DIVISIVE COMPLIANCE

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Professor Gregory M. Gilchrist. It is a privilege to be able to speak to you today at Belmont University. I want to thank Dean Gonzales, Professors Dervan and Usman, and the Belmont Criminal Law Journal both for putting together this symposium and for giving me the opportunity to expand my thinking about corporate crime and law enforcement. Today, I want to address how compliance efforts can generate conflicts between employers and employees.

Industry increasingly self-regulates. Our legal system has basically outsourced the law enforcement function to its targets in the corporate arena. This has given rise to an ever-expanding compliance function and an accompanying industry. That compliance effort can be a source of conflict. I want to think about how that conflict is manifest and what can be done to minimize it.

It is helpful to start by thinking about traditional law enforcement. Traditional law enforcement, say in the context of ordinary street crimes, generally functions through active investigation. Self-reports and exchanges of information for leniency exist, but these tend to come after wrongdoing has been detected, from someone who has already been targeted by the government. Blanket offers of leniency are just not how traditional law enforcement functions (with a few notable exceptions, like isolated amnesty programs for those turning in illegal firearms).[1] Rather, law enforcement functions through active investigations conducted by external actors looking for and into wrongdoing. Leniency plays a role, but it's usually after wrongdoing has been detected in an effort to gather additional information.

Corporate policing is fundamentally different. With a few exceptions, the vast majority of corporate law enforcement relies on blanket offers of leniency in exchange for information, or in exchange for self-reporting. The classic example of this would be the Department of

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[1] *See e.g.* Anna Bauman, "Omahans can drop off unwanted weapons Saturday as part of gun amnesty day," Omaha World Herald, May 22, 2018, available at https://www.omaha.com/news/public-safety/omahans-can-drop-off-unwanted-weapons-saturday-as-part-of/article_0ac4575c-9232-5d1c-a439-d8af57c07146.html.

Justice Antitrust Division's amnesty program for first reporting a price-fixing cartel.[2] But this once-niche rule has now become more the norm in corporate law enforcement. Firms that report wrongdoing receive more leniency than firms that do not do self-report.[3] Leniency-incentivized self-reporting, along with concerns about board duties under Caremark,[4] spawned compliance as a dominant component of corporate governance.

So, what is compliance? I am thinking here of Geoff Miller's definition, "The compliance function consists of efforts organizations undertake to ensure that employees and others associated with a firm do not violate applicable rules, regulations, and norms."[5] Such efforts will involve at least two components. It will involve the effort to educate the employees about their responsibilities and the legal limits on their conduct, and it will involve efforts to police employees, to identify wrongdoing, and record violations. The second component creates a plain conflict. When you are being policed, you have a conflict with those who are policing you. That is fairly clear. What I am more interested in is the conflict that is spawned by the educational aspects of compliance. I think this is less obvious and potentially more problematic as a result.

Compliance is arguably problematically named. "Internal regulation," would certainly be less appealing, but it might also be more accurate. The difficulty with the term, "compliance," is that compliance sounds like a good thing, and, too often, more of a good thing sounds like a net benefit. Compliance in the abstract is not a good thing. Compliance is good, but only to the extent that the substantive rules being complied with are good. But more than that, compliance is good only to the extent it is efficient.

To illustrate this, take a moment to consider the possibility of maximum compliance. Imagine maximum compliance as a firm making all possible efforts to further compliance with the substantive law. That is almost always, and almost surely, not the ideal. In a highly sophisticated free market like the United States, maximum compliance with all possible law is neither reasonable nor admirable. In fact, maximum compliance will chill far more beneficial activity than can be justified by the marginal harms that are avoided compared with marginal or moderate compliance. What I am getting at here is that there is, at least in theory, a point of efficient compliance, where the harms that are avoided are equal to the costs incurred, and that point will be less than maximum compliance. If this seems controversial, let us talk about a concrete example.

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[2] *See generally* U.S. Department of Justice Antitrust Division, *Corporate Leniency Policy* (August 10, 1993); *see generally* U.S. Department of Justice Antitrust Division, *Individual Leniency Policy* (August 10, 1994).

[3] *See* Justice Manual at 9-28.900 available at https://www.justice.gov/jm/jm-9-28000-principles-federal-prosecution-business-organizations#9-28.900.

[4] *In re* Caremark International Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996).

[5] Geoffrey P. Miller, *The Compliance Function: An Overview* (N.Y.U. Law and Econ. Working Papers, Paper No. 393, 2014), http://lsr.nellco.org/nyu_lewp/393

As Professor Dervan has just noted, bribing foreign government officials is harmful, and therefore it is illegal under the Foreign Corrupt Practices Act.[6] Society, I think it is safe to say, would like to minimize bribery of foreign government officials because it corrupts competition, it undermines the quality of goods and services around the world, and ultimately, it degrades core principles of democracy. But, should a firm do everything possible to prevent such bribery by its agents? It should not. Salespeople need to be trained about the positive law, about consequences for their violations, about enforcement initiatives, and about corporate expectations. But how much training should they receive? There can always be more training. At some point, we can imagine additional training resulting in fewer risky interactions with foreign government officials, but, to such a marginal degree, that the benefit cannot be justified by the loss of time selling actual products.

Taken to the extreme, imagine a firm continuing this training around the clock. This would definitely result in bribery approaching zero, but it would do so because the sales personnel would have no time to bribe, or to sell … because they are training. That cannot work. It is an absurd example, of course, but the point of it is to demonstrate the absurdity of maximum compliance. That is not the goal. Indeed, the example illustrates what may be a greater absurdity, and that is the chilling of socially valuable conduct that exists in the gray areas of uncertain law. The FCPA is replete with uncertainty. Truly maximizing avoidance of risk will involve avoiding beneficial and probably legal activity aimed at establishing and bolstering influence and goodwill.

From the entity perspective—here I am thinking of the perspective of, say, management or the board absent any agency cost—optimal compliance involves investment to a level where preventive costs equal the harm avoided by the firm. Regulators enjoy a different perspective. Here, I am in debt to Donald Langevoort for this formulation, "From a regulator's or enforcer's perspective, the goal of a compliance obligation is to cause corporations to invest in compliance up to the level where the preventive costs equal the social harm caused by the wrongdoing, not the harm to the corporation from being caught."[7] Obviously, the two differ based on constituencies—the corporation serves ownership, and the regulators serve the public. To bridge that gap, it is the duty of law enforcement to create regimes of penalties that will cause firms to internalize the social costs that their behavior has created. This ought to be non-controversial. However, it is useful, I hope, because it reminds us that *even* regulators do not favor, or ought not to favor, maximum compliance in a mechanical fashion. Returning to Professor Langevoort's formula,[8] regulators favor only those compliance measures, the sum costs of which do not exceed societal gain.

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[6] 15 U.S.C. § 78(D)(d)(1).

[7] Donald C. Langevoort, *Caremark and Compliance: A Twenty Year Lookback*, 90 Temple L. Rev. 727, 731 (2018).

[8] *Id.*

There is one constituency that may favor, if not maximum compliance, then inefficiently expensive compliance, and that is the compliance industry. There are obvious risks generated when more compliance is aligned with more profit. But I am more interested in another place where we can get inefficient compliance. And that is not where it comes from the profit growth, but rather, whether it comes from internal salaried personnel who work in compliance. Of course there are efficiencies in compliance based on agency problems. But what is interesting is that, sometimes, inefficient compliance is the result of good intentions, mission creep, and overenthusiasm, rather than anything rational.

It is therefore important that the compliance industry generally, and those who receive products from the compliance industry, be vigilant against the assumption that more compliance is better. It is not. Better compliance is better. It ought to be a basic cost-benefit analysis. You want to add a hotline for ethics complaints? Here is a quantifiable cost and predictable set of benefits associated with that. You want to train your sales personnel in China next August? There is a cost and a benefit, you can analyze that. Assume that on a particular issue the legal system has achieved effective regulation and law enforcement, such that the social costs of wrongdoing are borne by the corporation. In that case, the corporation is incentivized to incur those costs where it can do so efficiently. And here is where I think there is a growing disconnect, or potential disconnect I should say, between the employer and employee, or between a firm and its people.

A corporation's reasons for engaging in compliance differ from those individual employees. Corporations establish a particular compliance program in best cases because the organization has determined the risks of noncompliance outweigh the costs of compliance. How does the organization calculate the costs of compliance – costs, of say, educating its employees about compliance? Well, the most obvious are resources directed toward compliance efforts: Salaries for training, audit, and leadership personnel committed to the compliance function and third party fees for products such as training materials or hot line management. But there is also the cost to noncompliance employee time that compliance initiatives take. And this last cost – that is the cost of the noncompliance employees – creates conflict.

Compliance initiatives rarely work to the benefit of employee time and morale and frequently undermine them. This is not to suggest compliance initiatives are bad; rather, it is to recognize that these are costs of compliance initiatives. There are increasing efforts to change this, but the fact remains that for most target employees, compliance is neither fun nor productive. Employees mostly do not enjoy it. And mostly when they are doing it, they are not doing what their actual job is. This can generate conflict. How can firms manage that conflict and should they even try? Does it matter? I think in many cases the organizational cost benefit analysis will align closely enough with individual employees' analyses that there is not a serious concern.

To return to the FCPA[9] example, an organization with a large international sales team will need to spend money and time on educating their sales personnel about the Foreign Corrupt Practices Act. Violations of this law could be costly and avoiding violations is relatively simple in many, but not all, instances. Training will have an impact. That training, that education, though does have two costs.

First, there is the cost of salespeople's time while being educated and not selling. Second, however, there are the lost sales that would have resulted from "less compliance." This second point, I think, is worth further consideration. Just as a company can earn more profits by fixing prices with its competitors, so too the company can earn more profit by generating goodwill among government contractors. Sometimes, to generate goodwill presents a plain violation of the law. Siemens employees bringing large quantities of cash to bribe foreign government officials represented a plain violation of the law.[10] Other times, the legality of behavior is more uncertain. Here, consider the question of whether to hire the highly qualified daughter of an important foreign government official to a desirable position. Absent additional facts, the legality of this move is uncertain. It's likely a complicated issue that remains uncertain even if more facts are known. One cost of compliance is a loss of potential legal and profitable acts that would have represented a net social benefit, even discounted for the risk of subsequent detection and determination that it was on the wrong side of the line. That is, the cost can be overcompliance.[11]

With these FCPA examples, however, the company interest in compliance more or less mirrors that of its sales employees. The company has a strong and obvious interest in not generating overcompliance through too much training or training that is too heavy-handed. Sales personnel will share that interest. The corporate compliance function ought to generate costs to the employees that at least, as a matter of incentive, mirror the potential costs to the entity. So, if engaging in a particular type of conduct risks financial and reputational harm to the corporation, there need to be comparable, incentive-wise, penalties to the individuals who commit the wrong. These penalties could take the form of internal discipline, termination, or external prosecution. At the end of the day, both sides share an interest in a compliance program that maintaining and bolsters sales while avoiding the corporate and personal stresses associated with actual or potential violations. That is, both parties are incentivized to achieve effective and efficient compliance.

There is another category of compliance, however, where this model fails. Specifically, there are cases where the corporate cost benefit analysis differs too greatly from that of the

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[9] 15 U.S.C. § 78(D)(d)(1).

[10] *See* Eric Lichtblau and Carter Dougherty, "Siemens to Pay $1.34 Billion in Fines," N.Y.Times Dec. 15, 2008, available at https://www.nytimes.com/2008/12/16/business/worldbusiness/16siemens.html ("Company employees created off-the-books slush funds, used middlemen posing as consultants and delivered suitcases filled with cash to bribe foreign officials.").

[11] *See generally* Frank H. Easterbrook, *Criminal Procedure as a Market System*, 12 J. Legal Stud. 289, 294 (1983).

employees. Since we are in an academic setting, I thought I would use an academic example: the Clery Act.[12] The Clery Act is a federal law requiring colleges and universities that receive federal funding to report on-campus crimes.[13] The Clery Act is fundamentally a consumer-protection law aimed at creating more transparency and providing better information to prospective parents and students. Complying with the Clery Act requires educating university personnel of their individual reporting obligations. The university can only report on matters it knows about. Whoever is ultimately responsible for filing reports under the Clery Act on behalf of the institution is limited to describing matters of public record or matters that have been reported internally.[14]

If university employees do not report to the university about relevant events, the ultimate disclosure will necessarily be incomplete. The Clery Act addresses this by creating what Campus Security Authorities, or CSA's, and CSA's are required to report crimes covered by the Act.[15] CSA is very broadly defined as any university employee "who has significant responsibility for student and campus activities."[16] Generally, that means if you are the law review advisor or you manage a moot court team you are a CSA. But, so too if you agree with your dean to supervise the business law student's association, and you do that because you know the business law student's association does not need any supervising, you are still probably a CSA.

How much Clery Act compliance is the right amount in terms of training? The answer is, or ought to be, exactly the same as for questions about how to train foreign sales team on the Foreign Corrupt Practices Act. The university ought to invest in the Clery Act compliance to the point where expenditures equal the likely costs of marginal noncompliance. So, a rational model would identify the risk of a violation and the cost of detected and punished violations and discount that cost by the chance of non-detection and non-prosecution. That would represent the effective institutional cost of non- or limited compliance, and it could be compared to the cost of further compliance measures. The problem here is, unlike the under the FCPA, it is likely that the institution will fail to fully account for costs of further Clery Act compliance measures.

Consider a hypothetical institution that has engaged in Clery Act compliance through requiring all CSA's to engage in thirty minutes of training online every two weeks. Someone in the university Compliance department proposes enhancing the training in two ways. First, expand target audience. Rather than train only CSA's, the university could train all faculty and staff. In doing so, it is necessarily overbroad. However, it might be justifiably overbroad. Why? Because CSA status is uncertain, it is fluid, it changes over time. So, perhaps it is sensible to train everyone. Second, however, is a proposal to require

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[12] 20 U.S.C. §1092(f) (West, Westlaw through Pub. L. No. 116-5).
[13] §1092(f)(1).
[14] §1092(f)(3).
[15] §1092(f)(1)(F)(i).
[16] 34 C.F.R. §668.46(a)(iv) (2015).

that all faculty and staff complete an internally developed report every thirty days on which they will be asked to report on any reportable events under the Clery Act.

Why do Clery Act violations occur? Sometimes they are the result of bad faith, or cover-ups. Probably, however, far more common than bad faith violations would be violations caused by benign neglect. When university faculty or staff hear a student report or describe a potential reportable event, they understandably concentrate on the student's welfare rather than on federal reporting requirements. The result is systematic underreporting.

This proposal will work. That is, it will be effective in increasing compliance by curbing underreporting. Transparency will be enhanced. The second proposal, to compel monthly reports by all employees, serves as a simple reminder to catalogue anything one forgot about in the last month; it also raises awareness and vigilance about the Clery Act; finally, it serves an expressive function of signaling the university commitment to compliance with the Act. Does that mean it is a good idea? It does not. It may be, but the mere fact that it will lead to greater compliance with the Act does not itself justify embracing the proposal. The university ought to determine the costs associated with the proposed changes and whether those costs are justified.

This analysis ought to mirror the analysis about additional FCPA training for a foreign sales team. There is a direct cost to compliance personnel and third-party contracts, there are the costs to target employee time and morale for the additional training. And finally, there are costs of over compliance, as measured by beneficial activity lost for fear of harmful activity. In this case, however, there is a very real concern that the last two categories will not be accounted for by the institution.

Sales is different. A business feels lost sales immediately, whether those comes from the sales team losing time and morale or from chilled beneficial sales conduct, the lost sales are manifest quickly and directly. Of course, the university relies on faculty and other personnel to function, but the link between institutional success and individual success is both less direct and more elastic. So, with the possible exception of, say, admission officers, lost employee time and morale costs the university only indirectly and over time.

It's probably uncontroversial to say that effective and happy employees are hallmarks of the best organizations. But, if we are realistic, we must also admit that there are plenty of successful organizations with overworked personnel and poor morale. It might not be an enviable situation. It may not be viable in the long term, but the connection between personnel success and organizational success is generally looser than that between sales success and corporate success.

There is another problem where compliance education erodes morale. It can undermine a positive organizational culture. Prosecutors increasingly care more about culture than about any formulaic compliance initiative. Compliance programs can and ought to be tools for enhancing and bolstering corporate culture. But, they can have the opposite effect, harming positive corporate cultures. To the extent compliance programs antagonize, or

demoralize employees, there is a real risk they will undercut the ultimate goal: a positive organizational culture of actual compliance because personnel want to do a little bit better.

Then there is the chilling cost of overcompliance to consider. Returning to the Clery Act hypothetical, training university employees to report incidents covered by the Clery Act[17] has costs entirely unaccounted for by the university. CSAs must report and reports are not subject to approval by the affected party. Over time, this could change the dynamic between the students and the university personnel. Students who want to generally trust and rely on the wisdom of university faculty or staff as they deal with personal issues, may be less willing to do so as they realize they lack confidentiality, or even full loyalty, in their would-be confidant. Again, none of this is to suggest these harms outweigh the benefits of increased reporting and transparency. None of this is to suggest the Clery Act is anything less than an excellent act. My point is far simpler; these are costs, and they tend to be systematically ignored by institutions deciding how much compliance to impose.

So, what can be done? The answer is simple and perhaps not wholly satisfying: raise awareness. Organizations ought to be on guard against the easy assertion that more compliance is better compliance. And those in the compliance industry need to advocate in good faith for the best compliance, taking into account how compliance initiatives will influence the time, the morale, and the culture of the people who are working for the institutions. More compliance is no better than more food. It depends.

To be clear, none of this is about the FCPA,[18] or the Clery Act;[19] these are just examples. Fundamentally, I am interested in those scenarios where the institutional incentives for compliance differ too much from the employees' incentives. This will tend to occur where substantive law introduces relatively lower risks for the employee, for the organization, and for society, and where the target employees are less directly connected to the short-term success of the business or institution. In these cases the disconnect between the employer and employee is greatest. The employer, out of sheer inattention to full costs, tends to engage in overcompliance, creating unnecessary and harmful conflicts with employees.

Now, I will end by mentioning that the economic models offered by way of example, I think, are simplistic and unrealistic. Organizations no more calculate with any precision the costs and benefits of marginal compliance improvement than does a bank robber who is deciding whether to rob one more bank. But economic returns models are useful. They are useful for thinking about crime, punishment, and compliance. They may not be realistic in individual cases, but they are fundamentally sound. The organization, whether corporate or otherwise, ought to pay as much attention to the costs of compliance—all of them—as they do to the benefits. There is an ever-growing industry that benefits from more compliance. That cannot, and ought not, be the only goal.

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[17] 20 U.S.C. §1092(f).
[18] 15 U.S.C. §78(D)(d)(1).
[19] 20 U.S.C. §1092(f).

Thank you, and I will take any questions.

Q: To what extent can the cost of performance and the risks of compliance in any particular industry be pushed over onto an insurer? And to what extent can the insurer help the firm deal with it?

A: That is a great question. I am not sure I have a great answer; but the answer seems to be much of the analysis would be shifted to the insurer. But the insurer would have less incentive to care about the more subtle down the road costs of employee morale so I would have to think about it more. That is a good question, but that can amplify the problem, that would be my first take.