compliance and ethics program brings all of the company’s compliance activities under one umbrella. This allows for objective oversight and documentation that the company is meeting its obligations. It provides a process for making sure that individual employees and management are receiving the training
they need and that the board receives the information it needs to provide proper oversight. It organizes compliance activities into a comprehensible bundle. And it provides a process for evaluating existing and developing risks and making sure that the organization is prepared to meet them appropriately.

Without the structure of a compliance and ethics program, an organization’s compliance activities can be disjointed and scattered. They are typically overseen by the very people who are required to comply and who often have other reasons, both business and personal, to take compliance shortcuts, often with disastrous results for the organization.

The Role of a Compliance and Ethics Program

Ethical Conduct and the Corporate Culture

Q 1.3 How does a compliance program help prevent unethical or illegal conduct from occurring?

The regulatory and ethical guidelines, training, reporting, and disciplinary requirements incorporated into a program set corporate-wide standards. These standards clearly identify hazards and establish policies to guide conduct away from them. In the event that unethical or illegal conduct occurs, a program will include mechanisms to enforce appropriate disciplinary action, to conduct an investigation and to implement changes that will prevent similar conduct in the future.

Q 1.3.1 How can a program change a corporate culture?

Initially, by adopting a program, the company declares the ethical and legal values and standards by which it wishes to be judged and by which it will measure its employees, vendors, and customers. In turn, the program becomes a central coordinating
mechanism for furnishing and disseminating to employees information and training on their ethical and legal obligations. The program provides a mechanism allowing employees to report potential ethical and legal problems and to seek information and guidance before problems become crises. It also provides a framework for rapid responses to any potential ethical or legal misconduct and gives warning of the consequences of such conduct.

Why Businesses Need Compliance and Ethics Programs

Q 1.4 Why does my organization need a compliance and ethics program?

Most companies, whether public or private, doing business in the United States and/or overseas, are subject to a wide range of state, federal, and/or international laws and regulations. Violation of these laws and regulations often comes with significant civil and/or criminal penalties. An effective compliance and ethics program can mitigate the problems, costs, and damages of such violations and the investigations they often trigger.

Participation in activities that are the subject of complex regulatory requirements is a high-risk activity, make no mistake about it. The rewards from such participation are frequently high, but the risks of failing to meet one or more of the regulatory requirements are also high, even for the best-intentioned organization. Compliance programs provide a significant level of insurance against such risks. For the boards and management of organizations involved in government programs, receiving government money, or subject to regulatory regimes, it is, literally, a breach of fiduciary duty not to have a compliance program in place.  

Also, in virtually all government enforcement actions involving almost all agencies, a condition of most settlement agreements involving companies that do not have a demonstrably effective compliance and ethics program is the implementation of such a program. Organizations that already have a program in place are typically allowed to simply update their existing programs to correct any problems discovered during the government investiga-
tion. Organizations without a program are required to implement one, often with onerous and expensive bells and whistles, including frequent outside audits and the appointment of an outside compliance program overseer.

Q 1.4.1 Can’t we just start a compliance program after we get hit with a government investigation?

Not if you want to get credit for the program. The Department of Justice, along with numerous other federal agencies, formally give credit to companies for having a compliance and ethics program. The famous (or infamous) “McNulty Memorandum” continues the well-established principle that “the existence and adequacy of the corporation’s pre-existing compliance program” is a factor to be considered by federal prosecutors in “conducting an investigation, determining whether to bring charges, and negotiating plea agreements” with corporate targets. In evaluating potential criminal charges against business entities, a prosecutor will evaluate whether the organization’s compliance program was already in existence at the time the investigation was begun, or at the time the organization first became aware of it, and whether the program was “merely a ‘paper program,’” that is whether it was designed and implemented in an “effective” manner.

Compliance programs that are begun or implemented only after the company learns of a government investigation are viewed with skepticism by prosecutors and agents. To receive the full benefit from an “effective” program, the company must be able to demonstrate that it was implemented voluntarily, because the company wanted to “do the right thing” and had an ethical approach to business relationships, particularly those involving government funding. A company that begins its program after learning of an investigation is viewed as developing a conscience only under duress.
Q 1.4.2  What happens if we don’t have a compliance program, learn of a government investigation, and still don’t implement a program?

You will be viewed by the government as having a completely cavalier attitude about your legal and ethical obligations. In fact, in at least one case, the government has taken the view that, in heavily regulated industries like healthcare, not having a comprehensive compliance program is alone evidence supporting an intent to commit fraud. (See the discussion of United States v. Merck-Medco, on the facing page.) As a result, all companies that derive revenue from federal funding should ensure that they have compliance and ethics programs and that their programs are “effective” under applicable legal standards and industry practices.

Compliance and the Law

Q 1.5  Does the law require businesses to have compliance and ethics programs?

As discussed in chapter 2, the Federal Sentencing Guidelines provide the basic framework for all compliance programs. However, there also are many statutes that require companies to implement various compliance measures. For instance, the Bank Secrecy Act mandates that banks and other financial institutions adopt programs to prevent the “laundering” and deposit of proceeds from illegal activities such as drug trafficking and the financing of terrorist activities. The Sarbanes-Oxley Act of 2002 requires that publicly traded companies establish audit committees and compliance procedures to better promote the integrity of a company’s internal accounting controls and financial reporting. Recently the Medicare Modernization Act implemented a requirement that all Medicare drug plans implement a compliance program to reduce the risks of fraud and abuse. Certain government contractors are also required to have compliance and ethics programs.
CASE STUDY:  
*United States v. Merck-Medco Managed Care LLC*¹³

The government contended that Merck's failure to maintain an adequate compliance program demonstrated that they acted with reckless disregard or deliberate ignorance of the falsity of the claims it had submitted. Merck moved to dismiss on the grounds that the lack of a compliance program was insufficient to establish that the company or its upper management acted in reckless disregard in submitting such claims. The court, however, refused, holding as a matter of law that the company's failure to have an adequate compliance program “satisfied” the allegation that the company acted with reckless disregard of the truth or falsity of the claims.

This case arose out of a civil action brought by the Department of Justice under the False Claims Act, which provides that companies that “knowingly” submit false claims paid with federal funds are liable for *three times* the actual damages suffered by the government, plus additional penalties of up to $11,000 *per claim*. These per-claim penalties alone can snowball into astronomical amounts for a company that submits thousands of claims for payment each year. Because the government is *not* required to prove the company had *actual* knowledge that a claim was false in order to find that it acted in “reckless disregard” or “deliberate ignorance” of the truth or falsity of its claims—a much easier legal standard for the government to meet—a company that is merely sloppy or careless in the preparation of claims can get caught in a quagmire of complex litigation and substantial liability, even though it intended no wrongdoing.
Q 1.5.1 Are there state law requirements related to compliance and ethics programs?

Yes. States also have begun to experiment with direct legislative requirements. California has passed legislation requiring all pharmaceutical manufacturers to certify that they have adopted a compliance program that is in accordance with HHS-OIG guidance and that incorporates the guidelines of the Pharmaceutical Research and Manufacturing Association’s Code of Conduct related to interactions with healthcare professionals. Maine requires manufacturers and labelers of prescription drugs to report on marketing costs and expenses, and imposes prohibitions on advertising and disclosures regarding clinical trials. Numerous other states have passed, or are considering, statutes intended to restrict activities related to marketing and advertising of pharmaceutical and medical device products, all with the intent of limiting or driving down the costs of drugs and/or devices and related products and services.

Q 1.5.2 Do some agencies require (rather than recommend) compliance programs?

Yes. Several agencies that oversee compliance issues require formal compliance programs. The trend throughout the federal government is to remove compliance and ethics programs from the “recommended” list to become a clear requirement for participation. As time passes, more and more federal agencies are expected to mandate compliance procedures, including codes of conduct, ethical business practices, training, auditing, etc.

For example, on November 23, 2007, the Department of Defense (DOD), the General Services Administration (GSA), the National Aeronautics and Space Administration (NASA), and the Office of Federal Procurement Policy (OFPP) adopted a final rule amending the Federal Acquisition Regulation (FAR) to require most federal contractors and subcontractors to adopt and promote a code of business ethics, along with training and an internal control system designed to “[f]acilitate timely discovery of improper conduct” and to “[e]nsure corrective measures are promptly instituted.”
In addition, these same agencies issued a further proposed rule that would mandate contractors to implement compliance and ethics programs that meet the Sentencing Guidelines criteria, and that would require mandatory disclosure of overpayments or violations of federal criminal law, as well as mandating "full cooperation" with government investigators.  

Federal banking law requires a variety of mandatory compliance measures, including anti-money laundering programs; the SEC mandates other compliance measures; the Deficit Reduction Act of 2005 requires all organizations that receive more than $5 million per year in funding from the Medicaid program must have many healthcare fraud prevention policies and procedures in place as a condition of payment; and all companies with access to confidential health information must have privacy and security programs under the Health Insurance Portability and Accountability Act (HIPAA), to name just a few.

Q 1.5.3 What have the courts said about compliance programs?

Courts increasingly are beginning to recognize that a corporation’s failure to have a functioning and operational compliance plan may give rise to considerable legal exposure. In the landmark case In re Caremark International Inc. Derivative Litigation, the Delaware Court of Chancery held that corporate directors violate their fiduciary duty if they fail to assure that corporations implement “information and reporting systems” to appropriately supervise and monitor the corporation and to prevent wrongdoing. In Caremark, the shareholders brought a derivative action against the board of directors alleging that the board breached its fiduciary duty of care to the corporation by failing to monitor actively or to give appropriate attention to the corporation’s performance. The court explained that directors have an "obligation" to attempt in good faith to assure that a corporate information and reporting system exists and that the failure to do so can render a director liable for losses caused by noncompliance by the corporation with applicable legal standards.
Specifically, the shareholders blamed the board of directors for failing to detect and prevent numerous violations of the anti-kickback statute and of the False Claims Act, which in turn gave rise to civil and criminal investigations by various federal agencies. Caremark ultimately settled the underlying investigations by pleading guilty to one count of mail fraud. It also paid civil and criminal fines totaling $250 million.

In United States v. Merck-Medco Managed Care, LLC, the court found that, as a matter of law, a company’s failure to maintain an appropriate program may be used as evidence in and of itself that the company acted with reckless disregard of its legal obligations by submitting false claims to the government. The court held that Merck-Medco, a large pharmacy benefits manager, could be held liable for violating the False Claims Act as a result of failing to have a program to prevent the submission of false or fraudulent claims for payment to the government. The court held as a matter of law that the company’s failure to have an adequate program “satisfied” the allegation that the company acted with reckless disregard of the truth or falsity of the claims it submitted to federal healthcare programs.

Your Compliance Program

The Costs

Q 1.6 Can our business afford a program?

The better question may be whether you can afford not to have a program. The cost of implementing and maintaining a program always will be much less than the cost of responding to an investigation or the cost of settling civil or criminal claims.

In the last few years ruinous corporate scandals have brought down several large companies in the United States: WorldCom, Adelphia, Tyco, Enron, Arthur Andersen, and BellSouth. A fully implemented program with commitment from top leadership might have prevented each of these corporate downfalls. In the Enron case
there is the now-famous story of how, when investigators searched the office of Enron CFO Andrew Fastow, they found a copy of the company’s compliance program and procedures still sealed in the plastic wrapping in which it had arrived.

Many of these cases started with whistleblowers who, instead of reporting wrongdoing to company, went to the government. In many instances, the employees tried to report wrongdoing, but there was no effective internal mechanism. In others, the corporate culture discouraged reporting wrongdoing or actively encouraged the wrongdoing in the first place. Perhaps warnings were ignored or the employee was written off as “difficult” or as an “under-performer” because of his or her refusal to engage in questionable conduct. Either way, an effective program would have addressed these issues and given the company a chance to prevent illegal or unethical conduct or at least stop it at its earliest and least expensive stages.

**Q 1.7 What are the potential costs of an investigation?**

Responding to government investigations, internal or external reports of violations, fraud audits, and the like is extremely expensive. Sometimes just responding to government subpoenas or requests for information can cost millions of dollars, and in many cases, these out-of-pocket costs of defense counsel and related consultants are only the tip of the iceberg. (See the extensive discussion of the Boeing Company case, below, for a vivid illustration of the costs—monetary and otherwise—of an investigation.) Furthermore, criminal and civil penalties can reach into the hundreds of millions of dollars; these penalties are sometimes accompanied by suspensions, debarments, exclusions, or other prohibitions from doing business with the government or receiving specified government benefits.
Additionally, if the target of the investigation is a public company, the stock price frequently takes a significant tumble, thus damaging shareholders. This, in turn, often leads to shareholder suits against management and the board. Dealing with these problems distracts executives and employees from their duties, and time is consumed in responding to subpoenas, customer inquiries, grand jury testimony, and civil and administrative discovery demands. No company can keep its eye totally on business in the midst of an investigation.

Q 1.7.1 Why not just pay the fine and move on?

Studies have shown that the impact of fraud on a company can be enormous. “Estimates of the cost of white-collar crime to companies in the United States range from $200 billion (Touby, 1994) to
The Business Case for Compliance Programs

$600 billion per year (Association of Certified Fraud Examiners (ACFE, 2002)). White-collar fraud impacts a typical company between 1% and 6% of annual sales. Such compliance violations are reported to have caused 30% of new business failures. An analysis of 114 companies (matched pairs of companies, half of which had suffered a white-collar fraud event and half of which did not) revealed that "a firm’s clarity of policies and procedures, formal communication, contingent pay for employees [compensation tied to performance criteria], . . . audit committees, contingent pay for board members and codes of conduct are also associated with fewer crimes."

Busy executives sometimes view compliance and ethics programs only as overhead items that do not add to the bottom line, and compliance officers as nay-sayers, reasoning that bad things that happen at other companies won’t happen to “good” companies and “good” people like ours. However, true commitment to ethical behavior and compliance with laws and regulations is becoming an important competitive advantage for companies.

Q 1.7.2  Shouldn’t compliance programs be viewed as cost centers?

No. An increasing number of sources are demonstrating that strong compliance and governance programs have a positive impact on the bottom line. They can help to:

- improve production and profitability
- enhance and build brand loyalty
- maintain customer retention and growth
- enhance vendor relationships
- prevent damage to reputation
- prevent damage to brand
- enhance director retention and recruitment
- lower D&O insurance premiums
- enhance employee retention and recruitment
- prevent loss of intellectual property
• avoid damage to business operations such as:
  • denial of export licenses
  • loss of security clearances
  • prohibition of stock trading
  • suspension/debarment/exclusion
  • FDA approval denials
  • elimination of product lines
  • loss of suppliers and business partners
  • loss of IPO opportunities
  • loss of M&A opportunities
  • damage to post-merger integration

The Benefits

Q 1.8 What other benefits does an effective compliance program provide?

As noted above, it is the formal policy of the Department of Justice that, before making a decision on whether or not to bring criminal charges against a company, the prosecutor must, among other things, take into account whether or not the company has in place an “effective” compliance program. Experience shows that, for the most part, companies that have an “effective” compliance and ethics program in place when the investigation begins are not charged criminally. Of course, the program, and the company’s commitment to it, must be real. The company should, ideally, have a program that is well-documented and includes all of the elements identified in the Sentencing Commission’s guidance on compliance programs.

Included in the Sentencing Commission’s Guidelines Manual’s chapter devoted to the sentencing of organizations is a series of exacerbating or mitigating factors that, when relevant, are combined to create a final “culpability score,” which, in turn, is used to develop a recommended sentencing range. Of all of the mitigating factors that combine to benefit an organization being
The Business Case for Compliance Programs

sentenced, the largest reduction in sentence comes from having an effective compliance and ethics program. Of course, the goal is not to have to face a criminal sentencing at all, and several of the other compliance and ethics program benefits can help organizations to avoid prosecution altogether.

Several federal agencies have “voluntary disclosure” programs. These programs are intended to provide organizations with incentives to self-audit and self-report regulatory violations and to repay any moneys that may have been improperly paid. One of the best known is that of the Health and Human Services Department’s Office of Inspector General (OIG). The OIG Self-Disclosure Protocol (the “OIG Protocol”) and similar programs at other agencies are designed to encourage self-reporting of compliance failures by companies that have business relationships with the government, receive government funding, or are covered by regulatory schemes.

An effective compliance and ethics program can protect a company from the government and private litigants.

The numerous whistleblower provisions of the federal, state, and even local False Claims Acts are the scourge of almost all types of organizations that receive federal, and increasingly, state funding of any kind. An effective compliance and ethics program is a tremendous bulwark against whistleblower complaints. In many respects, it is an insurance policy, protecting the organization against potentially catastrophic damage from highly risky activities. (The various false claims acts are discussed in detail in chapter 6.)

COMPLIANCE FACT

The Department of Justice has pending at any one time literally hundreds of such whistleblower suits that it must investigate. In 2005 alone, there were 394 new qui tam False Claims Act suits filed.
Finally, in addition to the protective reasons for having a compliance program outlined above, there is beginning to be an extensive body of research demonstrating that companies with good compliance and governance structures receive a number of financial benefits, or return on investment, flowing from such programs.

Q 1.8.1 What is the proof that there is a link between corporate governance and corporate performance?

Although evaluations of compliance and governance returns on investment are relatively new, independent research, university studies, and corporate surveys demonstrate the positive impact of strong compliance and governance systems.

Independent Research. GMI, an independent corporate governance research and rating agency, reports that “[i]n recent years traditional investor safeguards—broker research, credit rating agencies, accounting firms—fell short, leading to enormous losses and a crisis in confidence.” This has caused investors to “place a premium on the quality of information and quality of earnings, not just earnings growth.” Through a proprietary ratings system, GMI prepares ratings of corporate governance ratings on thousands of companies traded on certain public exchanges. The ratings are based on “hundreds of metrics organized into six broad categories of analysis:

- Board Accountability
- Financial Disclosure and Internal Controls
- Shareholder Rights
- Executive & Director Remuneration
- Market for Control/Ow nership Base
- Corporate Behavior/Corporate Accountability.

Over a multi-year period of analysis, GMI was able to demonstrate a “consistent link between total shareholder returns and GMI ratings. . . .” Additional findings showed that the benefits of good governance included:
The Business Case for Compliance Programs

- lower cost of capital;
- lower D&O insurance premiums;
- enhanced reputation as an aid to recruiting;
- lower chance of shareholder suits; and
- increased shareholder returns;

Furthermore, a company’s good governance factored into credit risk models by commercial banks and was used as a screen by director and executive search firms.48

On the other hand, poor governance ratings demonstrated that governance and compliance issues were an “early warning system” for future problems and that there was a strong correlation between compliance and governance red flags and subsequent problems.49

University Studies. The GMI findings are supported by independent analyses undertaken by several universities. Researchers from the University of Iowa and the University of Wisconsin found that “firms with better governance have a lower cost of equity. Better governed firms, on average, have a cost of equity that is 88 basis points lower than firms with weaker governance after controlling for known risk factors.”50

Similarly, a team of researchers from Harvard, Yale, and Stanford found that firms with “stronger shareholder rights” had:

- higher firm value;
- higher profits;
- higher sales growth; and
- lower capital costs.51

In an interview with Harvard Business School’s “Working Knowledge for Business Leaders,” Harvard Business School Professor Lynn S. Paine discussed the conclusions of her book Value Shift.52
In recent years, however, I have seen more attention being paid to the positive side of ethics. More managers are waking up to the ways in which positive values contribute to a company’s effective day-to-day functioning, as well as its reputation and long-term sustainability. In the book, I trace these connections in some detail and show how they play out in practice—sometimes in surprising ways.53

Among the ways that having a positive value system can add to the bottom line, Paine identifies:

- better access to talent;
- enhanced employee commitment;
- better information sharing;
- greater creativity; and
- enhanced reputation.54

**Corporate Surveys.** A Global Investor Opinion survey conducted by McKinsey & Co. in 2002 concluded: “An overwhelming majority of investors are prepared to pay a premium for companies exhibiting high governance standards.”55 McKinsey further found that:

- 57% of institutional investors said that good corporate governance determined whether they increased or decreased their holdings in a company.
- Investors are willing to pay a premium of up to 41% for good governance.
- By moving from worst to best practices in governance, companies can expect a 10–12% gain in market valuation.

Two employees of the SEC said it well:

Many issuers might prefer to avoid the costs associated with even minimal corporate governance measures, particularly if they can give the appearance of maintaining high corporate governance standards without actually having to do so. Yet, as American president Abraham Lincoln almost said, you can’t fool all of the
investors all of the time. Pyramid schemes inevitably collapse. Holes in corporate accounts are uncovered, if only because bills eventually go unpaid. Furthermore, recent empirical research—not to mention common sense—suggests a correlation between poor corporate governance and poor corporate performance, as well as a link between strong corporate governance standards and superior corporate performance. If nothing else, investors will notice these performance differences, and punish or reward issuers accordingly.56

Q 1.8.2 What if I have a program and wrongdoing still occurs?

Having an effective program is an important factor that prosecutors consider in deciding whether to pursue criminal charges against a corporation. The U.S. Department of Justice recently revised the criteria it uses in deciding on whether to prosecute corporations. Three of the key criteria that guide the prosecutor’s decision are:

1. the corporation’s timely and voluntary disclosure of wrongdoing and willingness to cooperate in an investigation;
2. the existence and adequacy of the corporation’s pre-existing program; and
3. the corporation’s remedial actions, including any efforts to implement an effective program or to improve an existing one.

Having a program also makes a company a less attractive target to prosecutors. Prosecutors and juries often have some sense of fairness, and prosecutors may forego indicting a company if the company has made a real effort through its program to comply with the law. Programs do not guarantee that all unethical or criminal misconduct will be prevented. Rather, a comprehensive program helps minimize the risk that criminal misconduct will occur. In the event that misconduct occurs, having an adequate and operational program is tangible proof to prosecutors that the company was and is serious about preventing violations of the law, and permits the company to argue better that it is in fact a victim of such misconduct as opposed to the beneficiary or the promoter of the conduct.
CASE STUDY: Boeing Company

Boeing Co. believed that it was a “good” company that made useful products. At a Boeing Leadership Meeting on January 5, 2006, however, Boeing’s Executive Vice President and General Counsel Doug Bain laid out the reasons why Boeing should have paid more attention to its compliance and ethics requirements. Bain described the initial shock of federal prosecutors and others that Boeing was under investigation for ethical violations:

They say, “You guys are the Boeing Company. You build things that are larger than life. You do things that are larger than life. You’re not a sleazy company. How did this happen?” And the question that they always ask: Where was the leadership?

By the end of six years of investigations, some still ongoing, Bain reported that the prosecutors had changed their view of Boeing.

[There are some within the prosecutors’ offices that believe that Boeing is rotten to the core. . . . They talk to us about pervasive misconduct and they describe it in geographic terms of spanning Cape Canaveral to Huntington Beach, to Orlando, to St. Louis to Chicago. . . . The U.S. attorney in Los Angeles is looking at indicting Boeing for violations of the Economic Espionage Act, the Procurement Integrity Act, the False Claims Act and the Major Frauds Act. . . . The U.S. attorney in Alexandria, Virginia, is looking at indicting us for violation of the conflict-of-interest laws. And both are looking to throw in a few conspiracy and aiding-and-abetting charges for good measure.

How did a company with a strong reputation for good work and integrity, and that is highly knowledgeable about government contracts, end up with government officials, the public, and many of Boeing’s own employees believing that company officials “just don’t get it.” Bain suggested there was an unwritten code of silence that resulted in employees’ failing to report suspected wrongdoing when they saw it and management’s not following up when reports finally reached them.
For the alleged use of proprietary documents that a former Lockheed employee brought with him to Boeing:

- Boeing lost $1 billion of launches and was suspended from the launch business for twenty months;
- Boeing was sued by Lockheed for more than $1 billion;
- Boeing employees were fired and indicted.

A separate investigation into violations of conflict-of-interest laws related to the hiring of government employees:

- Lost Boeing the U.S. government tanker market and made Italy its only customer;
- Forced Boeing to re-compete the C-130 AMP [Avionics Modernization Program] and the small-diameter bomb;
- Caused the “biggest hit” to Boeing’s reputation;
- Forced a senior executive to plead guilty to one felony count of aiding and abetting a violation of the conflict-of-interest laws, serve time in a federal prison, pay a fine of $250,000, and “forfeit approximately $5 million in equity-based compensation.”

Indirect costs related to these scandals included:

- Denial of export licenses;
- Potential loss of security clearances;
- Re-suspension or debarment;
- Potential prohibition of use and possession of explosive devices (used to trigger airplane door “actuators”);
- Denial of State Department licenses; plus
- Additional millions in fines and penalties.

Bain challenged Boeing’s leadership to change the culture that allowed these and other violations to occur without being reported internally until it was too late. He pointed out that it was important to continue talking about these problems. “Our job as [leaders] is to establish a culture that ensures that there is no next time. And frankly the choice is ours.”

On June 30, 2006, the DOJ announced it had reached a “record” settlement with Boeing: a $565 million civil fraud settlement and a $50 million penalty related to a separate criminal agreement. This settlement and the other costs related above do not include what must have been additional millions in attorney fees and related investigation costs.
Identifying Whether You Already Have One

Q 1.9  How do I tell if my company already has a compliance program?

If you have to ask the question, you don’t have a complete or comprehensive program.

Fully effective compliance and ethics programs are visible, known entities within the organization. If employees are surveyed on the question of whether their organization has a compliance program, they will overwhelmingly answer “Yes.” They will have at least a basic understanding of its structure and know how to make a report of a potential violation or obtain guidance on compliance issues.

Q 1.9.1  If we don’t already have a functioning compliance program in place, how do we start from “zero” to build one?

Even if your company does not have a fully operational compliance and ethics program that would be recognized as “effective” under the Sentencing Guidelines criteria, it is quite likely that many pieces of a compliance program are already in place. It is extremely rare that a company will have to start completely from scratch in developing a compliance program.

For example, your human resource department may have procedures in place to comply with regulations affecting employees, such as wage and hour laws, labor laws, employment discrimination, and unemployment insurance laws. Your accounting or finance department may already have procedures in place to comply with Sarbanes-Oxley section 404 requirements. Manufacturing units may have procedures in place to comply with environmental regulations. Shipping departments may have procedures in place to comply with import and export laws. All of these are pieces of a comprehensive compliance program.

What is missing from these examples is the structure to tie the pieces together—the process and documentation to be able to demonstrate to employees, management, the board, stakeholders,
regulators, and the outside world that your company is committed to act in accordance with industry rules and standards, to meet its commitments and contracts, and to act ethically and with integrity in its dealings.

Q 1.9.2 What happens as my business grows and changes over time?

A program is not static. A company continually must evaluate its legal and ethical risks, character, and behavior; collect reports on and learn from violations or lapses that may occur; and plan for correcting any violations or ethical lapses that may occur in the future. A well-run program will be integrated into the business operations of an organization. It is a part of the long-term strategic plan to achieve business goals by providing proactive guidance and protection as new challenges arise. Continued risk analysis and modification to address growth as well as legal, business, and operational changes is an essential part of any program.
Notes

1. THE COMPLETE COMPLIANCE AND ETHICS MANUAL (Society of Corporate Compliance and Ethics 2004).
2. See U.S. SENTENCING GUIDELINES MANUAL § 8B2.1(c) and Commentary (Nov. 2006).
3. See infra chapter 24 for a discussion of the work of the Committee of Sponsoring Organizations of the Treadway Commission (COSO), which has published guidance for an integrated framework for enterprise risk management and legal and regulatory compliance. In many respects, the Sentencing Commission’s guidance for effective compliance and ethics programs is similar to the COSO guidance.
4. See Stone v. Ritter, 2006 Del. LEXIS 597, at *30–*31 (Del. Nov. 6, 2006), in which the Delaware Supreme Court affirmed the standard set forth in In re Caremark Int’l, Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996), holding that corporate boards of directors have an affirmative duty, in heavily regulated industries, to see that the company has implemented a compliance program and to exercise reasonable oversight of that program. They have this duty even if they do not have any reason to believe that there has been wrongdoing within the company. See also Miller v. McDonald, et al., Bankr. Case No. 06-10166, Adv. Pro. No. 07-51350 (Bankr. D. Del. Apr. 19, 2008), which held that corporate officers, and in particular the general counsel, can be held personally liable for corporate wrongdoing even if they do not have personal knowledge of, involvement in, or benefit from the underlying wrongful activities.
6. McNulty Memo, supra note 5.
7. Id. at 14.
8. Compliance requirements for specific industries are discussed in greater detail in the following chapters.
11. See chapter 18, infra.
The Business Case for Compliance Programs

12. See 48 C.F.R. §§ 3.10, 52.203-13, and 52.203-14. (These are sections of the Federal Acquisition Regulation (FAR), which is codified at 48 C.F.R.) See also chapter 11 on Government Contractors.


15. See ME. REV. STAT. ANN. tit. 22, §§ 2698-A and 2700-A.

16. In 2007 alone, twenty-seven states were considering some form of compliance legislation requiring reporting of, or restrictions on marketing of pharmaceutical and medical device products to healthcare professionals.

17. See FAR Case 2006-007, Contractor Code of Business Ethics and Conduct, 72 Fed. Reg. 65,873 (Nov. 23, 2007). This provision took effect on December 24, 2007, and covers all federal contractors and their subcontractors except for: commercial items; contracts performed entirely outside the United States; and amounts under $5 million or taking less than 120 days to perform.


19. See chapter 23 on anti-money laundering compliance.

20. See chapters 25 and 26 on Sarbanes-Oxley and the SEC.

21. See chapter 17 on healthcare organizations.

22. See chapter 21 on HIPAA compliance.


27. The False Claims Act is discussed in detail in chapter 6.

28. In one recent tax fraud case, defense counsel estimated the cost of a “reasonable defense” to be “anywhere from $10 million to $44 million.” Beth Bar, Defense Cost Estimates Offered in KPMG Case, N.Y.L.J, July 13, 2007.


30. Id.

31. Id.

32. Id. at 588.

33. See McNulty Memo, supra note 5, at 4, 12–15.


35. Id. ch. 8.

36. Id. § 8C.

37. Id. Additional mitigation is provided for self-reporting of wrongdoing. See id. § 8C2.5(g).

38. For more information, see chapter 5.

40. Other agency programs include, but are not limited to: credit in debarment proceedings (FAR 9.406-1(a)(2)); credit for defense contractors (DFARS 203.7001(a)(6)); Department of Defense Voluntary Disclosure Program; Department of Justice Antitrust Division, Corporate Leniency Program; The Environmental Protection Agency Voluntary Environmental Self-Policing and Self-Disclosure Interim Policy Statement.

41. “DOJ’s Civil Division received 8,869 FCA cases from fiscal years 1987 through 2005. During this period, the number of qui tam FCA cases generally increased as a proportion of total FCA cases. . . . The median FCA recovery in a qui tam case was $784,597, of which the median relator share was $123,885.” Letter from Laurie E. Ekstrand, Director, Homeland Security and Justice, U.S. GAO, to The Honorable F. James Sensenbrenner, Jr., Chairman, Committee on the Judiciary, House of Representatives, The Honorable Chris Cannon, Chairman, Subcommittee on Commercial and Administrative Law, Committee on the Judiciary, House of Representatives, and the Honorable Charles E. Grassley, U.S. Senate, GAO-06-32OR (Jan. 31, 2006).

42. Id. at 25.


45. Id.

46. Id.

47. Id.

48. Id.

49. Id.

50. Hollis Ashbaugh (University of Wisconsin), Daniel Collins (University of Iowa) & Ryan LaFond (University of Wisconsin), Working Paper, Corporate Governance and the Cost of Equity Capital (Dec. 2004), at 3.


54. Id.


The Business Case for Compliance Programs

57. Speech by Doug Bain, Boeing Senior Vice President and General Counsel, at Boeing Leadership Meeting, Orlando, Fla. (Jan. 5, 2006), reprinted in Transcript of Speech by Boeing’s Doug Bain, SEATTLE TIMES, Jan. 31, 2006 (Business & Technology section).

58. Press Release, U.S. Dep’t of Justice, Boeing to Pay United States Record $615 Million to Resolve Fraud Allegations (June 30, 2006).