§ 5.04 Codes of Business Conduct

Business conduct codes—sometimes analogized to the private laws of a private state—typically spell out expectations companies have of their directors, officers, employees and agents. Codes range from vision statements to detailed announcements of company policies on specific issues. The best code outline policies and procedures for implementing and enforcing the norms propagated by the code, and contain information on how violations can be reported, will be investigated, and will be penalized. Also key to a successful code is publication and communication to directors, officers, employees and agents of the company, as well as participation by these people in the development and continual revision of the code. The best codes are developed as living documents, undergoing revision both on a regular basis and as circumstances warrant. Designated individuals should be responsible for making such revisions.

Care must be taken not to place undue faith in the effectiveness of business conduct codes as drivers of ethical practices. Note for instance that the Special Investigative Committee of the board of directors of Enron Corporation concluded that Enron’s officers had failed to comply with that company’s Code of Conduct of Business Affairs in the chain of events leading to the firm’s collapse. While not necessarily in step with current thinking, at least one empirical study has concluded that ethical compliance programs do not lessen legal violations by companies.

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While companies should establish conduct codes, having such codes does not always result in improvements in actual practice. In explaining their results, the authors of the empirical study speculated that codes and compliance programs may be inherently ineffective, reflecting the fact that ethics cannot simply be implanted in a company. Additionally, some codes can do more harm than good by implying to officers, employees and agents of the company that those behaviors not specifically proscribed by the code are proper, even when unethical by any objective standard.

However, these discouraging empirical results may reflect a more fundamental truth: more important in creating a culture of ethics than any code is commitment to ethical principles by top management. Specifically, “[i]f employees think top management is the key to organizational ethics, and the behavior of top management does not match the behavior advocated by ethics program, this discrepancy will probably be enough to render the ethics program fairly useless.” Put another way, the company’s ethics are driven by its leaders, not some papers it issues to its employees and stakeholders. That said, corporate ethics that are well grounded through an effective and well communicated tone of ethics and compliance at the top, can be augmented through the publication and indoctrination of a code of ethics to directors, officers and employees. The laudatory benefit of such codes, in combination with other corporate therapeutics, no doubt justifies the continued focus on them as implements of effective corporate governance.

[1]—Federal Laws and Regulations Encouraging the Introduction of Codes of Conduct

In addition to prescribing, among other things, “internal control” mechanisms with respect to financial matters, regulators have also
sought to induce companies to introduce more comprehensive codes of conduct or ethics. The Federal Sentencing Guidelines have been identified as the impetus behind a proliferation of corporate “codes of conduct” establishing company policies on an assortment of matters. This proliferation probably results from a company’s ability to reduce its “culpability score” by demonstrating that it exercised due diligence in preventing and detecting criminal conduct. Part of the due diligence required the company to take “steps to communicate effectively its standards and procedures to all employees and other agents” by, \textit{inter alia}, “disseminating publications that explain in a practical manner what is required.”

\textbf{[a]—Sarbanes-Oxley Requirements}

Aside from the Federal Sentencing Guidelines, other federal laws also strongly encourage—and sometimes require—such codes, particularly in the corporate governance area. Most notably, Section 406 of the Sarbanes-Oxley Act mandates that the SEC issue rules requiring publicly traded companies “to disclose whether or not, and if not, the reason therefore, [the company] has adopted a code of ethics for senior financial officers, applicable to its principal financial officer and comptroller or principal accounting officer, or persons performing similar functions.” Technically, Section 406 does not require a company actually to develop and implement a code of conduct, it merely requires disclosure as to the existence of such a code. Furthermore, the requirement is technically limited to a small proscribed group. As a practical matter, however, the provision makes the potential negative fallout from disclosing the lack of a code of ethics enough for most companies to consider this a “requirement” and find it necessary to have a code that embraces a large segment of the corporate population, if not the population in its entirety.

Section 406 defines a “code of ethics” as “such standards as are reasonably necessary to promote: (1) honest and ethical conduct, in-
cluding the ethical handling of actual or apparent conflicts of interest between personal and professional relationships; (2) full, fair, accurate, timely, and understandable disclosure in the periodic reports required to be filed by the issuer; and (3) compliance with applicable governmental rules and regulations.”

Under the regulation, the SEC had ninety days to implement proposed rules under Section 406 and 180 days to issue final ones, which they did in January of 2003.

[b]—SEC Implementing Regulations

Under the implementing regulations published by the SEC, companies are required to disclose whether they have adopted a code of ethics applying to the company’s principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. Those companies failing to adopt such a code are required to provide an explanation. Disclosure of any code of ethics is to be made either as an exhibit to the company’s annual report, on the company’s Web page or in response to a request from any person, at no charge. “Code of Ethics” is defined in the regulation as written standards to deter wrongdoing and to promote:

- Honest and ethical conduct, including the ethical handling of actual or apparent conflicts between personal and professional interests;

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15 The SEC felt that it was consistent with the goals of Sarbanes-Oxley to extend the scope of its rules to include a company’s principle executive officer. In its words, it “seems reasonable to expect that a company would hold its chief executive officer, an official superior to the company’s senior financial officers, to at least the same standards of ethical conduct to which it holds its senior financial officers.” The final SEC rules therefore apply to the company’s principal executive officer, principal financial officer, principal accounting officer or controller, or persons performing similar functions. Id., 68 Fed. Reg. at 5118.
16 Id.
17 Id., 68 Fed. Reg. at 5119. As originally proposed, the SEC rules would have required the ethics code to be filed as an exhibit to a company’s annual report. However, many commentators objected to this approach. Most of the comments concerned the length of certain ethics codes and the difficulty of filing them on the SEC’s EDGAR electronic filing system. Also, several commentators suggested that some ethics codes contained significant detail that would be of little interest to investors. 68 Fed. Reg. at 5118-5119.
• Full, fair, accurate, timely, and understandable disclosure in reports and documents that a registrant files with, or submits to, the Commission and in other public communications made by the registrant;
• Compliance with applicable governmental laws, rules and regulations;
• The prompt internal reporting of code violations to an appropriate person or persons identified in the code; and
• Accountability for adherence to the code.\textsuperscript{18}

In the discussion accompanying the rules, the SEC noted its belief that the person identified in the code to whom reports of violations are to be made should have “sufficient status within the company to engender respect for the code and the authority to adequately deal with the persons subject to the code regardless of their stature in the company.”\textsuperscript{19} This is entirely consistent with the Federal Sentencing Guidelines proscriptions on the matter.

Likely inspired by the Enron case, the SEC rules also include specific provisions for the disclosure of:

• The nature of any amendment to the code of ethics applying to the company’s principal executive officer, principal financial officer, principal accounting officer or controller or persons performing like functions; and
• The nature of any waiver, including an implicit waiver, from a provision of the code of ethics provided to one of these officers, the name of that officer, and the date of the waiver.\textsuperscript{20}

\textsuperscript{18} Id., 68 Fed. Reg. at 5127. As can be seen from a comparison with the Sarbanes-Oxley definition of “code of ethics,” the SEC has broadened the definition by adding the fourth and fifth principles stated here, which the Commission felt to be consistent with the goals of the Act. 68 Fed. Reg. at 5118.

\textsuperscript{19} Id. 68 Fed. Reg. at 5118 n.45.

\textsuperscript{20} Id., 68 Fed. Reg. at 5119. Sarbanes-Oxley mandated that the SEC require “immediate disclosure” of any change or waiver from the company’s code of ethics. Sarbanes-Oxley Act of 2002 § 406(b), Pub. L. 107-204, 116 Stat. 745 (codified at 15 U.S.C. § 7264(b)). The term “waiver” is defined as “the approval by the registrant of a material departure from a provision of the code of ethics.” “Implicit waiver” is defined as “the registrant’s failure to take action within a reasonable period of time regarding a material departure from a provision of the code of ethics that has been made known to an executive officer.” SEC Rel. No. 33-8177, 68 Fed. Reg. 5110, 5129 (Jan. 31, 2003).
A company may disclose these items via Form 8-K within five business days after it amends its ethics code or grants the waiver. Alternatively, it may supply the disclosure on its Web page, but only if, in its most recently filed annual report on Form 10-K or 10-KSB, it has announced both its intention to do so and the relevant Web site.21

[2]—Listing Rules Encouraging the Introduction of Codes of Conduct

[a]—NYSE Rules

Propelled by the same concerns underlying the Sarbanes-Oxley Act and the SEC regulations, the major stock exchanges have implemented changes that require codes of conduct.

Prompted by a request from the SEC that it review its corporate governance standards, in June 2002 the NYSE published the report of its Corporate Accountability and Listing Standards Committee.22 Among many other recommendations, the Committee recommended that listed companies be required “to adopt and disclose a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors or executive officers.”23 Any waiver of the code for executive officers or directors should be made “only by the board or a board committee,” and would be disclosed promptly to shareholders.24 The Committee reasoned that

“This disclosure requirement should inhibit casual and perhaps questionable waivers, and should help assure that, when warranted, a waiver is accompanied by appropriate controls designed to protect the company. It will also give shareholders the opportunity to evaluate the board’s performance in granting waivers.”25

23 Id. at 20.
24 Id.
25 Id.
Subsequently, in its proposal to the SEC, the NYSE adopted the recommendations of the Committee. On November 4, 2003, the SEC approved the NYSE Listing Standards, including the code of conduct provision, and the rules became effective. Specifically, the NYSE provision states that “listed companies [must] adopt and disclose a code of business conduct and ethics for directors, officers and employees, and promptly disclose any waivers of the code for directors or executive officers.” The NYSE rules provide that each code of business conduct must be available on the company’s Web site, be made available free to shareholders upon request and that the company’s Form 10-K, filed with the SEC, indicate the availability of the code of business conduct.

The NYSE deliberately chose a flexible approach to the code of conduct as it specifically recognized that “[n]o code of business conduct and ethics can replace the thoughtful behavior of an ethical director, officer or employee.” Instead, the intent of the code is to “focus the board and management on areas of ethical risk, provide guidance to personnel to help them recognize and deal with ethical issues, provide mechanisms to report unethical conduct, and help to foster a culture of honesty and accountability.”

Moreover, as a recognition that a mere paper code, without more, cannot induce proper behavior, the commentary noted that “[e]ach code of business conduct and ethics must also contain compliance standards and procedures that will facilitate the effective operation of the code.” It further noted that “[t]hese standards should ensure the prompt and consistent action against violations of the code.” The message is unmistakable: no longer will companies be permitted simply to publish standards—behavior must follow the articulated standards.

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29 Id. at 19.
30 Id. at 20.
31 Id.
32 Id.
33 Id.
In addition, in the discussion accompanying the rule, the NYSE, while recognizing that listed companies should determine and address the most important topics to the company, a code of conduct should, at a minimum, address the following:

- **Conflicts of Interest.** The policy should prohibit conflicts of interest and provide a means for employees, officers and directors to communicate potential conflicts to the company. The NYSE provision employs a broad definition of conflict of interest to include not only situations where a person’s private interests directly interfere with the exercise of his or her responsibilities to the corporation but where such interests might appear to interfere. Conflicts of interest are said to arise where an officer, director or employee takes actions or has interests that make it difficult to perform his or her work objectively and effectively or where any of these individuals (or members of their immediate family) receives improper personal benefit (especially loans or guarantees of obligations).

- **Corporate Opportunities.** The NYSE policy emphasizes the primacy of the corporate interest over any individual interests and requires that officers, directors and employees have a duty to advance the legitimate interests of the company when there is an opportunity to do so. The NYSE directs that companies’ policies should prohibit employees, officers and directors from (1) taking for themselves personally opportunities that are discovered through the use of corporate property, information or position; (2) using corporate property, information, or position for personal gain; and (3) competing with the company.

- **Confidentiality:** The policy should require employees, officers and directors to maintain the confidentiality of information entrusted to them by the company or its customers, except when disclosure is authorized or legally mandated. Confidential information is defined relatively broadly to include all nonpublic information that might be of use to competitors or harmful to the company or its customers. It does not include the use of publicly avail-
able information, highlighted in unhelpful ways, although it should be expected that corporate codes of conduct will likely include such misuse of information.

• **Fair Dealing.** The NYSE seeks for companies (and their agents) to deal fairly with others, such as customers, suppliers and employees. Accordingly, the NYSE suggests that company policies bar employees, officers and directors from taking unfair advantage of anyone through manipulation, concealment, abuse of privileged information, misrepresentation of material facts, or any other unfair-dealing practice while not altering existing legal rights and obligations.

• **Protection and Proper Use of Company Assets.** The NYSE recognized that each dollar (in cash or in-kind) that is misdirected from a legitimate corporate purpose adversely impacts a company’s bottom line and as such harms shareholders. The NYSE suggests that company policies should instruct all employees, officers and directors to protect the company’s assets and ensure their efficient use.

• **Compliance with Laws, Rules and Regulations (Including Insider Trading Laws).** The company’s policy should proactively promote compliance with laws, rules and regulations, including insider trading laws. The NYSE further instructs that insider trading is illegal and unethical and should be dealt with decisively.

• **Encouraging the Reporting of Any Illegal or Unethical Behavior.** The NYSE seeks to encourage an open-door policy among employees and their management both in terms of reporting violations and with respect to asking questions regarding the company’s standards and their applicability to specific behavior. The NYSE suggests that company policies should encourage employees to talk to supervisors, managers or other appropriate personnel when in doubt about the best course of action in a particular situation. To encourage employees to report ethical or legal violations, the company must ensure that
employees know that the company will not allow retaliation for reports made in good faith.\textsuperscript{34}

Like the Corporate Accountability and Listing Standards Committee report, the NYSE requires that any waiver of the code for executive officers or directors to be made by the board or committee of the board and followed by prompt disclosure to the shareholders.\textsuperscript{35}

[b]—NASD/NASDAQ Rules

NASDAQ also proposed rule changes requiring the introduction of company codes of conduct. The SEC approved the NYSE standards and the NASDAQ proposals in the same release.\textsuperscript{36} Under the NASDAQ rules, listed companies are required to adopt a code of conduct for all directors, officers and employees.\textsuperscript{37} The code must be made publicly available and must meet the definition of a “code of ethics” set out in Section 406(c) of the Sarbanes-Oxley Act and any regulation adopted pursuant to that Act.\textsuperscript{38}

While the rule does not set out the content of the code in a fashion analogous to the NYSE rule, the NASDAQ rule requires that ethical behavior is expected of every officer, director or employee, irrespective of the existence of a code.\textsuperscript{39} The code must demonstrate that the board and management have created a system to become aware of and respond to questionable behavior.\textsuperscript{40}

NASDAQ also requires disclosure of any waiver of the code’s provisions for executive officers or directors. Specifically, any such waiver must be made only by the board and must be disclosed promptly to shareholders, along with the reasons for the waiver.\textsuperscript{41}

\textsuperscript{35} Id., 68 Fed. Reg. at 19057.
\textsuperscript{36} See SEC Rel. No. 34-48745, 2003 SEC LEXIS 2654 (Nov. 4, 2003). The proposed NASDAQ rule was amended to clarify: (1) that any waivers of the company’s code of conduct for directors or officers be disclosed in a Form 8-K report within five days, and (2) that the code of conduct requirements did not apply to management investment companies, asset-backed issuers, and unit investment trusts. 2003 SEC LEXIS 2654 at *143.
\textsuperscript{38} Id.
\textsuperscript{39} Id.
\textsuperscript{40} Id.
\textsuperscript{41} Id., 68 Fed. Reg. at 41195.
“Promptly” has been clarified to mean that disclosure must be made on a Form 8-K within five days of any waiver.\footnote{SEC Rel. No. 34-48745, 2003 SEC LEXIS 2654 at *143 (Nov. 4, 2003).}

The NASDAQ rules also require a code that contains an enforcement mechanism ensuring prompt and consistent oversight of the code, protection for persons reporting questionable behavior, clear and objective standards for compliance, and a fair process by which to determine violations.\footnote{SEC Rel. No. 34-48125, 68 Fed. Reg. 41194, 41195 (July 10, 2003).}

[c]—AmEx Rules

AmEx also adopted rules requiring the introduction of company codes of conduct and ethics. Under the AmEx rules, listed companies are required to adopt a code of conduct and ethics that applies to all directors, officers, and employees in the company. The code must be publicly available. The code requires companies to comply with the definition of a “code of ethics” set out in Section 406 of SEC Regulation S-K or Item 406 of SEC Regulation S-B if the company files under SEC Regulation S-B.\footnote{American Stock Exchange, Company Guide, § 807, available at http://wallstreet.cch.com/AMEX/ (last visited June 28, 2006) (follow “Company Guide” hyperlink; then follow “Corporate Governance” hyperlink). SEC recognized AmEx’s adoption of regulations for companies. See SEC Rel. No. 33-8400, 69 Fed. Reg. 15593, 15602 (March 25, 2004).}

The AmEx rules take a flexible approach to standards and guidelines. AmEx employs a goal-oriented approach to promote honest and ethical conduct that extends to actual or apparent conflicts between personal and professional relationships. AmEx requires all waivers to be approved by the company’s board of directors and disclosure in an SEC Form 8-K within five days of such waiver.\footnote{Id. at § 807 (Commentary).}

[3]—Legal Risks of Codes of Conduct

The listing rules make business conduct codes mandatory. These listing rules must, of course be considered in conjunction with the Federal Sentencing Guidelines, the Sarbanes-Oxley provisions and the SEC rules, all of which strongly encourage companies to adopt codes of conduct and compliance mechanisms. In fact, failure to introduce codes (even prior to the requirements now imposed by the exchanges)
could expose directors to liability for gross negligence or otherwise render them susceptible to liability through shareholder derivative lawsuits.

It must be recognized, however, that business conduct codes can create enhanced litigation risk. Thus, with respect to the Sarbanes-Oxley rules, some observers warn that companies “will face liability under the Securities and Exchange Act of 1934 for their codes of ethics and could potentially even be subject to private rights of action.”

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46 Schehr, Note, “An Analysis of a Corporate Director's Duty to Ferret Out Wrongdoing: Have the Federal Sentencing Guidelines Effectively Overruled Graham v. Allis Chalmers?,” 42 Wayne L. Rev. 1617, 1642-1643 (1996) (“based upon the risk of substantial losses to a criminal corporate defendant, a failure to install a compliance program pursuant to the Guidelines would be considered a potential waste of corporate assets. Such disregard of long-term risk based on short-term cost cannot be reasonably considered as in the corporation's best interests, and should be considered gross negligence. Further, because compliance programs are commonplace in corporate America, a director's decision not to implement such a program could logically be thought of as a decision that an ordinary prudent director in good faith would not make. Thus, the failure to implement a proper compliance program pursuant to the Guidelines should result in a breach of the fiduciary duty of care.”); Nunes, Comment, “Organizational Sentencing Guidelines: The Conundrum of Compliance Programs and Self-Reporting,” 27 Ariz. St. L.J. 1039, 1055 (1995) (“[A] director's failure to establish an effective compliance program may constitute gross negligence. A director's failure to self-report may result in the same liability when the director could have saved the corporation thousands of dollars in fines by reporting to the authorities in a timely fashion”).

47 See: Maurer, Comment, “The Federal Sentencing Guidelines for Organizations: How Do They Work and What Are They Supposed to Do?” 18 Dayton L. Rev. 799, 831 (1993) (“[u]nder the Organizational Guidelines system, an organization must establish a compliance program. Failure to establish such a program could constitute professional malpractice, exposing a corporation and its officers and directors to shareholder derivative lawsuits where a drastic fine has been imposed”); Lynch and Merrill, “Enforcement in the 1990s: The Corporate Response - The United States Sentencing Commission Guidelines” in Twenty-Third Annual Institute on Securities Regulation, No. B4-6978 at p. 464 (PLI/Corp. Law and Practice 1991) (“Corporations will have to implement rigorous internal mechanisms to deter, detect and report employees' criminal activity or risk substantial fines and exposure to shareholder derivative suits.”).

48 See Letter from Mark Nebergall, President, SoFTEC on the Sarbanes-Oxley code of conduction provisions (Nov. 25, 2002) (hereinafter “Nebergall Letter”), available at http://www.sec.gov/rules/proposed/s74002/mnebergall1.htm (last visited March 1, 2007) (“We are concerned companies may be subject to harassment lawsuits seeking enforcement of codes of ethics. Such lawsuits would be expensive to defend and distract management from their day-to-day duties of running the company”).

Of course, liability can be most easily predicted where companies do not follow the clear edicts imposed on them such as for failing to disclose waivers of a code of ethics. In addition, a company that implements purely paper policies and then does not adequately communicate or enforce such policies creates significant regulatory and private civil litigation exposure. While in the past it might have been said that a company is better served by not adopting policies than adopting them and failing to follow them, the current regulatory requirements force both adoption and compliance.

50 Lublin and Emshwiller, “Enron Board’s Actions Raise Liability Questions,” Wall Street Journal, p. C1 (Jan. 17, 2002). By way of analogy, see Lutz v. Boas, 171 A.2d 381, 396 (Del. Ch. 1961) (directors of investment company liable, in part, because had they discharged their responsibilities as to general supervision they would have discovered violations of the company’s investment policy). Also, while not entirely on point, there are cases suggesting companies are liable to employees for not following announced employment policies. See, e.g.:

Second Circuit: Raymond v. International Business Machines Corp., 954 F. Supp. 744, 748 (D. Vt. 1997) (“At-will employment contracts may be modified by express agreement, statute, public policy, the personnel policies or practices of the employer, and actions or communications by the employer reflecting assurances of continued employment). (Emphasis added.)

State Courts:


Georgia: Dodd v. City of Gainesville, 268 Ga. App. 43, 601 S.E.2d 352 (2004) (the City was not negligent for overpaying a retired employee because the employee could have calculated the correct retirement amount by using the formula in the employee handbook).
