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Fostering a Culture of Trust:
Implications of the Federal Sentencing Guidelines

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Featuring a *Thought Leader Commentary™*
with James G. Martin, Partner, Armstrong Teasdale LLP
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CONTENTS

FOREWORD

The Business Roundtable Institute for Corporate Ethics is an independent entity established in partnership with Business Roundtable—an association of chief executive officers of leading corporations with a combined workforce of more than 10 million employees and $4 trillion in annual revenues—and leading academics from America's best business schools. The Institute brings together leaders from business and academia to fulfill its mission to renew and enhance the link between ethical behavior and business practice through executive education programs, practitioner-focused research and outreach.

Institute *Bridge Papers™* put the best thinking of academic and business leaders into the hands of practicing managers. *Bridge Papers™* convey concepts from leading edge academic research in the field of business ethics in a format that today's managers can integrate into their daily business decision making.

Fostering a Culture of Trust: Implications of the Federal Sentencing Guidelines is an Institute *Bridge Paper™* based on the research of Academic Advisor Timothy Fort, David Hess, and Robert S. McWhorter, which was first published in the *Fordham Journal of Corporate & Financial Law*'s Spring 2006 edition.* The authors interpret the 2004 Amendments to the Federal Sentencing Guidelines from both an ethical and legal perspective, providing executives and directors with insights needed to meet both the spirit and the letter of these provisions.

The accompanying interview with James G. Martin, Partner, Armstrong Teasdale LLP and Director, The PREVENE Group provides an interpretation of the Amendments' significance from the perspective of a former senior federal prosecutor.

*David Hess, Robert S. McWhorter & Timothy L. Fort, The 2004 Amendments to the Federal Sentencing Guidelines and Their Implicit Call for a Symbiotic Integration of Business Ethics, 11 Fordham J. Corp. & Fin. L. 725 (2006).

INTRODUCTION

In November 2004, the United States Sentencing Commission (the "Commission") substantially revised the Federal Sentencing Guidelines for organizations (the "Guidelines").[1] The Commission promised to create a "new era of corporate compliance" where an organization would focus on ethical corporate behavior and being a "good corporate citizen."[2] According to the Vice Chairman of the Commission, the new Guidelines seek to build a "model company" and stress that "a good corporate citizen must first and foremost operate ethically."[3] To accomplish this, the new Guidelines augment and strengthen the criteria an organization must follow to create an effective compliance program. Perhaps most importantly, the Guidelines require organizations to establish an effective compliance and ethics program that promotes an organizational culture that "encourages ethical conduct and a commitment to compliance with the law."[4] Although organizations are not required to comply with the new Guidelines, they set the benchmark for proper corporate conduct. If an organization is subsequently convicted of a federal crime, its failure to maintain "an effective compliance and ethics program" may result in the assessment of harsher penalties against the organization by the court.[5]

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The revised Guidelines integrate notions of a "good corporate citizen" from law, management, and ethics. Linking these perspectives is the concept of trust, specifically, three distinct but interrelated types of trust that can be characterized as: (1) Hard Conviction – having people do what they are supposed to do, (2) Real Confidence – having people live up to the promises they make and being honest, and (3) Good Faith – engaging personal meaningfulness and integrating individuals into communities.

THE ORIGINAL SENTENCING GUIDELINES

Organizational Criminal Liability and the 1991 Sentencing Guidelines

In 1991, the Commission announced rules for sentencing organizations convicted of committing federal felonies and Class A misdemeanors.[6] The 1991 Guidelines provide that the hallmark of an effective program is "that the organization exercise due diligence in seeking to prevent and detect criminal conduct by its employees and other agents."[7] "Due diligence" requires that the organization adopt a compliance program meeting the following minimum requirements:

1) Establish standards and procedures which are "reasonably capable of reducing the prospect of criminal conduct."
2) Appoint "high-level personnel" to oversee the program.
3) Ensure that authority in the program is not given to those that have "a propensity to engage in criminal conduct."
4) Communicate the program's

requirements to all employees and agents.
5) Ensure compliance through monitoring and auditing.
6) Enforce the program through "appropriate disciplinary mechanisms."
7) Once a violation has occurred, update the program to ensure effectiveness.[8]

An organization's failure to satisfy these seven requirements results in increased sanctions for criminal misconduct. As the Commission's chairperson explained: "these guidelines provide incentives for voluntary reporting and cooperation but punish an organization's failure to self-police."[9] An organization that incorporates all seven requirements, self reports, cooperates, and accepts responsibility for the illegal conduct of their employees may receive up to a 95% reduction in their federal fines.[10] In contrast, organizations that fail to comply with these requirements may be subject to a 400% increase in their federal fines.[11]

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Even more important than sentence reduction, the presence or absence of an effective compliance program may determine whether or not prosecutors initiate criminal proceedings against an organization. For example, from 2000 to 2004, of the 377 organizations sentenced under the guidelines, only 16 had any type of compliance program.[12] From 1993 to 2001, 812 organizations were sentenced under the guidelines, but only three of those organizations received a sentence reduction for having an effective compliance program.[13]

THE IMPACT OF THE 1991 GUIDELINES

The Guidelines have led to significant changes by corporations. Compliance programs are now standard practice, with over 90 percent of large corporations having an ethics code.[14] Despite widespread use of compliance programs, however, critics have challenged their effectiveness as a regulatory measure for several different reasons. The primary basis for many of these criticisms is the fear of cosmetic compliance – firms adopting only the appearance of a compliance program. According to one analysis, the adoption of these codes is commonly viewed by employees "as public relations vehicles or 'just a piece of paper.'"[15] According to a member of the Commission's Advisory Group, following the adoption of the Guidelines, many organizations developed token compliance programs by merely "checking the boxes" to comply with the seven minimum requirements of the Guidelines.[16]

Simply adopting a compliance program with the aforementioned seven factors does not assure a successful program; instead success depends on the company's approach to the program. Lynn Sharp Paine at Harvard Business School argued that firms could adopt either a compliance-based or an integrity-based approach.[17] Under a compliance-based program, firms typically over-emphasize the threat of detection and punishment for misconduct, which can be counter-productive if employees view the program as simply a tool to achieve leniency from prosecutors and to protect top management from blame.[18] An integrity-based approach, on the other hand, seeks to develop legitimacy with employees and focuses on internally developed organizational values. Under this approach, obeying the law "is viewed as a positive aspect of organizational life, rather than an unwelcome constraint imposed by external authorities."[19]

An integrity-based approach seeks to develop legitimacy with employees and focuses on internally developed organizational values.

The sum of these criticisms is that it is not simply the adoption of a compliance program that matters, but the culture of the firm that is the most important determinate for influencing employee behavior.[20] Although much has been written on the Enron case, it is a useful demonstration of both the importance of corporate culture and the problems with the 1991 Guidelines.

As is well known, Enron filed bankruptcy in December 2001 with debts over $100 billion amid allegations that it artificially boosted profits totaling over $1 billion. Enron, however, had a model code of ethics that likely satisfied the seven requirements of the Guidelines.[21] Enron's code "prohibited its employees from having financial or a management role in Enron's special purpose entities unless the chairman and the CEO determined that such participation would not adversely affect the best interests of the company."[22] However, Enron's directors waived the company's code of ethics in June 1999 to allegedly permit Enron's former CFO Andrew Fastow and former Enron employee, Michael Koppers, to run and financially benefit from Enron's special purpose entities.[23] For sure, a system of controls was either absent or seriously flawed. More importantly, the values of the code of ethics appeared to be exactly opposite of the true culture that existed there.

The Enron example clearly shows the limits of the 1991 Guidelines' approach. Even with a model code of ethics, the organization's system for rewarding employees and controlling risks can have a negative, and significantly stronger, impact on employee behavior.

THE AMENDMENTS TO THE SENTENCING GUIDELINES

The Ad Hoc Advisory Group and the Call for Increased Focus on Ethics

Enron and other corporate ethics scandals led to a closer look at compliance programs. In 2002, the Commission formed an ad hoc advisory group (the "Advisory Group") to review the general effectiveness of the Guidelines.[24] The Sarbanes-Oxley Act also suggested such a review.

During the hearings, various commentators urged the Advisory Group to include "ethics" as a requirement under the Guidelines. Bill Lytton, former counsel to Presidents Reagan and George H. W. Bush, testified that the overarching goal in amending the Guidelines should be to "provid[e] and foster [an] atmosphere where people who want to do the right thing are encouraged to do it and people who don't want to do the right thing are found out and prevented from doing it."[25]

After these hearings, the Advisory Group concluded 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."[26] As a result, the Commission modified the Guidelines to require organizations to specifically establish a "compliance *and ethics program*."[27] To have an effective compliance and ethics program, an organization must both "exercise due diligence to prevent and detect criminal conduct" and "promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law."[28] In its commentary, the Advisory Report states that:

> ...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 leadership of the organization, are often expressed as shared values or guiding principles, and are reinforced by various systems and procedures throughout the organization.[29]

Although the Advisory Report indicates that the Commission is not imposing duties on the organization beyond what the law requires, their approach requires firms to comply with the "spirit of the law" and not just the "letter of the law." The minimum requirements for establishing an effective compliance program and ethical culture are based on the seven requirements of the 1991 Guidelines, but include some significant changes.

Amendments to the Requirements for an Effective Program

First, the Guidelines created a new definition of compliance standards and procedures, as "standards of conduct and internal control systems that are reasonably capable of reducing the likelihood of criminal conduct."[30] Under the new guidelines, firms are responsible for updating their programs on a continuing basis to protect against the risk of violations. The Commission asserts 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 the law."[31]

Second, the Commission sought to clarify leadership responsibilities. Based on its investigation, the Advisory Group found that a key lesson from the corporate scandals was that the 1991 Guidelines did not adequately specify leadership responsibility. Accordingly, the new Guidelines sought to correct this problem in a few different ways. First, the new Guidelines require that the board of directors must be knowledgeable about the compliance and ethics program, including information on the compliance risks facing the firm and the programs installed to combat those risks, and be proactive in evaluating, monitoring, and managing this program.[32] Second, the Guidelines require that senior management must "ensure" that the organization has an effective compliance plan.[33] For example, some companies have elevated their Chief Ethics Officer to the senior executive team, with both the ability to monitor the organization and the access to report violations of the law. Third, those individuals with "day-to-day operational responsibility" must "be given adequate resources, appropriate authority, and direct access" to the board of directors or appropriate subgroup of the board. The provisions reflect a belief that a positive organizational culture requires all levels of the organization – the top, middle, and bottom – to be active in promoting the appropriate "organizational tone."[34]

Third, the Commission made it clear that ethics and compliance training was mandatory and that all employees, including the board of directors and executives, must receive training.[35] The Advisory Report also indicated that educating employees about compliance

...a positive organizational culture requires all levels of the organization to be active in promoting the appropriate "organizational tone."

requirements was not enough; organizations must also motivate all employees to comply.[36]

Fourth, the Guidelines require the program to include a system that allows employees to report misconduct and seek guidance without fear of retaliation. Based on information provided to the Advisory Group, there were two common problems plaguing companies who were ultimately convicted of a crime. In the first case employees or management knew or suspected that illegal conduct was occurring within the organization, but did not report it because they feared retribution, including possible job loss.[37] As a result, employees remain silent, thereby allowing the illegal conduct to continue. The second issue was that most organizations lack any mechanism to allow employees to report wrongful conduct confidentially.[38] The Advisory Group found that 44% of all non-management employees do not report the misconduct they observe.[39] Fifty-seven percent of those individuals failed to report because they felt that such a report would not be kept confidential; 41% feared retaliation from their manager, and 30% believed that co-workers would retaliate for any report of wrongdoing.[40] The purpose of this provision is to foster an organizational culture that promotes, rather than penalizes, employees who report violations of the law.

Overall, the new guidelines require firms to be more proactive in designing and updating their programs. Organizations are also encouraged to consider not only the risk of illegal activities by employees, but also ethical lapses.[41]

An Assessment of the Amendments

The changes to the Guidelines to achieve the Commission's goal—encouraging firms to adopt programs that actually work—are supported by research from management scholars.[42] A key factor is management commitment. When management demonstrates a commitment to ethics, then all members of the organization are more likely to view ethics as a key organizational value and take legal compliance initiatives more seriously.[43] Additionally, researchers have identified the following factors as important for a successful, integrity-based program: fair treatment of employees, open discussions of ethics in the organization, and rewarding ethical behavior (such as an employee reporting the unethical behavior of a co-worker) and not just self-interest.[44] The new Guidelines adhere to these research findings by expanding the roles of top management, requiring them to participate in training and creating a duty to ensure the effectiveness of the program.

There are, of course, limits to what the law can accomplish. For example, if the goal is to encourage integrity-based programs, then do the Guidelines actually work against it by developing even more stringent rules? Can these external inducements "force" a company to create an ethical organizational culture? Likewise, how do we balance between giving firms the flexibility to develop integrity-based programs and mandating best-practices, which can stifle experimentation on what works best for the firm's particular situation?

The new Guidelines—along with the Sarbanes-Oxley Act, changes to Securities and Exchange Commission regulations, and other government actions—are an attempt to develop trust between corporations and the public. For the Guidelines to be effective, however, there must also be trust within the organization.

THE 2004 AMENDMENTS AND PUBLIC TRUST IN BUSINESS

Hard Conviction, Real Confidence, and Good Faith

There are multiple ways to attempt to restore trust. One way to accomplish the re-creation of public trust is to insist upon stricter legal requirements. This is the approach taken by the Guidelines, its amendments, as well as a myriad of other mechanisms ranging from Sarbanes-Oxley to consumer protection. Another method, typically taken by schools of management, emphasizes trust deriving from the practice of certain virtues – such as production of quality materials or simple honesty – and thereby creating social capital. Still a third technique relies more motivationally on the kinds of passions that engender ethical behavior. This method depends on the development of trust through passionate commitment to being a certain kind of person or company. Rather than generally suggesting that corporations need to restore public trust, it may be useful for corporations following the 2004 Amendments to conceive of their task as fostering three related but distinct kinds of trust. One could characterize them as Hard Conviction, Real Confidence, and Good Faith.

Trust:
- **Hard Conviction** – Doing what one is supposed to do
- **Real Confidence** – Living up to promises, being honest, acting fairly
- **Good Faith** – Engaging personal meaningfulness, integrating individuals into communities

Hard Conviction is about how to make sure that people do what they are supposed to do. In large part, most of the turn-of-the-century scandals were about a breach of fiduciary duty. Rather than looking out for the interests of shareholders, executives from Enron, WorldCom, and Global Crossing were more interested in their own personal well-being, even at the expense of shareholders. The duty of loyalty and the duty of care are well-established legal constraints regulating the behavior of directors of corporations. So too, now, are the ethics and compliance provisions of the Guidelines. Other laws have been constraints on corporate behavior such as those related to securities fraud, unsafe working practices, unsafe products, and collusion. The hardness of this approach is that there are clear legal punishments if a company does not implement what is called an "effective" program. It may be that internally-driven programs tap more deeply into employee values than do externally driven ones, but laws help to ensure the public that their voice is also heard by companies.

The 2004 Amendments to the Federal Sentencing Guidelines reflect an attempt to reinforce Hard Conviction in order to assure compliance. The route it takes, however, interestingly relies on softer notions of culture and ethics because of a belief that reliance on coercion will not be sufficient to achieve corporate compliance. Thus, in addition to Hard Conviction, the Amendments have added what might be called Real Confidence.

Real Confidence is what most people think of when they hear the term trust, at least in relation to business. Real Confidence is about people living up to their promises, being honest, producing products and services that are of high-enough quality to satisfy customers, and rewarding people for doing the things the company says are important.[45]

Attempts to create conditions that foster Real Confidence thus stress acting fairly and by doing so, creating social capital so that integrity becomes a reinforced practice. This requires rewarding people for doing the right thing. Because social capital and Real Confidence trade on notions of fairness, corporate consideration of what is fair is a necessary part of developing a culture of ethics and compliance.

Several years ago, LaRue Hosmer developed a small vignette about a recent MBA graduate who worked for a department store in the gourmet food section.[46] In this real case, the store sold individually wrapped, sealed specialty cookies. Unfortunately, some customers found bugs on the cookies when they opened them. The graduate's manager instructed her to "dump" the cookies, but the graduate discovered that this did not mean to throw the cookies in the trash. Instead, the manager said that she knew of a convenience store in the inner city, where they could sell the infested cookies at a discount and get some of their money back.

From a twisted perspective, the supervisor's directive made sense because the manager's annual bonus was based on profitability per square foot; so was her future allocation of square footage in the store.[47] In short, the company rewarded her to maximize her profitability in whatever way she could. The manager simply followed the logic of the financial incentives.

One could argue that the manager still should not have sold the cookies. But the point is that if an organization wants to be ethical, it cannot rely on individual people to fall on their swords regularly to make it happen. Incentives need to be developed for rewarding people for not selling infested cookies and punishing them if they do. This means that ethics is not only about hiring people with personal integrity – it is also about organizational structures that reward the right actions. In other words, it is important to create win-win environments for multiple stakeholders.

The aim of the third kind of trust, Good Faith, is to engage personal meaningfulness and to integrate individuals into organizations and missions that transcend the individual – in ways that remain consistent with Hard Conviction and build on the moral duties of Real Confidence. Two critical dimensions comprise Good Faith. The first is that by commitment to a powerful good, individuals within the company can be energized to pursue ethical business behavior in their work.[48] The second is a notion of "mediating institutions" – particular kinds of communities within organizations that foster personal meaningfulness and moral identity.[49]

Individuals affect the moral character of organizations while also being shaped by them.[50] For example, anthropological data on the importance of small groups suggest that there may be a particular kind of a community – a relatively small mediating institution – whereby moral character is optimally developed.[51] Small groups within corporations that build a commitment of trust may be these optimal sized units that are able to foster an affective culture of ethical behavior within the larger organization.

The Role of the Law in Promoting Hard Conviction, Real Confidence, and Good Faith

The challenge the Guidelines has identified is how to build trust within organizations. Typically, the law works by forcing structures and rules upon organizations. However, compelling firms to force compliance programs upon their employees runs the risk of developing distrust and working against the development of compliant and ethical organizations. The Guidelines attempt to walk this balance by requiring certain "best practices," but still leaving firms with flexibility in implementing compliance programs.

One way to view how the law can support the development of trust through compliance programs is by viewing the new Guidelines as serving an "expressive" function.[52] Viewed in this way, the new Guidelines operate not as a threat of punishment for those firms that do not adopt the appropriate compliance program, but create awareness about an appropriate compliance program and the need for an ethical corporate culture. During the 1990s – rather than simply rubber-stamping the decisions of CEOs – directors became more active in setting the board's agenda and critically evaluating the performance of the CEO. This change may have occurred not due to liability concerns, but rather as a result of "a shift in the social norm governing directorial duties, from a nonobligational practice norm that insulated inactive directors from criticism and self-criticism, to an obligational norm that requires a higher level of care."[53] The driving force was a "change in the belief system of the business community" with respect to the role of directors.

...changing the norms of appropriate behavior among officers and directors will have stronger impact on the effectiveness of compliance programs than coercive, external pressures.

The main cause of this change in social norms was the law.[54] Although directors were essentially shielded from liability, the courts continued to define directors' obligations and how directors should "play their roles." Thus, the law provides essential meaning for how actors are to perform in these situations. In addition, the law creates social norms that can be enforced by social sanctions. For example, "no smoking" signs are rarely enforced by legal sanctions, but their presence allows others to "enforce" the smoking bans by "dirty looks" or "harsh words." With respect to compliance programs, the new Guidelines work towards creating new social norms that indicate "paper" compliance programs are not satisfactory and all levels of management – including the board – must be involved in ethics and compliance training. This allows those both inside and outside the organization that support meaningful compliance programs the legitimacy to demand such changes if they are not being made.

Over time, these norms should become institutionalized and lead to more proactive compliance and ethics programs. The research of management scholars shows that changing the norms of appropriate behavior among officers and directors will have stronger impact on the effectiveness of compliance programs than coercive, external pressures.[55]

CONCLUSION

Overall, seeking effective compliance and ethics programs would be further enhanced by an authentic symbiotic corporate governance strategy. Hard Conviction is an important step to insisting on proper corporate behavior. But as the 2004 Amendments implicitly recognize, there must be an integration of law with other dimensions. Real Confidence measures, the building of reliability and trust in an organization through the practicing of normative behavior, and the building of social capital are important ways to build an ethical culture with an attitude toward achieving good citizenship. In addition, fostering the passion for ethics through

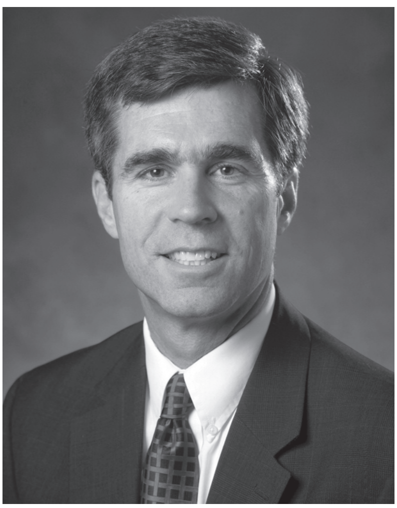
The challenge is finding the appropriate role for legal mandates in encouraging organizations to comply with both the letter and spirit of the law.

Good Faith completes a three-level integration of corporate responsibility. The challenge is finding the appropriate role for legal mandates in encouraging organizations to comply with both the letter and spirit of the law. The Commission enacted the new Guidelines both to solve the problem of cosmetic compliance programs and to encourage firms to adopt certain best practices. Additionally, the Guidelines can serve a broader purpose: supporting the components of trust identified as hard conviction, real confidence, and good faith.

A THOUGHT LEADER COMMENTARY™ with James G. Martin, Partner, Armstrong Teasdale LLP and Director, The PREVENE Group

Q: How much weight should the 2004 Amendments to the Federal Sentencing Guidelines carry in the formulation of a corporation's compliance program?

James G. Martin: It's indisputable that the Sentencing Guidelines are a driving force today in how corporate compliance programs are structured. But, their legal application is at sentencing, so, we should never lose sight of the fact that a compliance program which is given high marks by a sentencing judge has nonetheless failed in its primary purpose. By the time a judge is applying the factors set forth in the Guidelines to a corporate compliance program, the corporation has already been investigated, indicted and convicted. No matter how small a criminal fine the court may impose, the company has already incurred significant legal bills, negative publicity, injury to its customer and business partner relationships, and probably subjected itself to significant civil or class action law suits.



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James G. Martin

I don't want to imply that the amendments to the Sentencing Guidelines are not important. If a corporation ever finds itself with a federal criminal conviction, it is important to be able to show it is in full compliance with the Guidelines. But, the primary focus and goal in structuring a compliance program should not be ensuring compliance with some checklist derived from the Guidelines in order to satisfy a sentencing court. The primary focus, from the criminal law perspective, must be in ensuring there is a program in place which can effectively keep the corporation from ever being indicted.

Q: How does a corporate compliance program ensure that an effective program is in place in today's heightened prosecutorial environment?

Martin: There is no doubt that the individual, or group of individuals, who have the final say in whether a corporation is going to be indicted are the prosecutors. So structuring a compliance program that is viewed as effective by the prosecutor is very important. In my experience working and talking with fellow federal prosecutors from all around the country, the key question they want answered is – did corporate practices and policies encourage or discourage the misconduct?

In part, as this paper points out, the Sentencing Guidelines try to address that question with the new emphasis on a "culture of ethics." While a corporation can have an extensive checklist of rules and regulations for its employees (what this paper calls "Hard Conviction"), and it can produce a comprehensive Corporate Code of Conduct, in most cases the prosecutor will look past all of that to see what sort of culture exists within the corporation.

A key factor for most prosecutors in assessing the corporate culture of ethics relates to this paper's concept of "Real Confidence." The paper puts it in terms of having organizational structures that reward the right actions. Prosecutors, because they do not investigate good actions but investigate misconduct, come at it from the other direction and look to see if there are organizational structures that encourage bad actions.

Most prosecutors want to know whether the misconduct involved is something the company encouraged or discouraged. Not infrequently, a company can put out a strong message that employees are expected "to do the right thing," only to undercut that positive message with a contradictory negative message.

A trend that can be seen in many of the more recent corporate fraud cases is that the criminal misconduct often occurred during a crisis. It is human nature to shift into a survival mode when confronted by a crisis. Once in a survival mode, we tend to do whatever it takes to get out of the predicament without the ability to see the potential negative long-term consequences of our actions.

Certain corporate practices can create the likelihood for crises to arise and thereby cause the erosion of a culture of ethics. The best example of this point is one many commentators have written about – that is the all-consuming drive by some companies to make the quarterly numbers. At several of the corporations caught in the web of corporate fraud, the culture of ethics was overrun by the culture of making the numbers. The prospect of failing to make the numbers put employees into a crisis and blinded them to the negative consequences of their behavior. When corporations impose this sort of pressure on employees, the prosecutor will likely blame the company for the employee's actions.

And, it does not have to be the quarterly numbers. Whenever the misconduct being investigated is caused by a corporate intolerance for missing a goal or target, a prosecutor will likely see the intolerance as the company encouraging the misconduct.

Of course, a corporation today cannot operate without there being pressures to reach goals and make certain numbers. That is how businesses succeed. But, when creating a culture of ethics and considering how the prosecutor will view the ethical environment, it becomes a matter of degrees. The lower the tolerance for failure within the corporation and the more likely a crisis will arise, the greater chance a prosecutor will hold the company responsible for the actions of its misguided employee.

Q: What other business practices besides an all-consuming drive to "make the numbers" can cause a business crisis?

Martin: Another related situation which can create a business crisis and erode the culture of ethics is a corporate environment which does not acknowledge that mistakes happen. This does not mean there should be no consequences for mistakes, but when mistakes are made in an environment where they are simply not acceptable, the company is again creating the potential for crisis situations. In the view of a prosecutor, no matter how extensive the attempts to create a culture of ethics, a corporation where mistakes are unacceptable will often be held responsible for the criminal conduct of an employee trying to cover-up or rectify a mistake.

Q: The Sentencing Guidelines do not give a lot of definition to a culture of ethics. How do corporations create the right culture of ethics?

Martin: A culture of ethics is a nebulous concept. Somewhat more problematic is the reality that a business executive's view of ethical behavior may be different than a prosecutor's view of ethical behavior. Business executives are making decisions all the time which fall into various shades of gray – and gray can sometimes mean bad in the view of the prosecutor. Most prosecutors have never worked in the corporate world and they tend to see business decisions very simplistically as either black or white. That dichotomy can cause honest and ethical business executives to find themselves being investigated for conduct they never imagined could be considered criminal.

Q: Can you give us a real life example of what you are talking about?

Martin: Back in the 1980's, what was then Chrysler Motors was operating a quality assurance program where assembly plant executives drove new vehicles back and forth from their homes and work in order to detect flaws in the cars and the assembly process. Lee Iaccoca wrote about the program in his book *Talking Straight*. In the book, he talked about the day he heard that one of his plant executives had been pulled over for speeding and tried to talk his way out of a ticket by explaining to the officer that he did not know how fast he was going because he was driving one of the test cars and the odometer was disconnected. Mr. Iaccoca wrote that when he heard about this incident, he did not think much of it. As he viewed the program, test driving the cars was an effort to make better cars, disconnecting the odometers during testing was an industry practice, and the disconnected odometer protected the customer's warranty mileage. He also wrote that they even talked to one of their lawyers and were told it was okay because that was the way it had always been done.

The problem was the business perspective towards the program was completely different from that of the federal prosecutor who saw nothing except a clear case of odometer fraud. It's not a matter of whose view of ethics is right – they may both be right – but, as is usually the case, the prosecutor's perspective carries more weight in the criminal arena, and Chrysler was convicted in federal court for mail fraud and odometer fraud.

Q: What does that mean in terms of establishing a culture of ethics within a corporation?

Martin: Simply having an appreciation that the business executive's view of corporate ethics may be different from that of prosecutors and others is a significant step in the right direction. As annoying and as wrong as business executives may view a prosecutor's perspective, if a corporation can get its employees to appreciate that the prosecutor's ethical perspective of business decisions may be different from their own, and, accept that the prosecutor's perspective can have a significant impact on their corporation, they will be creating a stronger culture of ethics.

In evaluating alleged misconduct, prosecutors, more so today than ever, will not care that the company has always conducted business a certain way or that everyone in the industry also does it.

In the Institute's Bridge Paper "Developing Ethical Leadership," Professor Ed Freeman talked about the need for ethical leaders to "take a charitable understanding of others' values." This concept has direct applicability to being able to appreciate the prosecutor's perspective.

I think incorporating this concept into the corporate culture of ethics is fairly straight forward. In an ethical corporate culture, business executives already ask, "What is the right thing to do?" They should also ask, "Will others think this is the right thing to do?" And, it is important that these questions are asked at each layer of the decision-making process. In the Chrysler scenario, it was not enough to ask, "Will others think it is the right thing to have a quality assure program by test driving new cars?" The question needed to be asked of each component part of the program, including, "Will others think it is the right thing to disconnect the odometers?" Moreover, the questions need to be asked looking at the core issues without attaching any business justifications or explanations for the conduct. In evaluating alleged misconduct, prosecutors, more so today than ever, will not care that the company has always conducted business a certain way or that everyone in the industry also does it. Disconnecting the odometer didn't look bad when viewed as an industry practice done during quality assurance testing. But, when viewed in isolation – which is how the prosecutor viewed it – it can look fraudulent.

I think there is also a bonus to looking at business decisions in this way. If a company asks the question, "Will others think this is the right thing to do?" – it not only can help the corporation's "relationship" with the prosecutor, but also its relationship with customers and business partners. As Lee Iaccoca acknowledged in his book, had they asked the right question, they could have added value to the testing program by simply connecting the odometers and selling the cars with a placard which said "this car was test driven by one of our plant executives." And, when a corporation can add value and conduct business in a manner prosecutors deem legal and ethical, that is a successful compliance program.

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Fostering a Culture of Trust

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NOTES

1. The Sentencing Guidelines are not limited to corporate or business entities, but also apply to "corporations, partnerships, associations, joint-stock companies, unions, trusts, pension funds, unincorporated associations, governments and political subdivisions thereof, and non-profit organizations." U.S. Sentencing Guidelines Manual § 8A1.1, cmt. n.1 (2004).
2. News Release, U.S. Sentencing Commission, Commission Tightens Requirements for Corporate Compliance and Ethics Programs 1 (May 3, 2004), http://www.ussc.gov (follow "Press Releases" hyperlink; then follow "May 3, 2004 News Release: Commission Tightens Requirements for Corporate Compliance and Ethics Programs" hyperlink).
3. Michael Bobelian, "New Sentencing Guidelines Cover Corporate Misdeeds," *New York Law Journal*, May 4, 2004, at 1.
4. U.S. Sentencing Guidelines Manual § 8B2.1(a)(2).
5. See *ibid*. § 8A1.2(a)(2)(D). In the recent decision of *United States* v. *Booker*, 543 U.S. 220 (2005), the United States Supreme Court found that if the Guidelines were "merely advisory provisions that recommended, rather than required, the selection of particular sentences in response to differing sets of facts, their use would not implicate the Sixth Amendment." *Ibid*. at 233. The Court found that "[t]he Guidelines as written, however, are not advisory; they are mandatory and binding on all judges." *Ibid*. Based on this language, the Guidelines are treated as advisory in nature and not binding upon the judges.
6. U.S. Sentencing Guidelines Manual § 8 (2004).
7. *Ibid*. § 8A1.2 cmt. n.3(k) (1991) (amended 2004).
8. *Ibid*. § 8A1.2 cmt. n.3(k)(1) – (7) (1991) (amended 2004).
9. News Release, U.S. Sentencing Commission, Sentencing Commission Convenes Organizational Guidelines Ad Hoc Advisory Group 1 (Feb. 21, 2002), http://www.ussc.gov (follow "Press Releases" hyperlink; then follow "February 21, 2002 News Release: Sentencing Commission Convenes Organizational Guidelines Ad Hoc Advisory Group" hyperlink).
10. Paul Fiorelli, "Will U.S. Sentencing Commission Amendments Encourage a New Ethical Culture Within Organizations?," 39 *Wake Forest Law Review* 567 (Fall 2004).
11. *Ibid*.
12. F. Joseph Warin and Michael D. Billok, "Navigating the Legal Requirements of Internal Compliance Programs," *The Corporate Governance Advisor*, November/December 2004, at 13-14.
13. U.S. Sentencing Commission, Report of the Ad Hoc Advisory Group on Organizational Sentencing Guidelines 26 (Oct. 7, 2003), http://www.ussc.gov/corp/advgrp.htm (follow "Report of the Ad Hoc Advisory Group on Organizational Sentencing Guidelines: October 7, 2003" hyperlink) [hereinafter "ADVISORY REPORT"].
14. Janet S. Adams et al., "Codes of Ethics as Signals of Ethical Behavior." 29 *Journal of Business Ethics* 199 (2001).
15. Jeffrey M. Kaplan et al., *Compliance Programs and the Corporate Sentencing Guidelines, Preventing Criminal and Civil Liability*, § 7:14, at 7-30 (West. Pub. 2003).
16. Paul Fiorelli, at 567.
17. Lynn Sharp Paine, "Managing for Organizational Integrity." *Harvard Business Review*, March/April 1994: 111.
18. *Ibid*.; G.R. Weaver and Linda Kelbe Trevino, "Compliance and Values Oriented Ethics Programs: Influences on Employees' Attitudes and Behavior," 9 *Business Ethics Quarterly* 315 (1999).
19. Paine, at 111.
20. For a more complete discussion of ethical culture and ethical climate, see Linda Klebe Trevino et al., "The Ethical Context in Organizations: Influences on Employee Attitudes and Behaviors," 8 *Business Ethics Quarterly* 447 (1998).
21. "Corporate Ethics Training: Top-to-Bottom Training, Employee 'Ethics Help Line' are Key to Corporate Culture of Ethics," *Chartwell's Best Practices for Utilities and Energy Companies* (Chartwell Inc., Atlanta, GA, Sept. 2002), at 141.
22. Raphael S. Grunfeld, "Enforcing a Written Code of Ethics, Well-Ingrained Guidelines Given Higher Priority, Encourage Executives to Do the Right Thing," *New York Law Journal*, November 18, 2002, at S3.
23. Greg Farrell, *Enron Law Firm Called Accounting Practices 'Creative'*, USA Today, January 15, 2002, at D1.
24. News Release, U.S. Sentencing Commission, Sentencing Commission Convenes Organizational Guidelines Ad Hoc Advisory Group (Feb. 21, 2002), http://www.ussc.gov (follow "Press Releases" hyperlink; then follow "February 21, 2002, News Release: Sentencing Commission Convenes Organizational Guidelines Ad Hoc Advisory Group" hyperlink).
25. *Public Hearing Before the U.S. Sentencing Commission Ad Hoc Advisory Group on Organizational Sentencing Guidelines* 40-41 (Nov. 14, 2002) (testimony of Bill Lytton, Executive Senior Vice President and General Counsel, Tyco International), http://www.ussc.gov/corp/ph11_02/plenary2.pdf.
26. Advisory Report, at 51.
27. U.S. Sentencing Guidelines Manual § 8B2.1(a) (2004).
28. *Ibid*.

29. Advisory Report, at 52.
30. U.S. Sentencing Guidelines Manual § 8B2.1 cmt. n.1 (2004).
31. Advisory Report, at 56.
32. Advisory Report, at 60-61; U.S. Sentencing Guidelines Manual § 8B2.1(b)(2)(A).
33. Advisory Report, at 60-61.
34. Paul Fiorelli, at 582.
35. *Ibid*. at 583.
36. Advisory Report, at 71.
37. *Public Hearing Before the U.S. Sentencing Commission Ad Hoc Advisory Group on Organizational Sentencing Guidelines* 14 (Nov. 14, 2002) (testimony of Deborah Yang, United States Attorney, Central District of California), http://www.ussc.gov/corp/ph11_02/plenary2.pdf.
38. *Ibid*.
39. Advisory Report, at 78 (citing Ethics Resource Center, 2003 *National Business Ethics Survey* (2003), available at www.ethics.org).
40. *Ibid*.
41. Jeffrey M. Kaplan, "Compliance Programs 2.0: The Next Generation in Compliance Programs," *The Corporate Governance Advisor*, November/December 2004, at 10-11.
42. For a general review of the research in this area, see Linda Klebe Trevino and Gary R. Weaver, *Managing Ethics in Business Organizations: Social Scientific Perspectives* (2003).
43. Trevino, Linda Klebe et al., "Managing Ethics and Legal Compliance: What Works and What Hurts," 41 *California Management Review*, 131 (1999).
44. Trevino et al., *supra* note 20, at 447; Trevino et al., *supra* note 43, at 131.
45. See generally F.A. Hayek, *The Fatal Conceit: The Errors of Socialism* (W.W. Bartley ed., 1988)(arguing from a strictly economic basis, the market works best with there is trust between actors in the economy).
46. LaRue Tone Hosmer, *Moral Leadership in Business* 86-87 (1994).
47. *Ibid*.
48. See generally Timothy L. Fort & Cindy A. Schipani, *The Role of Business in Fostering Peaceful Societies* (2004) (arguing that the goal of sustainable peace is both such a possible aspirational goal as well as something led to by common ethical business practices).
49. For a complete discussion of mediating institutions, see Timothy L. Fort, *Ethics and Governance: Business as Mediating Institution* (2001).
50. See Errol E. Harris, *Formal, Transcendental, and Dialectical Logic: Logic and Reality* (1987).
51. See Timothy L. Fort, "Goldilocks and Business Ethics: A Paradigm That Fits "Just Right"," 23 *Iowa Journal of Corporate Law* 245, 264-67 (1998).
52. See generally, Robert Cooter, "Social Norms, Social Meaning, and the Economic Analysis of Law: A Conference Sponsored by the University of Chicago Law School and the John M. Olin Program In Law and Economics: Expressive Law and Economics", 27 *Journal of Legal Studies* 585 (1998); Lawrence Lessig, "The Regulation of Social Meaning," 62 *University of Chicago Law Review* 943 (1995); Richard H. McAdams, "The Legal Construction of Norms: A Focal Point Theory of Expressive Law," 86 *Virginia Law Review* 1649 (2000). Cass R. Sunstein, "On the Expressive Function of Law," 144 *University of Pennsylvania Law Review* 2021 (1996).
53. Melvin Aron Eisenberg, "Corporate Law and Social Norms," 99 *Columbia Law Review* 1268-69 (1999).
54. For a similar line of analysis, see Edward B. Rock, "Saints and Sinners: How Does Delaware Corporate Law Work?," 44 *UCLA Law Review* 1009 (1997).
55. Trevino and Weaver, *supra* note 42, at 117-18, 141; Gary R. Weaver et al., "Integrated and Decoupled Corporate Social Performance: Management Values, External Pressures, and Corporate Ethics Practices," 42 *Academy of Management Journal* 539 (1999); Gary R. Weaver et al., "Corporate Ethics Programs as Control Systems: Influences of Executive Commitment and Environmental Factors," 42 *Academy of Management Journal* 41 (1999). For example, one study by Trevino and Weaver found that management commitment to ethics (measured by the frequency that top management discussed ethics related topics) was positively related to an ethics program that was integrated into the firm's operations. Trevino and Weaver, *supra* note 42, at 137-144. Although awareness of the guidelines also had a positive impact on the adoption of more integrated ethics programs, it had significantly less influence than management's commitment to ethics. Trevino and Weaver, *supra* note 42, at 144. The empirical question then is whether the changes in the content of the guidelines, which will require top management to discuss issues related to developing an ethical culture, will lead to more integrated ethics programs.

For more information on the **Business Roundtable Institute for Corporate Ethics** please visit or call

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