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The Business Judgment Rule and the Sentencing Guidelines: Uneasy Bedfellows or Intractable Foes?

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The "business judgment" rule, crafted by courts, protects decisions by a corporate board of directors from second-guessing when those decisions come under attack in a judicial forum. That rule "is process oriented and informed by a deep respect for all *good faith* board decisions." [1]

Recent developments raise the possibility that the business judgment rule's protection may prove to be less airtight than had been the case. In light of the increasing demands for personal liability on the part of corporate directors, a diminution in the protection available from the business judgment rule might prove a significant additional hurdle to recruiting qualified directors.[2]

Those developments relate to the Sentencing Guidelines for Organizational Defendants issued by the United States Sentencing Commission (the "Guidelines" and the "Commission" respectively)[3] and the role that those Guidelines play in setting standards for organizational behavior. The interplay between the Guidelines and the business judgment rule presents some interesting – perhaps troubling - issues for corporations and their directors.

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The Business Judgment Rule and Its Relationship to Corporate Compliance Programs

Court decisions

While the business judgment rule has a long history, it has continued to receive considerable attention in recent years with the increase in shareholder suits related to corporate failures and the like. Beginning with the *Caremark* case (see n.1, *supra*), however, courts have begun to explore the relationship between the business judgment rule and corporate compliance programs.

Caremark International, Inc., had settled charges filed against it by the federal government, paying fines totaling over $150 million for criminal and civil violations of Medicare and Medicaid reimbursement statutes and regulations and agreeing to various other provisions. After settling those charges, the company faced and settled civil claims against it by various private insurers.

Chancellor Allen of the Delaware Court of Chancery, in order to review a proposed settlement of those private actions, analyzed the company's actions precedent to the federal charges as well as its conduct relative to the private-party plaintiffs. In the course of that review, the Chancellor considered the actions of Caremark's directors, since the plaintiffs "charge[d] the director defendants with breach of their duty of attention or care in connection with the on-going operation of [Caremark's] business."[4]

The Chancellor viewed the plaintiffs' complaint as alleging a failure to oversee adequately corporate operations. Had the directors monitored those operations appropriately, then, accepting the plaintiffs' allegations as true,

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presumably the directors would have noticed the failure to comply with government rules more quickly than they did. Reviewing the case law as to such a duty to oversee operations, Chancellor Allen stated that "absent grounds to suspect deception, neither corporate boards nor senior officers can be charged with wrongdoing simply for assuming the integrity of employees and the honesty of their dealings on the company's behalf."[5] Accordingly, he found that "a director's obligation includes a duty to attempt in good faith to assure that a corporate information and reporting system, which the board concludes is adequate exists, and that failure do so under some circumstances may, in theory at least, render a director liable for losses caused by non-compliance with applicable legal standards."[6]

Since "it does appear that the Board was to some extent unaware of the activities that led to liability"[7] and that the company had a functioning corporate information system, the plaintiffs' claims were "extremely weak."[8]

The directors in Caremark had seen to the establishment of a corporate information system, which constitutes one of the basic elements of an "effective compliance and ethics program" under the Guidelines, thereby satisfying the duty of care.[9] Since they were "ignoran[t] of liability creating activities," the claims against them were weak and the court approved the settlement.

Ten years later, the Supreme Court of Delaware applied the reasoning of the *Caremark* case, declaring "that *Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."[10]

Do directors have any longer the defense that they did not know about wrongdoing within the company and that they had no reason to investigate the occurrence of that wrongdoing? Developments in respect of federal sentencing guidelines and the requirements of recent statutes cast some doubt that they do.

The Guidelines

Congress created the Commission, by means of the Sentencing Act of 1984,[11] to achieve greater certainty and uniformity of sentences handed down by federal judges. After issuing in 1987 standards for the sentencing of individuals and of organizations convicted of violating the antitrust laws, the Commission undertook a study of possible approaches to the sentencing of business organizations for other criminal violations[12] and, in 1991, issued the Guidelines.[13]

The Guidelines as drafted by the Commission incorporate incentives by which organizations would have reason to prevent and detect crimes by their employees and agents, rather than rely solely on retroactive punishment to deter criminal conduct by companies. To that end, the Commission included in the Guidelines criteria by which a judge could gauge whether he or she should deem an organization's compliance program effective.[14]

When the Commission issued the Guidelines in 1991, it laid out seven basic elements that should appear in a corporate compliance program for that program to deserve to be treated as "effective." In 2001, the Commission established an Ad Hoc Advisory Group on the Organizational Sentencing Guidelines, to review real-world experience during the sixteen years that the Guidelines had been in force.[15] The Ad Hoc Advisory Group issued its report in October 2003 and in May 2004, based to a large degree on that report, the Commission revised the Guidelines considerably.

The changes to the Guidelines adopted in 2004 reflect two significant themes: the Commission made ethics a more central and explicit focus than it had in the 1991 Guidelines; and it focused increased attention on the role of corporate directors with respect to a corporate compliance and ethics program in several respects. That second theme holds implications for the continuing viability of the business judgment rule.

The Guidelines now provide that an "organization's governing authority [i.e., the board of directors in the case of a corporation] shall be knowledgeable

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about the content and operation of the compliance and ethics program and shall exercise reasonable oversight with respect to the implementation and effectiveness of the compliance and ethics program"[16] and that "[i]ndividual(s) with operational responsibility [for the program] shall report periodically to high-level personnel and, as appropriate, to the governing authority, or an appropriate subgroup of the governing authority, on the effectiveness of the compliance and ethics program."[17]

Sarbanes-Oxley Act

The now-famous (or, perhaps, infamous) Sarbanes-Oxley Act of 2002, enacted after the Enron and WorldCom scandals, also included a provision that is relevant to the continuing effect of the business judgment rule. In §301, Congress mandated that the Securities and Exchange Commission "direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with the requirements" of certain provisions of that law, including the requirement that the audit committee of the board of directors "establish procedures for – (A) the receipt, retention and treatment of complaints received by the [company] regarding accounting, internal accounting controls, or auditing matters; and (B) the confidential, anonymous submission by employees of the [company] regarding questionable accounting or auditing matters."[18]

Prosecutors' view

The Guidelines apply (as guidance only) when a business has already been found to have violated federal law and its sentence remains unset. Admittedly, very few business organizations will ever find themselves in such a position. For many observers, then, the terms of the Guidelines may seem very academic, but of little real-world consequence.

If only a handful of companies find themselves represented in a courtroom awaiting sentence, though, quite a few more can find themselves targets of investigation by prosecutors. When those prosecutors are federal, they look to guidance from the United States Department of Justice when considering whether to charge a company and, if they decide to charge it, how they should do so.

That guidance is contained in Principles of Federal Prosecution of Business Organizations[19] issued most recently by Deputy Attorney General Mark Filip on August 28, 2008. Federal prosecutors, while applying "no formulaic requirements regarding corporate compliance programs," do attempt to discern whether "the corporation's compliance program [is] well designed."[20] Among the considerations that they weigh are the following questions:

- Do "the corporation's directors exercise independent review over proposed corporate actions rather than unquestioningly ratifying officers' recommendations"?
- Have "the directors established an information and reporting system in the organization reasonably designed to provide management and directors with timely and accurate information sufficient to allow them to reach an informed decision regarding the organization's compliance with the law."[21]

Federal prosecutors also consider a company's compliance program and the directors' involvement in that program when they settle charges with firms. For example, Mellon Bank settled criminal charges related to its actions as an agent of the United States Treasury Department as collector of income tax payments. The settlement agreement that it entered into with the federal government[22] specified, among other things, the following:

- "Mellon shall adopt a strong board of directors resolution endorsing and setting requirements for the overall compliance and ethics program. The resolution shall delineate the role of the board in providing oversight of the program, including which committee(s) of independent directors has been delegated such responsibilities. The resolution should provide that the chief compliance and ethics officer serves at the exclusive discretion of the board of directors and has access to the board in executive session. The board shall receive training on exercising its compliance and ethics oversight role."
- "Trends [of compliance and ethics matters] should be identified and analyses of trends, as well as reports of significant matters, shall be

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> reported to the board. Reports to the board shall also cover all aspects of the program."

Such detailed requirements can arise in several contexts. Accordingly, it becomes more and more likely that adverse events involving a company will, or should, come to the attention of its board of directors.

The Conundrum

The combination of Sarbanes-Oxley's requirement that the audit committee of the board of directors set up an issues-submission procedure and the 2004 Guidelines' mandate that the "governing authority" of an organization "be knowledgeable about the content and operation of the compliance and ethics program" (which will include the "system whereby employees and agents may report or seek guidance regarding potential or actual criminal conduct") may make it increasingly difficult for a board of directors to invoke the business judgment rule successfully. When invoking that rule to insulate a board's decision from judicial review, court's predicate its applicability on the absence of "grounds to suspect deception" (as formulated in *Caremark*).[23] The existence of such reporting mechanisms, combined with the requirements of the Guidelines (i) that the board be "knowledgeable about the content and operation of the compliance and ethics program" and (ii) that the individual responsible for day-to-day operation of that program have an opportunity to report directly to the board or a committee of the board as appropriate, the board may be less able to plead such ignorance.

The government's prosecution in Mellon represents the ongoing effort by prosecutors to keep pressure on directors despite the business judgment rule. This gives companies a Hobson's choice: create mechanisms that undercut the ability of directors to claim the business judgment rule because they will have access to information and therefore no opportunity to claim ignorance (*Caremark*) or risk prosecution and/or rely on a court later determining that the failure to create an effective compliance program (or, at least, the reporting mechanism cited in *Caremark*) to prevent and detect violations of law did not constitute a basis for director liability. ◆

Endnotes

1. *In re Caremark International Inc. Derivative Litigation,* 698 A.2d 959, 968 (Del. 1996) (italics in original).
2. Efforts to assess personal liability on the part of directors for corporate missteps have continued for some time. See, for example, Lauer, Slaughter, Greenburg and Massand, "Wanted: Corporate Directors Not Afraid to Face Millions of Dollars of Personal Liability Since We Cannot Afford D & O Insurance," *Committee on Corporate Counsel Newsletter of the American Bar Association Section of Business Law*(vol. 1, no. 1, August 2004).
3. For information about the Commission and the Guidelines, see http://www.ussc.gov/.
4. *In re Caremark,* 698 A.2d, at 967.
5. *Id.*, at 969.
6. *Id.*, at 970.
7. *Id.*, at 971.
8. *Id.*, at 972.
9. The existence of an "effective compliance and ethics program" entitles a business organization to credit upon sentencing under federal law. See §8B2.1 of the Guidelines.
10. *Stone v. Ritter* , 911 A.2d 362, 2006 Del. LEXIS 597 (2006), at p. 9.
11. 18 U.S.C. §3551 *et seq.*
12. Incarceration, a primary penalty for individuals convicted of crime, obviously has little applicability in the sentencing of organizations, which are not corporeal beings.
13. Chancellor Allen cited the Guidelines when he approved the *Caremark*settlement, saying that they ""offer powerful incentives for corporations today to have in place compliance programs to detect violations of law, promptly to report violations to appropriate public officials when discovered, and to take prompt, voluntary remedial efforts." *In re Caremark, supra*, n. 1, at 969.
14. The Guidelines themselves merely provided that "[i]f the offense occurred despite an effective program to prevent and detect violations of law, subtract 3 points" form the organization's culpability score. §8C2.5(f). The criteria by which to measure a compliance program's effectiveness appear in the form of a definition of the term "effective program to prevent and detect violations of law" in application note 3(k) to §8A1.2 of the Guidelines.
15. That report is available at http://www.ussc.gov/corp/advgrprpt/AG_FINAL.pdf.
16. §8B2.1(b)(2)(A) of the Guidelines.
17. §8B2.1(b)(2)(C).
18. Codified at 15 U.S.C. §78f.
19. Those Principles appear as Title 9, Chapter 9-28.000 of the United States Attorneys' Manual issued by the Department of Justice and posted at http://www.justice.gov/opa/documents/corp-charging-guidelines.pdf. Mr. Filip's memorandum followed earlier memoranda by various Deputy Attorneys General (Deputy Attorneys General Holder, Thompson, and McNulty) issuing previous versions of those guidelines.
20. §9-28.800(B) (Comment).
21. *Ibid.*
22. That settlement agreement is posted at http://judiciary.house.gov/hearings/pdf/deferredprosecution/Mellon060817.pdf.
23. See, for example, Dellastatious v. Williams, 242 F.3d 191 (CA4 2001) ("as long as directors have no knowledge that makes reliance unwarranted, they may rely on financial statements prepared by corporate officers, legal counsel, or public accountants.... [W]here shareholders allege that directors have insufficiently supervised the corporation's affairs, directors can avoid liability by showing that they attempted in good faith to ensure that an adequate corporate information-gathering and reporting system was in place") and McCall v. Scott, 239 F.3d 808 (CA6 2001) ("when director liability is predicated upon ignorance of liability creating activities only a sustained or systematic failure of the board to exercise oversight – such as an utter failure to attempt to assure a reasonable information and reporting system exists – will establish the lack of good faith that is a necessary condition to liability").