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CHIPPING AWAY AT COMPLIANCE: HOW COMPLIANCE PROGRAMS LOSE LEGITIMACY AND ITS IMPACT ON UNETHICAL BEHAVIOR

David Hess[*]

ABSTRACT

Employee perceptions of an organization's compliance program are critical. A program that has lost legitimacy with its employees is not just ineffective, but it creates more harm than good by leading to more unethical behavior. This Article identifies ways in which compliance programs can start to lose legitimacy, explains how that lost legitimacy leads to increased wrongdoing, and then concludes by setting out some basic reforms focused on helping stop this downward spiral and protecting the legitimacy of the compliance function.

INTRODUCTION

Jump-started by the Organizational Sentencing Guidelines over twenty-five years ago, compliance programs rapidly spread and became a common practice.[1] Today, compliance is now its own profession[2] and academic field of study.[3] Despite these developments, the media is still telling the same stories of dramatic corporate compliance failures; that is, a toxic corporate culture has led to significant, and often widespread, wrongful behavior by employees.[4] For example, the investigation into Barclays' involvement in

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1. For a history of the development of compliance programs, *see* David Hess, *Ethical Infrastructure and Evidence-Based Corporate Compliance and Ethics Programs: Policy Implications from the Empirical Evidence*, 12 N.Y.U. J. L. & BUS. 317, 324–40 (2016).

2. Cristie Ford & David Hess, *Can Corporate Monitorships Improve Corporate Compliance?*, 34 J. CORP. L. 679, 692–93 (2009).

3. *See, e.g.*, COMPLIANCENET, https://www.compliancenet.org (last visited Aug. 30, 2019) (an organization of academics studying compliance).

4. Jennifer Wells, *Transparency in the Face of Harassment: We Want the Facts on How Corporations Deal with Sexual Harassment*, TORONTO STAR, Oct. 29, 2018, at B1 (discussing allegations of a "toxic corporate culture" at Nike that involved unfair pay practices and dismissal of allegations of sexual harassment); Julie Creswell et al., *At Nike, Revolt Led by Women Leads to Exodus of Male Executives*, N.Y. TIMES, (Apr. 28, 2018), https://www.nytimes.com/2018/04/28/business/nike-women.html (stating that life for women at Nike had "turned toxic" due to a culture that ignored allegations of sexual harassment); Elizabeth Knight, *Uber Pays a $26 Billion Price of Toxic Culture*, SYDNEY MORNING HERALD (June 30, 2017), https://www.smh.com.au/business/uber-pays-a-26-billion-price-for-its-toxic-corporate-culture-20170630-gx1x3w.html (noting that the company's estimated loss of US $20 billion in value was due to a series of scandals, including alleged theft of intellectual property, sexual harassment, and

the London Interbank Offered Rate (LIBOR) rigging scandal pointed to the relevant department's focus on meeting short-term financial targets (and not serving clients' needs), a lack of articulated and shared values to guide employees' decision making, and unwillingness of top management to hear bad news.[5] General Motors' failure to correct its deadly ignition switch problem was blamed on a culture where everyone sought, and was able to avoid responsibility and accountability, and they feared retaliation for speaking up.[6] At Wells Fargo, the corrupt cross-selling scandal was due to an employee incentive system that strongly encouraged unethical behavior. Rather than recognizing the systematic pressure placed on employees, Wells Fargo took what investigators called a "narrow 'transactional' approach" to any issues that arose and treated them individually; in other words, the company's attempts to address the problems focused on individuals as bad actors and refused to look at the influence of situational pressures created by company practices.[7]

Of course, those headline-grabbing scandals of corporate cultures that pressure employees to commit wrongdoing and/or not report the wrongdoing that they observe are the exceptions in terms of their size and impact. However, they are not the exceptions in terms of their ubiquity. For many years, the Ethics and Compliance Initiative has conducted a business ethics survey.[8] One of their questions asks employees if they have faced pressure to compromise company standards. Starting in 2000, 14% of employees stated that they had faced such pressure.[9] With the exception of 2009, this figure has always been in double digits and reached a high of

workplace bullying); Jon Picoult, *What Went Awry at Wells Fargo? The Beaten Path of a Toxic Culture*, N.Y. TIMES (Oct. 8, 2016), https://www.nytimes.com/2016/10/09/jobs/what-went-awry-at-wells-fargo-the-beaten-path-of-a-toxic-culture.html (discussing how toxic corporate cultures at Wells Fargo, Volkswagen, G.M., and Veterans Affairs, led to widespread wrongdoing).

5. ANTHONY SALZ, SALZ REVIEW: AN INDEPENDENT REVIEW OF BARCLAYS' BUSINESS PRACTICES 6–7 (2013).

6. ANTON R. VALUKAS, REPORT TO BOARD OF DIRECTORS OF GENERAL MOTORS COMPANY REGARDING IGNITION SWITCH RECALLS 252–53, 255–56 (2014).

7. INDEPENDENT DIRECTORS OF THE BOARD OF WELLS FARGO & COMPANY SALES PRACTICES INVESTIGATION REPORT 1, 13 (2017). At Wells Fargo, employee promotions were based heavily on sales performance. *Id.* at 28. These limited promotion criteria became institutionalized in the organization as "witnesses said that inexperienced bankers frequently were promoted based on sales success and became inexperienced managers who understood that success was measured by sales performance." *Id.* These managers then pressured employees to focus only sales goals, and in some cases even taught employees how to manipulate the system to avoid detection. *Id.* at 37-38. There was significant evidence that it was this pressure, and not simply an individual employee's desire for increased compensation, that fueled the unethical and illegal sales practices. *Id.* at 38. Even when presented with these problems, management refused to change the sales incentives system for fear of reducing sales and instead focused on increased training and punishing of individual wrongdoers. *Id.* at 3, 46.

8. *See* ETHICS & COMPLIANCE INITIATIVE, THE STATE OF ETHICS & COMPLIANCE IN THE WORKPLACE 1, 4 (2018).

9. *Id.* at 8.

16% in the most recent survey conducted in 2017.[10] In addition, in 2017, of those employees that faced pressure to violate standards, 63% of them stated that their company rewarded "questionable practices."[11] Among those employees that stated they did not face pressure, one-third also stated that their company rewarded "questionable practices."[12]

A properly implemented compliance program should reduce those pressures on employees and correct misguided financial incentives. However, an effective compliance program requires that the company's top management are involved in oversight, the company devotes sufficient organizational resources to compliance, and managers throughout the organization have a commitment to compliance values.[13] Unfortunately, many corporations are unwilling to make the commitment to ensure they have a well-resourced compliance program in place that is supported by an ethical corporate culture. Instead, due to the "compliance game," many corporations have little incentive to move much beyond symbolic efforts.[14] The "commodification of compliance" (due to indistinguishable programs and solutions) and the inability of regulators to evaluate compliance program effectiveness,[15] creates the following ruse:

> This is a game that seeks optimal compliance expenditures to minimize liability risks, gives all players moral and legal cover, placates constituencies with the appearance of legitimacy, and offers beautifully crafted images of leadership and governance with integrity. This game is aligned with a regulatory system that possesses a very limited capacity for determining the effectiveness and genuineness of compliance, and even less commitment to aggressively using the corporate criminal law.[16]

This approach to compliance is not only a significant waste of time and resources for those companies that engage in merely half-hearted attempts at compliance, but it could also result in an increase of wrongdoing. The focus of this Article is when and how a poorly implemented compliance program can actually lead to more wrongdoing. For example, if management views short-term business interests as conflicting with the

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10. *Id.*

11. *Id.*

12. *Id.*

13. *See* Christine Parker & Vibeke Lehmann, *Corporate Compliance Systems: Could They Make Any Difference?*, 41 ADMIN. & SOC'Y 3, 28–29 (2009).

14. William S. Laufer, *The Missing Account of Progressive Corporate Criminal Law*, *14 N.Y.U. J. L. & BUS. 71*, 112–14 (2017).

15. *See* Eugene Soltes, *Evaluating the Effectiveness of Corporate Compliance Programs: Establishing a Model for Prosecutors, Courts, and Firms*, 14 N.Y.U. J. L. & BUS. 965, 970–74 (2018) (describing the various challenges in measuring the effectiveness of compliance programs, including lack of agreement on metrics and lack of appropriate data).

16. Laufer, *supra* note 14 at 112–13. "Ultimately, stakeholders in this game seek to protect and enhance their positions without disturbing the equilibrium and, remarkably, without concern for whether their efforts actually affect rates of offending behavior." *Id.* at 113.

compliance program, then they may decide to allow an exception to a compliance program rule. This exception chips away at the compliance program's legitimacy and can do lasting damage. Over time, due to repeated exceptions and other problems identified below, the problem festers. The compliance program not only becomes ineffective, but it leads to increased wrongdoing.

This Article proceeds as follows. Part I presents two different, but often working in tandem, ways that corporate actors can inadvertently diminish the legitimacy of the compliance program. Part II discusses how an illegitimate compliance program can lead to an increase in unethical and illegal behavior. Part III suggests reforms to help protect against this process of a compliance program slowly losing its legitimacy within the organization.

I. HOW COMPLIANCE PROGRAMS SLOWLY CHIP AWAY

Many legal commentators have criticized the effectiveness of compliance programs. Some, using such terms as "cosmetic compliance" or "paper programs," focus on managers intentionally failing to implement a compliance programs.[17] Consequently, the compliance program becomes decoupled from actual practice in the organization in a manner that causes the compliance program, and the values behind the program, to lose legitimacy.[18] As with decoupling for many types of organizational practices, however, this process can also begin with unintentional managerial behavior.[19] This Part discusses how that inadvertent decoupling process can start to occur. The following highlights recent research that discusses two general ways that compliance programs start to chip away.

A. RESISTANCE TO CHIEF ETHICS AND COMPLIANCE OFFICERS

The Chief Ethics and Compliance Officer (CECO)—which may go by different titles depending on the organization—is the individual in charge of designing and implementing the company's compliance program. For CECOs to effectively do their job, they must have legitimacy, which is the

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17. Ford & Hess, *supra* note 2, at 694–95 (describing "paper programs" as compliance programs that result when "corporations adopt policies and procedures on paper but do not embed them into their actual operations"); Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L.Q. 487, 487, 491–93 (2003) (arguing that companies can seek to avoid liability without changing problematic practices by simply "mimicking an effective compliance system"); *See* Parker & Lehmann, *supra* note 13, at 9–11 (reviewing criticisms of compliance programs, including management intentionally implementing compliance programs in a way that does change company practices).

18. *See infra* Part II.

19. Patricia Bromley & Walter W. Powell, *From Smoke and Mirrors to Walking the Talk: Decoupling in the Contemporary World*, 6 ACAD. MGMT. ANNALS 1, 2 (2012).

perception by others that their actions are proper and appropriate.[20] This perception of legitimacy is essential because CECOs are setting the standard for ethical behavior in the organization and may be asking employees to undertake activities that they are uncomfortable doing (e.g., reporting misconduct).[21]

Recent research finds that CECOs regularly face challenges to their legitimacy.[22] First, CECOs lose legitimacy in the eyes of others within the organization because they face challenges in measuring the effectiveness of their work and the compliance program, and encounter obstacles in demonstrating how they add value to the organization.[23] Second, many managers and employees believe that they are ethical people and do not need the assistance of the CECO to ensure their compliance with the rules, especially in the absence of a rules violation crisis that would provide direct evidence to the contrary.[24] In addition, managers are less likely to view themselves as lacking ethics knowledge compared to knowledge from other business disciplines.[25] Third, CECOs lose legitimacy because compliance is often viewed as an impediment to achieving business imperatives.[26] This does not necessarily mean a complete rejection of the program, but managers may seek selective enforcement of rules by avoiding the rules that they perceive as most directly clashing with business goals.[27] Fourth, the organization's legal department may view the work of the CECO as conflicting with their goal of protecting the organization.[28] Because the legal function within organizations has significant legitimacy,[29] the organization often prioritizes the legal department's protection goals over the CECO's goals of identifying and correcting ethical and legal problems, which further diminishes the CECO's authority and legitimacy.[30]

B. MANAGER RATIONALIZATIONS

Rationalizations and the related concept of "moral disengagement," are long-recognized as ways that individuals are able to engage in wrongdoing, for their own benefit or the benefit of their organization, without viewing

20. Linda Klebe Treviño et al., *Legitimating the Legitimate: A Grounded Theory Study of Legitimacy Work Among Ethics and Compliance Officers*, 123 ORG. BEHAV. & HUM DECISION PROCESSES 186, 187 (2014).

21. *Id.*

22. *Id.* at 189–90.

23. *Id.* at 191.

24. *Id.* at 191, 194.

25. *Id.* at 194.

26. *Id.*

27. *Id.*

28. *Id.*

29. This level of legitimacy is credited to the long-standing history of corporations having a legal department, the standing accorded the legal profession, and the legal department's role in protecting the organization. *Id.*

30. *Id.*

themselves as violating social norms on ethical behavior;[31] the individual views his or her action as an exception to the ethical norm as opposed to a violation of that norm.[32] Examples of such rationalizations, or disengagement strategies, include the excuses that the action is not technically illegal, no one is actually harmed by the action, and loyalty to the actor's in-group members is more important than obligations to broader society.[33] Moral disengagement in organizations is described as follows:

> [M]oral disengagement may assist individuals in more easily and expediently making unethical decisions that are in the organization's interest. Moral disengagement may ease unethical decision-making by pre-empting the psychological discomfort . . . experienced by individuals at the prospect of making an organizationally valued but morally questionable decision. . . . Moral disengagement may also expedite unethical decisions by operating to shield competing values from adding to the cognitive complexity of the decision.[34]

Rationalizations and moral disengagement are well-recognized concepts for understanding why individuals commit wrongdoing in organizational settings, but these concepts also come into play when understanding why compliance programs start to break down. In this context, the concern is that even if a compliance program works as designed and catches the rule violation, then the rule violation may be ignored due to managers rationalizing away the necessity to take corrective action. This can be a key step in the chipping away of the effectiveness of the compliance program.

As an illustration of this process, a recent study finds that many managers use rationalizations to avoid dealing with observed misconduct.[35] These researchers studied occupational fraud, which is fraud committed by an employee against his or her employer.[36] Occupational fraud may be committed individually by the employee or by working with a customer of the employer, such as by inflating a contract price for purposes of funding a bribe paid by the customer to the employee.[37] The study identified a variety of rationalizations managers used to convince themselves to overlook

31. *See* Alexander Newman et al., *Moral Disengagement at Work: A Review and Research Agenda*, J. BUS. ETHICS at 5–6 (2019) (noting the "significant overlap" between the concepts of rationalizations and moral disengagement).

32. Blake E. Ashforth & Vikas Anand, *The Normalization of Corruption in Organizations*, 25 RES. ORG. BEHAV. 1, 15–16 (2003).

33. *Id.* at 18–19, 21.

34. Celia Moore, *Moral Disengagement in Processes of Organizational Corruption*, 80 J. BUS. ETHICS 129, 132 (2007) (emphasis omitted).

35. David Shepherd & Mark Button, *Organizational Inhibitions to Addressing Occupational Fraud: A Theory of Differential Rationalization*, 40 DEVIANT BEHAV. 971, 971 (2019).

36. *Id.*

37. *Id.* at 974.

instances of occupational fraud they discover.[38] Managers may overlook fraud as a way to protect the perceived financial interests of the organization. For example, ignoring the violation avoids the operational disruption that would be caused by dealing with the fraud[39] and avoids any negative commercial impact that could result from the public disclosure of management's failure.[40] In one organization, management refused to investigate claims of fraud because doing so would go against the organization's core value of trusting its employees.[41] Managers may also overlook fraud to protect themselves. They "fear the exposure of fraud and other illegalities within their departments . . . will reflect poorly on them and threaten their [career] prospects."[42]

Overall, the researchers found "managers use the same rationalizations as occupational [fraud] offenders, at times mixing a befuddling cocktail of self-justifications, in order to maintain their perception of themselves as responsible, moral persons."[43] To reduce the overlooking of fraud, the authors advocate for organizations to directly target those rationalizations.[44] For this Article, the significance of their findings is in showing one way that the legitimacy of a company's compliance program starts to deteriorate. A "culture of compliance" is not possible when managers are able to rationalize away their compliance duties.

C. SUMMARY

Part I highlighted recent research showing two ways in which compliance programs can start to lose legitimacy. In many organizations, the legitimacy of the CECO's position and work is challenged from the beginning due to other organizational actors' perceptions of compliance and ethics. This legitimacy is further chipped away when managers rationalize away their compliance obligations. This is the start of a downward spiral. Part II explores the continuation of this downward spiral and the research showing how this may result in increased unethical behavior.

II. THE DANGERS OF FAULTY COMPLIANCE PROGRAMS

A compliance program that lacks legitimacy is not just ineffective but is a risk factor for increased wrongdoing in the organization. The broken windows theory of disorder provides a simple, introductory example. In short, this theory suggests that visible signs of disorder lead to additional

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38. *Id.* at 977.
39. *Id.* at 977–78.
40. *Id.* at 978.
41. *Id.* (noting that the organization's adherence to the value of trust had become warped and was now used as "a shield for criminality rather than a protection against it").
42. *Id.* at 982.
43. *Id.* at 987.
44. *Id.* at 988.

disorder.[45] Recent research expands upon this theory and shows that this problem is exacerbated when actors observe the wrongful behavior in direct violation of prohibitions on that conduct.[46]

Researchers conducted multiple experiments on the impact of "anti-litter" prohibition signs on individuals' littering behavior when litter was visibly present in the area and when it was absent.[47] Most relevant for our discussion, the researchers found the presence of a prohibition sign in the area where litter was present made non-compliance more salient and led to increased littering compared to a situation where there was littering present but no prohibition sign.[48] In addition, not only did the clear evidence of non-compliance with the rule in the presence of a prohibition sign further increase non-compliance with that rule, but it also increased non-compliance with other norms of appropriate behavior.[49] For example, the presence of graffiti near a graffiti prohibition sign (which made the non-compliance more salient) increased littering (compared to a setting with graffiti but no prohibition sign).[50] By contrast, the lack of graffiti by a graffiti prohibition sign made compliance with a norm more salient and reduced the amount of littering.[51] As it relates to organizational compliance, one "must look at how the stated rules and values of the corporation are at odds with the practices and implied values, as this will stimulate extra rule offending as it delegitimizes compliance (when organizations stress values in line with the law that are commonly broken in practice)."[52] The following sections provide a brief review of theory and evidence supporting the argument that an illegitimate compliance program can lead to increased wrongdoing.

A. THE IMPACT OF A WEAK ETHICAL INFRASTRUCTURE

Ethical behavior within organizations involves individual factors, influences from the organizational environment, and their interaction.[53] When executives attempt to manage the organizational environment, they must consider both the organization's formal system of rules, including

45. For an empirical study supporting this theory, *see* Kees Keizer et al., *The Spreading of Disorder*, 322 SCI. 1681, 1681 (Dec. 12, 2008).

46. Kees Keizer et al., *The Reversal Effect of Prohibition Signs*, 14 GROUP PROCESSES & INTERGROUP REL. 681, 681 (2011).

47. *Id.* at 684.

48. *Id.*

49. *Id.* at 685–86 (see results of study 2.3).

50. *Id.*

51. *Id.* at 686. (see the results of study 2.4).

52. Benjamin van Rooij & Adam Fine, *Toxic Corporate Culture: Assessing Organizational Processes of Deviancy*, 8 ADMIN. SCI., June 2019, at 1, 9.

53. *See generally* Linda Klebe Treviño, *Ethical Decision Making in Organizations: A Person-Situation Interactionist Model*, 11 ACAD. MGMT. REV. 601 *passim* (1986) (developing a model that shows how ethical decision making in business involves an interaction between individual characteristics and situational variables).

their enforcement and the informal system of influences.[54] In addition, the formal and informal systems are embedded within the ethical climate of the organization, which is the employees' shared perceptions of ethical expectations and interpersonal relations within the organization.[55]

Researchers have developed an ethical infrastructure model that shows how the formal system is embedded within the informal system, which is then embedded within the ethical climate.[56] The strength of an organization's infrastructure depends on how consistent the three parts are with each other; an apparently well-designed formal system that is rooted in an unethical informal system and climate will not be effective.[57] From this model, they hypothesized that the relationship between the level of implementation of an ethical infrastructure and employees' ethical behavior would be curvilinear and not linear.[58] If an organization starts with no ethical infrastructure, such as no compliance program, then there will be a baseline level of unethical behavior. When those employees confront ethical issues in the workplace, they must rely on their sense of ethics to determine the morally correct action.[59] Of course, for a variety of reasons, not all employees will behave ethically, and there will be some level unethical behavior.[60] That level of unethical behavior will drop with a strong ethical infrastructure because employees will be trained on appropriate ethical decision making for their jobs, local social norms will encourage ethical behavior, and so on.[61] If the company has a weak ethical infrastructure, however, then we would expect an increase in unethical behavior as compared to the baseline level.[62] In brief, the reasoning is that:

> When a strong ethical infrastructure is in place, individuals behave ethically because the organization is telling them that they have to do so. However, when a weak infrastructure is in place, individuals do not perceive the ethical dimensions of the situation nor do they sense any deep ethical conviction from the organization. Consequently, ethical behavior is least likely when an ethical infrastructure is weak.[63]

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54. Ann E. Tenbrunsel et al., *Building Houses on Rocks: The Role of the Ethical Infrastructure in Organizations*, 16 SOC. JUST. RES. 285, 287–94 (2003).

55. *Id.* at 293–96.

56. *Id.*

57. *Id.* at 303.

58. *Id.* at 296–97.

59. *Id.* at 297.

60. *See* Linda Klebe Treviño & Michael E. Brown, *Managing to be Ethical: Debunking Five Business Ethics Myths*, 18 ACAD. MGMT. EXEC. 69, 69–72 (2004) (debunking the myth that it is easy to be ethical in business by showing how ethical decision making is complex, requires moral awareness, involves a multi-stage process, and is made more complex by the organizational context).

61. *See* Tenbrunsel et al., *supra* note 54, at 288–93 (discussing the roles of the informal and formal communication, surveillance, and sanctioning systems).

62. *Id.* at 297.

63. *Id.* at 299.

If there was no ethical infrastructure, then the individual would rely on his or her own moral reasoning. With a weak infrastructure, the organization is sending the message to the individual that those ethical concerns do not matter for doing his or her job.[64] This is consistent with the broken windows theory of disorder discussed above.[65] A compliance program that has lost legitimacy and is not consistent with the rest of the ethical infrastructure calls attention to the nonconformance and further delegitimizes compliance.[66] The next section briefly reviews some of the empirical evidence in support of that expectation.

B. THE DANGERS OF ILLEGITIMATE COMPLIANCE PROGRAMS

The general claim of a weak ethical infrastructure leading to more unethical behavior has support from research on compliance and ethics programs. Based on a survey of over 10,000 employees of large American companies, one study found that the employees' perception of the companies' compliance program influenced the program's effectiveness.[67] Most importantly for this Article's concerns, a compliance program that lacked legitimacy with employees—that is, a compliance program viewed as operating primarily to protect top management from blame for compliance failures—had a negative relationship with the indicators for an effective compliance program.[68] A compliance program without legitimacy was not just ineffective but was associated with more unethical conduct, less ethical awareness, and a lower likelihood of reporting bad news; seeking advice; and reporting violations.[69]

Researchers reached a similar conclusion in a meta-analysis of 136 studies related to ethical culture, ethical climate, codes of conduct, and other variables related to unethical behavior in the workplace.[70] They found that a properly enforced code of conduct decreased unethical behavior, but the simple existence of a code of conduct, after controlling for perceived code enforcement and corporate culture, increased unethical behavior.[71] Other researchers summarized those findings by stating that "employees can view the mere existence of a code as a negative sign that the code

64. "A weak ethical infrastructure is a house built on sand; it suggests that the ethical principles or values in question are relatively unimportant. Conversely, a strong ethical infrastructure is a house built on rock; it suggests that such values are significant." *Id.* at 297.

65. *See supra* notes 45–51 (describing the broken windows theory of disorder and recent empirical research that expands upon that theory).

66. van Rooij & Fine, *supra* note 52, at 9.

67. *See* Linda Klebe Treviño et al., *Managing Ethics and Legal Compliance: What Works and What Hurts*, 41 CALIF. MGMT. REV. 131, 135–38 (1999).

68. *Id.* at 136–39.

69. *Id.*

70. Jennifer J. Kish-Gephart et al., *Bad Apples, Bad Cases, and Bad Barrels: Meta-Analytic Evidence About Sources of Unethical Decisions at Work*, 95 J. APPLIED PSYCHOL. 1, 10, 19 (2010).

71. *Id.* at 10, 19, 21.

represents window dressing only, thus producing a cynical response that leads to more unethical behavior."[72]

Finally, qualitative research shows how this problem played out in one company.[73] This was a case study on an American mutual life insurance company that had adopted a compliance program to deal with regulations on deceptive sales practices,[74] but the program was defective in many ways.[75] Although the company pronounced to its employees that the company would not engage in the deceptive practices (even if their competitors did), the company failed to adopt an effective system to monitor such practices and actually encouraged such practices by paying sales commissions on transactions that were in fact deceptive.[76] The company's compliance training was focused primarily on ensuring employees had correctly completed a form that required them to mark the box by "Yes, I understand and comply" for twenty different statements.[77] The company's monitoring of compliance with the rules was infrequent and incomplete, and employees caught violating the rules typically received only a warning.[78] In addition, employees' history of violations had no impact on their ability to receive a promotion.[79] Due to the importance of the sales group, other departments, including regulatory compliance, had no power to further discipline rules violators.[80]

Although the compliance program lacked legitimacy with employees, it had the formal system pieces in place to give it legitimacy with external stakeholders.[81] In response to the compliance program that had become clearly decoupled from actual practice, employees did not try to pressure the company to implement the program to meet those external expectations, but instead "adopted a cynical view of the decoupled program, and as a result of its internal illegitimacy, began to violate the formal compliance rules in a widespread fashion."[82] Eventually, after many years, the organization also lost external legitimacy when complaints eventually resulted in significant fines and the settlement of a class action lawsuit filed by over ten million policy holders.[83]

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72. Linda Klebe Treviño et al., *(Un)ethical Behavior in Organizations*, 65 ANNUAL REV. PSYCHOL. 635, 639 (2014).

73. Tammy L. MacLean & Michael Benham, *The Dangers of Decoupling: The Relationship Between Compliance Programs, Legitimacy Perceptions, and Institutionalized Misconduct*, 53 ACAD. OF MGMT. J. 1499, 1499 (2010).

74. *Id.* at 1502.

75. *Id.* at 1506–08.

76. *Id.* at 1506–07.

77. *Id.* at 1507–08.

78. *Id.* at 1509.

79. *Id.*

80. *Id.*

81. *Id.* at 1510. The authors refer to this as a "dissonant legitimacy perceptions." *Id.*

82. *Id.* at 1516.

83. *Id.* at 1515.

C. SUMMARY

Employee perceptions of an organization's compliance program are critical.[84] A program that has lost legitimacy with its employees is not just ineffective but can have a negative impact on compliance; consequently, it can lead to more unethical and even possibly illegal behavior. Legitimacy can be lost when employees realize that the company has only adopted the formal aspects of a compliance program to protect management from blame and meet the legitimacy demands of external stakeholders, such as enforcement attorneys. This can be referred to as *compliance theater*, as the compliance personnel are primarily in place to perform for the external stakeholders. Perhaps more commonly, however, managers, though not intending to sabotage the compliance program, slowly reduce the program's legitimacy by not respecting the role of the CECO, and rationalizing away the obligation to enforce the program.[85] When employees witness an ineffective compliance program in the midst of wrongdoing, a strong downward spiral begins. The eroding legitimacy of the compliance program may not have a significant impact at first, but if left unchecked the wrongdoing becomes institutionalized and new members are socialized into those practices.[86]

III. STEPS TOWARDS ENSURING THE LEGITIMACY OF COMPLIANCE

This Part sets out some basic reforms focused on helping stop this downward spiral and protecting the legitimacy of the compliance function. The reforms in the first section are focused on developing and protecting the legitimacy of the compliance function in all corporations. The second section is focused on encouraging corporations to monitor the compliance process for purposes of recognizing the need for early intervention.

A. PROTECTING THE LEGITIMACY OF COMPLIANCE

As described in Part I, the compliance function has a legitimacy problem in many organizations. To help protect against legitimacy problems, there are two steps that an organization should take and, perhaps, should become part of the Organizational Sentencing Guidelines.[87] First, the board of directors should have a standing compliance committee.[88] Next, the CECO position should be a standalone position (i.e., separate

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84. *Id.* at 1516.
85. *See supra* Part I.
86. *See generally* Ashforth & Anand, *supra* note 32 (setting out the three foundations for the normalization of corruption in organizations: institutionalization, rationalizing, and socialization).
87. *See* Hess, *supra* note 1, at 326–341 (describing the Organizational Sentencing Guidelines).
88. *Id.*; *see infra* notes 90–98.

from the legal function) and report, as well as be accountable, to the board of directors.[89]

The board of directors is ultimately responsible for ensuring the organization has an appropriate compliance program in place.[90] The board should confirm the compliance program is effective, has adequate staffing and resources, and that the CECO has sufficient independence and authority.[91] In addition, there are a growing number of calls for the board to be directly involved in ensuring the corporation has an ethical corporate culture.[92] Finally, the board should approve and oversee any remedial measures recommended by the CECO in response to a failure of the compliance program.[93]

The board should have a standing compliance committee to oversee the CECO and the compliance program.[94] Currently, it is not a common practice for a board of directors to have a compliance committee. One study of all companies (except financial services) listed on the Russell 3000 between 2001 and 2013 found that only 3.6% of firms had a compliance or regulatory committee, and 0.6% had an ethics committee.[95] A recent study of the S&P 500 found that only 12% of companies had a compliance committee.[96]

A compliance committee requirement would not only allow the compliance program to be overseen by board members that have developed expertise in compliance and ensure board members devote sufficient time to the topic,[97] but it also helps establish the legitimacy of the compliance function and its importance to the organization. One compliance consulting

89. *See infra* notes 90–105.

90. James A. Fanto, *The Governing Authority's Responsibilities in Compliance and Risk Management, as Seen in the American Law Institute's Draft Principles of Compliance, Risk Management, and Enforcement*, 90 TEMP. L. REV. 699, 711–12 (2018).

91. *Id.* at 713–14.

92. Sabine Vollmer, *The Board's Role in Promoting an Ethical Culture*, J. ACCOUNTANCY (July 1, 2018), https://www.journalofaccountancy.com/issues/2018/jul/corporate-board-role-ethical-culture.html; Sir Winfried Bischoff, *Why It's Time Boards Faced Up to the Corporate Culture Challenge*, CITY A.M. (Jan. 12, 2015), http://www.cityam.com/206870/why-it-s-time-boards-faced-corporate-culture-challenge.

93. Fanto, *supra* note 90, at 716–17.

94. *See* David Hess, *A Business Ethics Perspective on Sarbanes-Oxley and the Organizational Sentencing Guidelines*, 105 MICH. L. REV. 1781, 1809 (2007) (arguing in favor of an ethics and compliance committee on the board of directors).

95. Kevin D. Chen & Andy Wu, *The Structure of Board Committees*, 2–3, 10, 24 (Harvard Bus. Sch. Working Paper 17-032, 2016), https://www.hbs.edu/faculty/Publication%20Files/17-032_22ea9e7a-4f26-4645-af3d-042f2b4e058c.pdf.

96. EY Center for Board Matters, *Board Committees Evolve to Address New Challenges*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Feb. 1, 2017), https://corpgov.law.harvard.edu/2017/02/01/board-committees-evolve-to-address-new-challenges/. Compliance committees were most common in the healthcare (25%) and energy (23%) sectors. *Id.* 11% of companies had a risk committee, which may have overlap with the compliance committee. *Id.* This committee was most common in the financial sector (73%). *Id.*

97. Fanto, *supra* note 90, at 717; Hess, *supra* note 94, at 1809.

organization interviewed twenty-six CECOs and their findings support this need.[98] The organization summarized the CECOs' general opinions as:

> [M]ost boards spend only a limited time on ethics and compliance (E&C) and require too little from senior management leadership in that regard, sending the signal that, despite aspirational statements of company values and behavioral expectations, ethics and compliance is not a high operational priority. CECOs receive little direction from boards and believe their boards often fail to have a deep understanding of ethics and compliance initiatives.[99]

A second necessary reform to help protect the legitimacy of compliance is each corporation should have a standalone CECO or equivalent position. This position should be separate from the legal function and report directly to the compliance committee of the board of directors, which includes the authority to hire and fire the CECO.[100] Many commentators have weighed in on the debate of whether the CECO should be independent of the general counsel.[101] This Article adds the importance of legitimacy to the need to elevate the role of the CECO. If the CECO reports directly to the board and not the general counsel, "[t]his reporting would also reflect the professional project of compliance officers, who want their position to be recognized as an independent internal control activity that is governed by established principles of practice and that has the same authority as do lawyers and general counsels of an organization."[102] To have the legitimacy to do their jobs appropriately, CECOs need this authority and status, as well as independence. Setting the tone from the top must not merely come from CEO pronouncements on company values, but it must come from commitments to compliance and ethics by elevating the role of the CECO.

In addition, if the CECO is accountable only to the CEO, then a conflict of interest arises, as the CECO may be placed in a position of having to call out the unethical behavior of the very person the CECO's continued employment depends upon.[103] This also creates potential legitimacy

98. LRN, WHAT'S THE TONE AT THE VERY TOP? THE ROLE OF BOARDS IN OVERSEEING CORPORATE ETHICS & COMPLIANCE 4 (2018).

99. *Id.*

100. *See* Fanto, *supra* note 90, at 715–16, 715 n.122 (stating that the ALI Compliance Project requires that the board of directors must approve the hiring and dismissal of the CECO; and citing federal regulations requiring the board of registered investment companies to have hiring and removal authority over the CECO, and similar requirements under the Commodity Futures Trading Commission's regulations for futures commission merchants, swap dealers, and major swap participants).

101. *See* Robert C. Bird & Stephen Kim Park, *The Domains of Corporate Counsel in an Era of Compliance*, 53 AM. BUS. L.J. 203, 204–07 (2016), for an overview of the arguments on both sides of the debate.

102. Fanto, *supra* note 90, at 723.

103. W. Michael Hoffman & Mark Rowe, *The Ethics Officer as Agent of the Board: Leveraging Ethical Governance Capability in the Post-Enron Corporation*, 112 BUS. & SOC. REV. 553, 557 (2007) ("If the [CECO's] job or career is dependent on the very people whom he or she may need

problems. In reference to these potential conflicts of interests, commentators argue:

> Not only can this conflict interfere directly with the [CECO's] judgment and effectiveness in monitoring the decisions and conduct of management, but it might also give rise to a perception among employees generally that management is treated differently. In that event, the [CECO's] credibility and that of the ethics and compliance program is at risk.[104]

B. MONITORING THE COMPLIANCE PROCESS BY EVALUATING THE ETHICAL CULTURE

Corporations should be required to regularly evaluate their ethical culture.[105] This recommendation focuses on helping ensure appropriate and ongoing monitoring of the ethical infrastructure to prevent the compliance program from chipping away to a point where it has lost legitimacy with employees. This deterioration process is insidious. Inadvertent challenges to the CECO's authority and legitimacy, exceptions to compliance program policies, and similar actions, place the compliance program on a slippery slope to illegitimacy unless the need for a deliberate intervention is recognized and then staged. Measurement of the ethical culture helps corporate actors recognize when intervention is necessary.

The corporation's ethical culture and formal compliance program must support each other.[106] This Article emphasizes the dangers of when they do not. That is, a formal compliance program in the midst of unchecked wrongdoing can lead to an illegitimate formal program and further an unethical corporate culture.[107] Required evaluations of a corporate culture can help provide the CECO and board of directors with early warnings of this downslide and allow them to structure appropriate interventions. It is important to note that without these mechanisms, top management is typically the last group of employees to know about problems with the culture.[108] The research on this topic has found:

> [T]hat senior managers have significantly more positive perceptions of organizational ethics when compared to rank-and-file employees. Senior managers are less likely to see ethics initiatives cynically and are more

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to call to account in respect of their own ethical conduct, there is immediately a possibility that the EO will be influenced by personal interest (consciously or subconsciously) and his or her objectivity or independence will be compromised") *Id.*

104. *Id.*

105. For simplicity, this Article will use the terms "ethical culture" and "ethical climate" interchangeably. By "required," I am including, for example, the strong incentives companies have to follow the Organizational Sentencing Guidelines' description of an effective compliance program. Hess, *supra* note 1, at 326–28.

106. *See* Tenbrusel et al., *supra* notes 54–57 (discussing the ethical infrastructure model).

107. *See supra* Part II.

108. Linda Klebe Treviño et al., *Regulating for Ethical Culture*, 3 BEHAV. SCI. & POL'Y 57, 62 (2017).

> likely to perceive the internal ethical environment to be supportive of ethical conduct in the organization. They are also more likely to believe that employees will raise ethical issues and report ethical problems to management.[109]

In addition, requiring measurement of the company's ethical culture, such as through the Organizational Sentencing Guidelines, makes it a responsibility of the compliance committee and the CECO. This helps ensure the evaluation gets completed in a meaningful way, as the committee and the CECO will be held accountable for this activity. In many organizations, this work is not done because it is not viewed as part of the CECO's role.[110] In addition, this requirement helps grant legitimacy to the CECO's claim that measuring and helping manage the corporate culture as it relates to ethics is both important and part of the CECO's duties.[111] Finally, shareholders are showing an interest in the measurement and evaluation of corporate culture due to its impact on company value, [112] and this proposal furthers their ability to provide external monitoring.

Reforms are already moving in this direction. For example, the 2018 version of the UK Corporate Governance Code states, "The board should establish the company's purpose, values and strategy, and satisfy itself that these and its culture are aligned."[113] The commentary provisions further state:

> The board should assess and monitor culture. Where it is not satisfied that policy, practices or behaviour throughout the business are aligned with the company's purpose, values and strategy, it should seek assurance that

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109. Linda Klebe Treviño, *Out of Touch: The CEO's Role in Corporate Misbehavior*, 70 BROOK. L. REV. 1195, 1209 (2005).

110. Hess, *supra* note 1, at 343.

> The compliance department most commonly has responsibility for compliance training, oversight of the organization's code of conduct, the whistleblower hotline, and compliance investigations. Few compliance departments, however, have responsibility for assessing the organization's culture. And, if no one in the organization has responsibility for this assessment, then it does not get done, and at best gets replaced by general reports.

Id. (citations omitted).

111. *Id.* at 365–67.

112. *See* Letter from Cyrus Taraporevala, President & CEO of State Street Global Advisors to Board Members (Jan. 15, 2019), https://www.ssga.com/investment-topics/environmental-social-governance/2019/01/2019%20Proxy%20Letter-Aligning%20Corporate%20Culture%20with%20Long-Term%20Strategy.pdf (describing State Street's new efforts to ensure that corporate boards are able to articulate how their companies' culture is aligned with their long-term strategy, and stating "flawed corporate culture has resulted in high-profile cases of excessive risk-taking or unethical behaviors that negatively impact long-term performance").

113. FIN. REPORTING COUNCIL, THE UK CORPORATE GOVERNANCE CODE 4 (Principle B) (July 2018), https://www.frc.org.uk/getattachment/88bd8c45-50ea-4841-95b0-d2f4f48069a2/2018-UK-Corporate-Governance-Code-FINAL.PDF.

> management has taken corrective action. The annual report should explain the board's activities and any action taken.[114]

Whether the data from the culture evaluation should be shared with stakeholders other than the board of directors is beyond the scope of this Article. It is important to note, however, that there are alternatives to public disclosure. For example, one proposal suggests that each industry should create "an independent third-party organization to serve as a neutral research entity that conducts assessments and facilitates communication of their results between the industry and regulators."[115]

Finally, the measurement of corporate culture should not be a one-time activity. The culture must be monitored on a continual basis. In addition, after a problem is uncovered, the corporation must, of course, design appropriate interventions, but it must also monitor whether the intervention is working.[116] The required evaluation process helps top management understand how their actions may be unintentionally undermining the compliance program, ensures they are held accountable for remediation, and helps the CECO use data to demonstrate when there is a problem and when interventions are effective.

CONCLUSION

Maintaining the legitimacy of the compliance program and the CECO is of paramount importance. An illegitimate compliance program is not just ineffective, but it can lead to more unethical and illegal conduct, whether in the entire organization or in subcultures of different departments and geographic regions. In recognition of the dangers of allowing a compliance program's legitimacy to chip away, this Article points to a board level standing committee on compliance, an independent CECO, and a mandatory evaluation of the corporation's ethical culture, as necessary reforms.

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114. *Id.*
115. Treviño et al., *supra* note 108, at 63.
116. *Id.* at 68.