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Culture Is the Key to Employee Adherence to Corporate Codes of Ethics

THIS ESSAY FOCUSES ON SECTION 406 OF THE SARBANES-OXLEY ACT of 2002[1] and the purported impact of a corporation's adoption of a code of ethics. This Essay uses Enron as an example of a corporation that adopted a code of ethics, but did not encourage employees to comply with the code of ethics. This Essay suggests that adopting a code of ethics is not sufficient—corporations must encourage employees to follow the codes of ethics. Finally, this Essay offers some suggestions on how corporations can encourage employees to adhere to a code of ethics.

Specifically, section 406 directs the Securities and Exchange Commission (SEC) to issue rules requiring each public company to disclose in its periodic filings whether or not it has adopted a code of ethics that applies to certain key employees.[2] The final SEC rules define the term "code of ethics" as written standards that are reasonably designed to deter wrongdoing and to promote:

- honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
- full, fair, accurate, timely and understandable disclosures in reports and documents that a company files with or submits to the SEC and in other public communications made by the company;
- compliance with applicable governmental laws, rules and regulations;
- the prompt internal reporting of any violation of the code of ethics to an appropriate person or persons identified in the code of ethics; and

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1. Pub. L. No. 107-204, 116 Stat. 745, 789 (codified as amended at 15 U.S.C. § 7264). The Act's provisions apply to all U.S. and non-U.S. issuers required to file periodic reports with the Securities and Exchange Commission (SEC) pursuant to sections 13(a) or 15(d) of the Securities Exchange Act of 1934. Pub. L. No. 73-291, 48 Stat. 881, 894–96 (codified as amended at 15 U.S.C.A. §§ 78a–78mm (2002)).

2. *See* Sarbanes-Oxley Act § 406. The Congressional mandate specifically targeted the corporation's senior financial officers, including the "comptroller or principal accounting officer, or persons performing similar functions." *Id.* § 406(a). The SEC's final rules extend the scope of section 406 also to include the company's chief executive officer. *See* Disclosure Required by Sections 406 and 407 of the Sarbanes-Oxley Act of 2002, Securities Act Release No. 8,177, Exchange Act Release No. 47,235, 68 Fed. Reg. 5,110, 117–18 (Jan. 31, 2003).

- accountability for adherence to the code of ethics.[3]

Although companies are not actually required to have a code of ethics under the new SEC disclosure requirements, few companies wish to explain the absence of such a code.[4] As a result, many companies likely have since developed such a code that also covers subordinate employees.

In drafting section 406, Congress seemingly viewed a corporation's adoption of a code of ethics as evidence that it would undertake better corporate governance.[5] The corporation's required disclosure under section 406 of the code's existence purportedly also would alert investors and other capital market participants to that corporation's recognition of, and sensitivity to, the public's expectation of transparency about the corporation's values.[6] Indeed, one of the principal aims of the Act's sweeping changes in the areas of corporate governance is to ensure better transparency and accountability within corporations.[7] Unfortunately, as Enron Corporation ("Enron") demonstrated, merely having an established code of ethics is insufficient to halt unethical and illegal acts within the corporation.

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3. *See* Disclosure Required by Sections 406 and 407, 68 Fed. Reg. at 5,118. The SEC's final rules require public companies to disclose whether or not it has a code of ethics that applies to "the company's principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions." *Id.* at 5,110. The final rules took effect on March 3, 2003. *Id.*

4. *See* Sarbanes-Oxley Act § 406; *Testimony Concerning Implementation of the Sarbanes-Oxley Act of 2002, Hearing Before the S. Comm. on Banking, Hous. and Urban Affairs*, 103d Cong. pt. III.C.2 (2003) (statement of William H. Donaldson, Chairman, SEC), *available at* http://www.sec.gov/news/testimony/090903tswhd.htm [hereinafter *Testimony*]; Lisa M. Fairfax, *The Rhetoric of Corporate Law: The Impact of Stakeholder Rhetoric on Corporate Norms*, 31 J. CORP. L. 675, 694 (2006). Such a disclosure is based on a shaming technique. Cyrus Afshar & Paul Rose, *Capital Markets Competitiveness: A Survey of Recent Reports*, 2 ENTREPRENEURIAL BUS. L.J. 439, 462–63 (2007). Moreover, companies are free to determine their own specific ethical provisions, compliance procedures, and disciplinary measures for ethical breaches. *See* Joshua A. Newberg, *Corporate Codes of Ethics, Mandatory Disclosure, and the Market for Ethical Conduct*, 29 VT. L. REV. 253, 264 (2005) (describing the different types of corporate codes of ethics that have developed in response to section 406).

5. *Testimony*, *supra* note 4, at pt. I.

6. *See* Newberg, *supra* note 4, at 269 (explaining how ethical commitments in corporate codes may improve standing with "customers, investors, current and prospective employees, government entities, and communities"); S. Prakash Sethi, *Codes of Conduct for Multinational Corporations: An Idea Whose Time Has Come*, 104 BUS. & SOC'Y REV. 225, 226 (2000) (stating that corporations project ethical codes to assure their stakeholder constituencies, and the public at large, that they conduct their business in a highly ethical and professional manner).

7. The Act requires executive certification of reports and internal controls, provides for SEC rules prohibiting fraudulently influencing and misleading auditors, requires attorney reports of evidence of fraud, and protects whistleblowers. *See* Sarbanes-Oxley Act §§ 302, 303, 307, 806. However, much of the legislation was tied to specific aspects of the corporate frauds that occurred between 2001 and 2002, such as remedying the corporation's auditors, directors, and lawyers' failure to be informed of the actions of corporate actors. *Testimony*, *supra* note 4, at pt. II (explaining that "the boom years had been accompanied by fraud, other misconduct and a serious erosion in business principles," necessitating the Sarbanes-Oxley Act of 2002). It was not very proscriptive. For a discussion of the absence of articulated principles in this hallmark legislation, see Jeffrey M. Lipshaw, *Sarbanes-Oxley, Jurisprudence, Game Theory, Insurance and Kant: Toward a Moral Theory of Good Governance*, 50 WAYNE L. REV. 1083, 1085–89 (2004); *see also* Note, *The Good, the Bad, and Their Corporate Codes of Ethics: Enron, Sarbanes-Oxley, and the Problems with Legislating Good Behavior*, 116 HARV. L. REV. 2123, 2123 (2003) (explaining that allegations of accounting fraud shook investor confidence in 2001 and 2002 and "gave rise to widespread calls for the reform of corporate diligence, ethics, and controls").

In Enron's case, all employees were required to read and sign a sixty-five page, detailed and stringent set of ethical codes.[8] Reportedly, however, there was never any further discussion or training instituted to inculcate those standards in any employee.[9] In fact, numerous waivers of the ethical code were granted.[10] Enron's managers simply paid lip-service to the code's existence while touting the company's bottom line and emphasizing an "ends justifies the means" attitude.[11]

Rather than prove that corporate codes of ethics are mere "window dressing," however, I believe that the Enron example and the resulting section 406 provision are of beneficial import. Established corporate codes of ethics can serve as a guide to employees on how to deal with novel ethical situations and reveal the company's expectations for that individual's response.[12] However, as the Enron example illustrates, good corporate governance requires vigilance.[13]

It is, therefore, not enough for purposes of good corporate governance to adopt such codes and ensure that all corporate employees are *informed* of the acceptable ethical standards of behaviors and values adopted by the corporation. To be effective, corporations also must ensure that their codes of ethics become an integral part of the corporate culture, highly valued by the boards of directors, top manag-

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8. Indeed, according to then CEO Kenneth L. Lay,

> [a]s officers and employees of Enron Corp. . . . we are responsible for conducting the business affairs of the companies in accordance with all applicable laws and in a moral and honest manner.
>
> To be sure that we understand what is expected of us, Enron has adopted certain policies . . . which are set forth in this booklet. I ask that you read them carefully and completely and that, as you do, you reflect on your past actions to make certain that you have complied with the policies. . . . If you have any questions, talk them over with your supervisor, manager, or Enron legal counsel.

ENRON, CODE OF ETHICS 2 (2000), *available at* http://www.thesmokinggun.com/graphics/packageart/enron/enron.pdf.

9. *See* BRIAN CRUVER, ANATOMY OF GREED: THE UNSHREDDED TRUTH FROM AN ENRON INSIDER 346 (2002); Note, *supra* note 7, at 2130.

10. PERMANENT SUBCOMM. ON INVESTIGATIONS, S. COMM. ON GOVT'L AFFAIRS, THE ROLES OF THE BOARD OF DIRECTORS IN ENRON'S COLLAPSE, S. REP. NO. 107-70, at 25–38 (2002), *available at* http://www.senate.gov/~gov_affairs/070902enronboardreport.pdf; *see also* Charles M. Elson & Christopher J. Gyves, *The Enron Failure and Corporate Governance Reform*, 38 WAKE FOREST L. REV. 855, 860–62 (2003) (describing Enron's habitually-granted conflict of interest waivers which directly conflicted with the company's stated code of ethics policy).

11. *See, e.g.*, Newberg, *supra* note 4, at 275 (referring to the Enron Code of Ethics as mere "window dressing" where the company's board of directors granted several waivers of its code of ethics). *See generally* CRUVER, *supra* note 9 (describing the irony of Enron's code of ethics and the reality that would later befall the corporation).

12. *See* Emily F. Carasco & Jang B. Singh, *The Content and Focus of the Codes of Ethics of the World's Largest Transnational Corporations*, 108 BUS. & SOC'Y REV. 71, 72 (2003); Newberg, *supra* note 4, at 269 (explaining that codes of ethics within an organization may serve as tools of social control upon employees or as means for inspiring employee efforts in pursuit of such values as excellence, integrity, or the spirit of innovation); Betsy Stevens, *An Analysis of Corporate Ethical Code Studies: "Where Do We Go From Here?,"* 13 J. BUS. ETHICS 63, 64 (1994).

13. *See* Note, *supra* note 7, at 2130 (concluding that "[t]he Enron debacle makes clear that a corporate code of behavior is only as good as the people charged with enforcing it and those who must demonstrate the importance of compliance by their example").

ers, and their subordinate employees.[14] Stated differently, corporate employees need to *accept* the legitimacy of the corporation's codes of ethics before they will act effectively thereon.[15]

Arguably, *acceptance* of the ethical codes would be unnecessary if effective compliance systems[16] also are adopted, given that some individuals will comply with the corporate codes after engaging in a conscious evaluation of the risks associated with disobeying them.[17] Additional employees may comply with corporate codes of ethics because they are hardwired to be good citizens who engage in law-abiding behavior simply because it is just "the right thing to do" even when there are no legal sanctions for misbehaving.[18] Nevertheless, good corporate governance requires that *all* employees desire to comply with the corporate codes.

There is evidence that the remaining individuals can be led to avoid undesirable actions without ever having to consciously choose to do so where they can legitimize their obligation to follow a code of ethics.[19] In this respect, compliance with the corporate codes can occur where the corporate actors internalize their ethical obligations.[20] The corporate culture plays an important role in helping to create an atmosphere whereby the corporate codes become so-called *internalized obligational social norms.*[21] These norms can arise if the external obligation is equally valued by the employee's community.[22]

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14. *See id.* at 2137 (explaining that codes that corporate leaders visibly respect and comply with have the potential to change the behavior of an organization's employees).

15. Stephen M. Cutler, Dir., Div. of Enforcement, SEC, Speech at the Second Annual General Counsel Roundtable, Tone at the Top: Getting it Right (Dec. 3, 2004), *available at* http://www.sec.gov/news/speech/spch120304smc.htm.

16. The compliance system could provide for oversight and reprimands and other penalties for noncompliance. *Cf.* Newberg, *supra* note 4, at 264.

17. *See* Geraldine Szott Moohr, *An Enron Lesson: The Modest Role of Criminal Law in Preventing Corporate Crime*, 55 FLA. L. REV. 937, 956 (2003); Lisa H. Nicholson, *Sarbanes-Oxley's Purported Over-Criminalization of Corporate Offenders*, 2 J. BUS. & TECH. L. 43, 51–53 (2007).

18. *See* STEVEN VAGO, LAW AND SOCIETY 190 (Sharon Chambliss et al. eds., 5th ed. 1997) (1981) (noting that "[i]ndividuals develop self-control by being taught early what is appropriate, expected, or desirable in specific social situations . . . [and that people] acquire a motivation to conform to the norms, regardless of external pressures"). *But see* Richard A. Posner, *The Problematics of Moral and Legal Theory*, 111 HARV. L. REV. 1637, 1664–68 (1998) (suggesting that the desire to act because it is morally "the right thing to do" is not necessarily innate or hardwired, as an academic moralist may persuade one that any action is "the right thing to do").

19. *See* Moohr, *supra* note 17, at 940, 961. *See generally*, PAUL H. ROBINSON & JOHN M. DARLEY, JUSTICE, LIABILITY, & BLAME: COMMUNITY VIEWS AND THE CRIMINAL LAW (1995) (examining notions of criminal liability and punishment); Dan M. Kahan, *Social Influence, Social Meaning, and Deterrence*, 83 VA. L. REV. 349 (1997) (identifying and explaining social influence and social meaning on criminal law).

20. VAGO, *supra* note 18, at 16 (observing that social control rests largely on the internalization of shared norms). To a great extent, obedience to the law stems from a sense of moral obligation, which is the product of socialization. *Id.* at 310.

21. *See* Kaushik Basu, *Social Norms and the Law*, *in* 3 THE NEW PALGRAVE DICTIONARY OF ECONOMICS AND THE LAW 476 (Peter Newman ed., 1998) (defining internalized social norms).

22. *Id.*

Unsurprisingly, good leadership can and should set an ethical tone and promote an inculcation of good corporate values. The root should lie in the top suite and create a top-down endorsement, and a bottom-up adoption of good ethical behavior. In other words, the "tone at the top" should permeate throughout the corporate culture to modify the behaviors and attitudes of all corporate agents about what is expected.[23] Ethical precepts cannot compete against the board's desire to see results that meet or exceed past performance or the market's focus on the corporation's bottom line, however.[24]

We have seen, in the case of Enron, that ethical behavior was sublimated to the goal of driving up the corporation's stock price.[25] Consequently, the communication of good ethical standards must not clash with other authoritative communications about meeting the bottom line at all cost.[26] Rewarding only results-oriented behavior clearly undermines the existence of the code of ethics. Such actions also fail to take into account that established corporate ethics programs add value to corporations by strengthening the corporate brand, enhancing the corporate reputation in the marketplace, and enabling better recruitment and retention of the best employees.[27] Moreover, corporate codes of ethics may help to reduce litigation costs.[28]

That stated, corporations can inculcate adherence to their codes of ethics by creating a corporate culture of ethics, *inter alia*, (i) where employees are actively counseled that increased profitability should be met only through the application

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23. *Testimony*, *supra* note 4, at pt. III.C.2 (explaining that the code of ethics rules are expected to improve the "tone at the top" and executive responsibility); David A. Skeel, Jr., *Corporate Shaming Revisited: An Essay For Bill Klein*, 2 BERKELEY BUS. L.J. 105, 110 (2005) (describing how the "tone at the top" may encourage a healthier corporate culture); Note, *supra* note 7, at 2130; Curtis C. Verschoor, *It Isn't Enough to Just Have a Code of Ethics*, STRATEGIC FIN., Dec. 2002, at 22 (observing that "best practices on paper are of no consequence if an ethical corporate culture and proper 'tone at the top' are lacking"). *See generally* Cutler, *supra* note 15.

24. *See* Cutler, *supra* note 15 (explaining that even with a corporate code of conduct, if the bottom line is short term profits, the employee will only work to that end).

25. *See generally* CRUVER, *supra* note 9 (explaining that Enron's corporate culture of ethics changed when the company switched its focus to short term earning goals and quarterly reviews of its stock price).

26. *See* Cutler, *supra* note 15.

27. *See* Fairfax, *supra* note 4, at 708; Newberg, *supra* note 4, at 287–88 (explaining how firms actively compete on the basis of ethical commitments and performance). The Tylenol scare of the early 1980's provides an example of how a corporation can add to its value by acting ethically instead of for immediate profits. In the Tylenol scare, someone injected medicine with cyanide poison, resulting in several deaths and negative publicity for the maker of Tylenol—Johnson & Johnson. *See* N.R. Kleinfeld, *Tylenol's Rapid Comeback*, N.Y. TIMES, Sept. 17, 1983, at 33. Johnson & Johnson responded to the crisis by removing all Tylenol from shelves nationwide and re-engineering every Tylenol bottle to prevent tampering. *Id.* Johnson & Johnson undertook these actions in spite of the short-term loss in profits. *Id.* After all, Johnson & Johnson recognized that corporate brand and marketplace reputation are more important than short-term profits. Not surprisingly, Johnson & Johnson recovered its market share within six months of the crisis. *Id.*; *see also* Taryn Fuchs-Burnett, *Mass Public Corporate Apology*, 57 DISP. RESOL. J. 26, 82–83 (2002). *See generally* Jason Richardson & Eric Bolesh, *Toward the See-Through Corporation*, PHARM. EXEC., Nov. 1, 2002. Johnson & Johnson's handling of the Tylenol scare illustrates that a corporation's reputation in the marketplace will increase if the corporation acts ethically.

28. Carasco & Singh, *supra* note 12, at 72.

of the company's ethical values; (ii) that visibly and equitably rewards ethical behavior; (iii) that includes analysis of ethical conduct as part of employee performance reviews; (iv) that implements regular and on-going training about the importance of the corporation's ethical standard and corporate values; (v) that encourages different voices amongst decision-makers, including voices of dissent; (vi) that promotes whistle-blowing protections; and (vii) that provides for an immediate investigation and discipline of unethical behavior complaints. When corporations uncover unethical behavior they should sanction violators with additional training, verbal and written warnings, paid and unpaid leaves, termination, or legal action. These steps will help corporations to create a culture that embraces the code of ethics imposed by section 406, which is a necessary step if the codes of ethics are ever going to be practically effective.