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## Organization Misconduct: Beyond the Principal-Agent Model

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## ORGANIZATION MISCONDUCT: BEYOND THE PRINCIPAL-AGENT MODEL

*Kimberly D. Krawiec*

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# ORGANIZATIONAL MISCONDUCT: BEYOND THE PRINCIPAL-AGENT MODEL

KIMBERLY D. KRAWIEC\*

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## I. INTRODUCTION

Recent high-profile events from the Columbia space shuttle disaster and Catholic Church sex scandal to the debacles at major U.S. corporations and financial institutions have caused a renewed interest in the subject of organizational misconduct.<sup>1</sup> Yet we still know

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1. John Schwartz & Matthew L. Wald, *Report on Loss of Shuttle Focuses on NASA Blunders and Issues Somber Warning*, N.Y. TIMES, Aug. 27, 2003, at A1 (quoting a report of the Columbia Accident Investigation Board that blames NASA's "broken safety culture" for the Columbia disaster); DAVID FRANCE, *OUR FATHERS: THE SECRET LIFE OF THE CATHOLIC CHURCH IN AN AGE OF SCANDAL* (2004) (discussing the role of the Catholic Church hierarchy in sustaining and covering up the sexual misconduct of numerous priests). *Organizational* misconduct—conduct undertaken at least in part to benefit the organization—should be distinguished from *occupational* misconduct—conduct undertaken solely to benefit the perpetrator and in which the organization may actually be the victim.

relatively little about this extremely important subject. For example, what induces large and important segments of an organization to engage in or ignore deviant behavior? What does and should our legal system do to deter such behavior? Are we currently doing enough?

This Article demonstrates that, at least since the adoption of the Organizational Sentencing Guidelines (OSG) in 1991, the U.S. legal regime has been moving away from a system of strict vicarious liability toward a system of duty-based organizational liability.<sup>2</sup> Under this system, organizational liability for agent misconduct is dependent on whether the organization has exercised due care to avoid the harm in question, rather than on traditional agency principles of respondeat superior. Courts and agencies typically evaluate the level of care exercised by the organization by inquiring whether the organization had in place “internal compliance structures” ostensibly designed to detect and discourage such conduct.<sup>3</sup>

I argue, however, that any duty-based liability system that conditions the organization’s duty on the presence of internal compliance structures is likely to fail because courts lack sufficient information about the effectiveness of such structures. As a result, an internal compliance-based liability system encourages the implementation of largely cosmetic internal compliance structures that reduce legal liability without reducing the incidence of organizational misconduct. This leads to two potential problems: first, an underdeterrence of organizational misconduct and, second, a proliferation of costly but ineffective internal compliance structures.

I then explore two possible explanations for the U.S. legal system’s move toward a compliance-based liability regime: (1) an overreliance on agency cost explanations for organizational misconduct and (2) public choice explanations. I argue that an overreliance on agency cost explanations for organizational misconduct and rent-seeking by

See MARSHALL B. CLINARD ET AL., *CRIMINAL BEHAVIOR SYSTEMS: A TYPOLOGY* 173 (3d ed., Anderson Publ’g Co. 1994) (1967) (dividing white collar crime into two types: corporate crime and occupational crime); John Braithwaite, *White Collar Crime*, 11 ANN. REV. SOC. 1, 19 (1985) (same). Common examples of occupational misconduct include embezzlement and the acceptance of kickbacks. In addition, the term “organizational misconduct” encompasses actions by all organizations, including corporations, nonprofits, and government entities, and includes not only crimes but torts and violations of the organization’s ethics or conduct codes, even when such violations are not illegal. See, e.g., Laura Shill Schragger & James F. Short, Jr., *Toward a Sociology of Organizational Crime*, 25 SOC. PROBS. 407 (1978) (defining “organizational crime”).

2. Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833, 836 (1994) (stating that the existing legal regime closely approximates a rule of “pure strict vicarious liability”).

3. See *infra* Part III.A for a definition of the term “internal compliance structures.” This move toward “compliance-oriented” regulation is part of a global trend. Christine Parker, *Reinventing Regulation Within the Corporation: Compliance-Oriented Regulatory Innovation*, 32 ADMIN. & SOC’Y 529, 529-30 (2000).

powerful interest groups both contribute to the growth of internal compliance-based liability regimes. As a result, the U.S. legal regime is likely to continue its march toward duty-based liability regimes that rely on internal compliance structures in assessing liability or sanctions, because deep-rooted theoretical and political forces conspire to promote such a regime.

Part II of this Article discusses the three primary methods for assigning firm-level liability for agent misconduct: strict vicarious liability, negligence, and a composite liability regime that combines elements of both negligence and strict liability.<sup>4</sup> Both negligence and composite liability regimes require a court or agency determination regarding whether the organization has met its duty of care, typically determined by reference to the organization's internal compliance structures. However, because courts and agencies lack reliable information regarding the effectiveness of such structures, internal compliance-based liability systems are likely to fail. As elaborated in Part II, this does not mean that strict vicarious liability systems are perfect or costless. However, many of these costs can be minimized through evidentiary privilege rules, mitigation rules that reward reporting and cooperation after the discovery of organizational misconduct, and various other relatively mild changes to the legal regime.

Part III argues that, although the OSG is typically held out as an ideal model of duty-based organizational liability, large and important areas of U.S. law are actually duty-based organizational liability regimes. Indeed, in many areas of law—including environmental, tort, employment discrimination, corporate, securities, and health care—organizational liability for agent misconduct is determined through either a composite regime that assigns blame based on a strict liability standard and determines sanctions based on a negligence standard or a negligence-based regime that bases organizational liability on a finding that the organization failed to satisfy the standard of due care. In both cases, the organization's negligence is determined by reference to a standard of due care that rewards organizations for (and, correspondingly, punishes organizations for the lack of) internal compliance structures.

Part IV argues, however, that the presumed effectiveness of duty-based liability regimes that premise organizational culpability on the presence of internal compliance structures is backed by little, if any, empirical support. Although there has been relatively little comprehensive study of the impact of internal compliance structures on the incidence of organizational misconduct, the available empirical evi-

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4. Hereafter, negligence-based vicarious liability and composite liability regimes are collectively referred to as "duty-based liability regimes," except where the context requires a distinction between the two.

dence does not support the contention that the internal compliance structures typically examined by courts and regulators in assessing organizational due care reduce organizational misconduct. Indeed, several large-scale empirical studies document a positive correlation between organizational misconduct and the types of internal compliance structures most frequently relied on by courts and regulators in assessing liability and sanctions, suggesting that some organizations may employ internal compliance structures primarily as a window-dressing mechanism that provides both market legitimacy and reduced organizational liability for agent misconduct.

Part V explains that, rather than adopting an effective system for deterring organizational misconduct, the U.S. legal regime may have adopted a costly “safe harbor” that allows organizations to evade liability for organizational misconduct, so long as they have adopted internal compliance structures.<sup>5</sup> I then explore some possible reasons for the legal regime’s extreme reliance on internal compliance structures in assessing organizational culpability, despite their poor empirical showing as a means of reducing organizational misconduct. Although it is of course possible that the legal regime’s enthusiastic embrace of internal compliance-based organizational liability is attributable to a simple misplaced faith in the effectiveness of internal compliance structures in deterring organizational misconduct, this Article suggests that the answer is likely far more complicated and may be due to two factors.

First, it is possible that the legal regime’s embrace of internal compliance structures is partly attributable to an overreliance on agency cost explanations for organizational misconduct. In other words, if the legal regime presumes that organizational misconduct is simply a principal-agent problem, legal incentives that induce principals to more carefully police their agents may be a rational response to that perceived problem.

Second, public choice theory may explain some aspects of the legal regime’s dependence on internal compliance structures as an organizational liability determinant. As discussed in this Article, although the implementation of comprehensive internal compliance structures is costly to organizations, it is far less costly than actually altering current business practices. Consequently, once public outcry makes regulation inevitable, organizations may settle, or even push, for a legal regime that incorporates internal compliance structures into organizational liability determinations. In addition, other powerful interest groups have a stake in and benefit from internal compliance-

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5. Cf. Vikramaditya S. Khanna, *Corporate Crime Legislation: A Political Economy Analysis*, 82 WASH. U. L.Q. 95 (2004) (querying why corporate interests have not lobbied for such a safe harbor from criminal liability).

based liability regimes, particularly legal compliance professionals such as lawyers, compliance and ethics consultants, in-house compliance and human resources personnel, and diversity trainers.

Part VI briefly addresses the possibility of holding board members and senior management vicariously liable for the misdeeds of lower-level agents and warns that such liability is unlikely to effectively substitute for organizational liability. Part VII concludes.

## II. THE CHOICE OF ORGANIZATIONAL LIABILITY REGIME

This Part outlines the three basic organizational liability standards for agent misconduct—strict vicarious liability, negligence, and composite liability—and the benefits and drawbacks of each.<sup>6</sup> I demonstrate that duty-based liability regimes that look to the presence of internal compliance structures to determine whether the organization has met its duty of care are likely to fail, because courts lack reliable information regarding the effectiveness of such structures. As a result, strict vicarious liability with some modifications to encourage reporting and cooperation with government investigations is superior to both negligence-based and composite liability systems for deterring organizational misconduct and inducing the appropriate level and type of internal enforcement measures.

### A. *Strict Vicarious Liability*

Under a strict vicarious liability standard, organizational liability is imposed whenever an organizational actor causes some punishable harm, regardless of any attempts by the organization to avoid the harm.<sup>7</sup> The premise behind strict vicarious liability is that by forcing

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6. It is generally recognized that some type of firm-level liability is necessary in order to effectively deter organizational misconduct for a variety of reasons, including the limited assets of organizational agents, the superior ability of firm-level liability to force the internalization of the costs of harmful activity, and the potential savings in enforcement costs. See, e.g., Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687, 692 (1997) (arguing that firm-level liability addresses problems of judgment-proof agents and costly government sanctioning); Daniel R. Fischel & Alan O. Sykes, *Corporate Crime*, 25 J. LEGAL STUD. 319, 322 (1996) (arguing that firm-level liability saves on enforcement costs because, “[r]ather than having to invest resources to penetrate the corporate hierarchy and decision-making structure to determine the culpability of particular individuals, the state can simply penalize the firm”). However, many scholars debate whether this liability should ever take the form of criminal, as opposed to civil or administrative, sanctions. See Fischel & Sykes, *supra*, at 322. In addition, cogent arguments can be made that vicarious liability of senior officers and directors for organizational misconduct is, under some circumstances, a useful complement to or substitute for organizational liability in deterring organizational misconduct. See *infra* Part VI for a discussion of this argument.

7. Under the doctrine of respondeat superior, the organization may be held liable for the acts of its agents undertaken with an intent to benefit the organization that are within the ordinary scope of the agent’s employment. I refer to such agents as “organizational actors” in this Article.

organizations to internalize all of the costs associated with their activities, the organization's products are appropriately priced and the socially optimal amount of the good or service is produced.<sup>8</sup>

In addition, strict vicarious liability systems may force the adoption of the socially optimal level of internal organizational enforcement and deterrence mechanisms (internal compliance structures). This is because when an organization bears all of the costs of any harm it causes, it has an incentive to reduce the incidence of such harm up to the point where the costs of such reduction equal the benefits.<sup>9</sup>

Despite these advantages, strict vicarious liability systems have been criticized on a number of fronts for creating incentives at odds with the goal of deterring organizational misconduct. For example, some internal compliance structures, known as "policing measures," may increase the probability of detection, either because information regarding the occurrence of misconduct may be reported to government authorities by the organization or a whistleblower or because the government may subpoena any information regarding organizational misconduct that has been internally generated. Accordingly, it has been argued that under a strict vicarious liability system, organizations have an incentive to avoid implementing internal compliance structures that might reduce the incidence of organizational wrongdoing.<sup>10</sup> This results in increased levels of organizational misconduct and more expensive and less effective government policing of such behavior.

In addition, some commentators argue that attempts to induce internal organizational policing under strict vicarious liability regimes suffer from credibility problems. In other words, firms' internal policing efforts will deter employee misconduct only if employees believe that firms will actually employ those efforts to detect, report, and punish such misconduct. Under a strict vicarious liability system, it is argued, these threats are not credible because the firm itself will suffer increased liability from such efforts.<sup>11</sup>

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8. Fischel & Sykes, *supra* note 6, at 321-22; Vikramaditya S. Khanna, *Should the Behavior of Top Management Matter?*, 91 GEO. L.J. 1215, 1223-24 (2003).

9. Arlen & Kraakman, *supra* note 6, at 703; Fischel & Sykes, *supra* note 6, at 324 (arguing that monitoring is desirable up to the point where the marginal cost would exceed the marginal social gain in the form of reduced harmful activity).

10. *See, e.g.*, Arlen, *supra* note 2, at 840; Arlen & Kraakman, *supra* note 6, at 708. Arlen and Kraakman distinguish "policing" measures that deter misconduct by increasing the probability of detection from "preventive" measures that deter misconduct by altering the costs or benefits of misconduct but do not impact the probability of detection. *Id.* at 701-02. Examples of preventive measures include the firm's compensation and promotion policies, strict controls over cash disbursements, and strict accounting for chemical waste. *Id.* According to Arlen and Kraakman, strict vicarious liability causes perverse incentive problems with respect to policing measures but not preventive measures. *Id.* at 707.

11. Arlen & Kraakman, *supra* note 6, at 712-14.



These problems, however, are even more severe under duty-based organizational liability systems than under strict vicarious liability systems. As discussed in Parts II.B and C of this Article, due to the informational disadvantages of courts and regulators regarding the effectiveness of internal policing measures, any duty-based organizational liability system produces perverse incentives of its own. Specifically, organizations have an incentive to invest in low-cost, potentially ineffective internal policing measures that fail to reduce organizational misconduct, yet nonetheless reduce organizational liability. More disturbing, the analysis of the empirical evidence in Part IV of this Article suggests that many firms have adopted exactly this cosmetic approach to organizational compliance. Furthermore, employees are keenly aware of the extent to which such policing measures are cosmetic; this can lead to potentially severe credibility problems in any duty-based liability regime that relies on internal compliance structures in assessing guilt or sanctions.<sup>12</sup>

In addition, to the extent that policing and credibility concerns are potential drawbacks of a strict vicarious liability system, these drawbacks are surmountable and need not prevent the implementation of successful strict (or modified strict) liability systems. Firms can still be encouraged to engage in internal policing and cooperation with government authorities through some combination of evidentiary privilege rules and reduced sanctions for cooperation with government investigations. In other words, firms can be rewarded not for the mere existence of internal compliance structures, but for ex post demonstrations that such structures revealed useful information that was then used to penalize those responsible for misconduct, thus presumably deterring future misconduct.

First, fears that subsequent government or third-party access to information produced by internal compliance structures will deter the implementation of such structures can be addressed through

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12. See, e.g., MARSHALL B. CLINARD, CORPORATE ETHICS AND CRIME: THE ROLE OF MIDDLE MANAGEMENT 132-36 (1983) (concluding from interviews with sixty-four retired managers of *Fortune 500* corporations that the behavior and philosophy of top management was most commonly asserted as the primary reason for illegal employee behavior); ETHICS OFFICER ASS'N, THE 2000 MEMBER SURVEY REPORT 30 (2001) (listing short-term financial pressures, lack of financial or staff support, and compensation system inconsistent with corporate values as three of the top four principal obstacles to the work of ethics officers); ETHICS RES. CTR., NATIONAL BUSINESS ETHICS SURVEY 2003: HOW EMPLOYEES VIEW ETHICS IN THEIR ORGANIZATIONS 31 (2003) ("Employees who perceive that their supervisors do more than 'talk about the importance of ethics' observe less misconduct in their organizations."); Gary R. Weaver et al., *Integrated and Decoupled Corporate Social Performance: Management Commitments, External Pressures, and Corporate Ethics Practices*, 42 ACAD. MGMT. J. 539, 547-48 (1999) (finding that top management commitment to ethical behavior is more important in deterring misconduct than are external forces, such as the OSG, which tend to promote only formal changes, such as the adoption of ethics codes, and are not fully integrated into organizational activities).

privilege rules, such as those employed by many states in connection with internal environmental and other audits.<sup>13</sup> Similarly, the attorney-client privilege has been successfully invoked in some cases to shield corporate audits from discovery and disclosure.<sup>14</sup> In other words, rules mandating that any information produced through internal policing measures will not be used against the organization, provided that the organization cooperates with any government investigation, could alleviate this concern and improve the deterrence function of strict liability.<sup>15</sup>

The proper role of privilege in organizational policing and enforcement is subject to much debate. The use of such privileges doubtless raises concerns of its own and may be more appropriate or practical in connection with some types of violations than others.<sup>16</sup> The point here, however, is that the most commonly advocated substitute for audit privileges—duty-based organizational liability—presents even greater problems.<sup>17</sup>

Fears that firms will fail to implement internal policing measures under a strict vicarious liability system can be further alleviated through rules that reward organizations for post-offense reporting and cooperation. For example, if organizations are offered reduced penalties in exchange for self-detection and reporting, the incentive to implement policing measures under a strict liability regime may

13. See, e.g., David Markert et al., *Environmental Crimes*, 41 AM. CRIM. L. REV. 443, 460-62 (2004) (discussing statutory, attorney-client, and other privileges designed to protect internal corporate audits).

14. *Id.* at 462 n.98.

15. Professors Arlen and Kraakman refer to this version of modified strict liability as “probability-fixed strict liability,” and they argue that it is unworkable in both practice and theory. Arlen & Kraakman, *supra* note 6, at 719-21. As a practical matter, they argue that modified strict liability is unworkable because it is not “truly possible to insulate a firm from the liability effects of its own policing efforts.” *Id.* at 720. However, evidentiary privileges such as these are successfully used throughout criminal law to prevent government authorities from accessing certain information. See, e.g., WAYNE R. LAFAVE ET AL., CRIMINAL PROCEDURE §§ 9.3-.6 (4th ed. 2004) (discussing the fruit of the poisonous tree and other exclusionary rules of criminal procedure). As a theoretical matter, Arlen and Kraakman argue that it would require prohibitively large sanctions in order to induce firms to police against low-visibility misconduct. Arlen & Kraakman, *supra* note 6, at 720. However, this is true as a practical matter with respect to duty-based organizational liability regimes as well.

16. See, e.g., David A. Dana, *The Perverse Incentives of Environmental Audit Immunity*, 81 IOWA L. REV. 969 (1996) (discussing the debate over these privileges); Steven A. Herman, *NCSL Study Finds that State Environmental Audit Laws Have No Impact on Company Self Auditing and Disclosure of Violations*, NAT'L ENVTL. ENFORCEMENT J., Dec. 1998/Jan. 1999, at 18, 19 (finding that more than three-fourths of companies surveyed report performing audits without regard to the existence of audit laws, but that most also fail to report violations, even when the state provides an audit privilege).

17. See, e.g., Jennifer Arlen & Reinier Kraakman, *When Companies Come Clean: Mitigation Is Better than Environmental Audit Privileges*, BUS. L. TODAY, Jan./Feb. 2000, at 46 (arguing that a compliance-based organizational liability regime is preferable to the use of internal audit privileges).

be substantially increased. In fact, such reduced penalties in exchange for self-reporting and cooperation already exist under the OSG and also are employed informally in connection with many investigations and prosecutions of organizational misconduct.<sup>18</sup>

In short, the problems identified by commentators in connection with a strict vicarious liability regime are real, but they are not insurmountable obstacles to an effective strict vicarious liability regime. Several relatively minor changes to the current legal regime (some of which have already been implemented with apparent success in certain regulatory settings) may alleviate many of the concerns expressed by critics of strict vicarious liability regimes. Finally, as detailed in Part II.C below, internal compliance-based organizational liability regimes pose similar, and arguably more severe, problems.

### B. Negligence

Under a negligence-based organizational liability regime, firm-level liability is imposed whenever an organizational actor causes some punishable harm and the standard of due care is not met. Typically, this means that the organization has failed to take sufficient measures to avoid the harm; for example, it has failed to implement training programs or other internal compliance structures or to observe industry standards regarding operating methods.

Negligence-based organizational liability regimes are considered inferior to strict liability regimes in terms of encouraging the socially optimal level of production, because negligence-based organizational liability regimes do not force organizations to bear the entire cost of their harmful conduct.<sup>19</sup> Accordingly, goods and services produced by

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18. U.S. SENTENCING GUIDELINES MANUAL § 8C2.5(g) (2004) [hereinafter SENTENCING GUIDELINES] (listing organizational cooperation in the investigation and voluntary self-reporting of the offense among several culpability factors); Shirah Neiman, *Corporate Fraud Issues II: Interview with United States Attorney James B. Comey Regarding the Department of Justice's Policy on Requesting Corporations Under Criminal Investigation to Waive the Attorney Client Privilege and Work Product Protection, November 2003*, *United States Attorney's Bulletin*, in 2 36TH ANNUAL INSTITUTE ON SECURITIES REGULATION 1089 (PLI Corporate Law & Practice Course, Handbook Series No. 1456, 2004) (discussing the role of corporate cooperation with prosecutors in inducing leniency); Memorandum from Larry D. Thompson, Deputy Attorney General, U.S. Department of Justice, to Heads of Department Components and United States Attorneys, U.S. Department of Justice 6 (Jan. 20, 2003), [http://www.usdoj.gov/dag/cftf/business\\_organizations.pdf](http://www.usdoj.gov/dag/cftf/business_organizations.pdf) (last updated Nov. 15, 2004) ("In determining whether to charge a corporation, that corporation's timely and voluntary disclosure of wrongdoing and its willingness to cooperate with the government's investigation may be relevant factors.").

19. See, e.g., Arlen & Kraakman, *supra* note 6, at 705; Fischel & Sykes, *supra* note 6, at 328; Khanna, *supra* note 8, at 1226 (stating that "negligence standards tend to fail on the activity level front because they do not force the firm to bear the full social costs of its products"); Steven Shavell, *Strict Liability Versus Negligence*, 9 J. LEGAL STUD. 1, 4 (1980).

organizations in such a regime will be underpriced, and too much will be produced.<sup>20</sup>

Furthermore, strict vicarious liability standards are considered superior to negligence-based organizational liability standards in terms of inducing the optimal level of internal compliance structures. Although negligence-based liability could in theory induce the optimal level of internal deterrence measures, it is unlikely to achieve this goal in practice due to the difficulty of accurately determining whether the standard of care has been met.

Judicial and agency determinations regarding whether a particular organization's internal compliance structures meet the required standard of due care may be faulty for a variety of reasons. First, courts and agencies may require either too many or too few structures in setting the standard because they lack sufficient information to make such decisions accurately.<sup>21</sup> As a result, they may demand internal compliance structures whose costs exceed their deterrence benefits, which would result in social waste. Alternatively, they may demand too few internal compliance structures, or internal compliance structures that are ineffective in deterring misconduct, resulting in underdeterrence. Second, even assuming that courts and agencies are able to accurately set the standard of care, they are likely to misjudge whether the organization has met that standard (in other words, whether it has adopted the appropriate number and type of structures) in the particular case at hand.<sup>22</sup>

Finally, courts and agencies are unlikely to possess the ability to differentiate effective internal compliance structures from cosmetic ones—that is, those structures designed to create the illusion of compliance for purposes of avoiding legal liability, rather than for the purpose of deterring misconduct.<sup>23</sup> This is because differentiating real internal compliance structures from purely symbolic ones is a difficult task for legal decisionmakers, particularly *ex post* when, by definition, the structures in question have failed to deter misconduct. Additionally, the indicators of an effective internal compliance structure are easily mimicked, and the true level of effectiveness is difficult for any decisionmaker lacking perfect information to determine.<sup>24</sup>

20. Shavell, *supra* note 19, at 4.

21. Fischel & Sykes, *supra* note 6, at 329; Khanna, *supra* note 8, at 1227-28; Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L.Q. 487 (2003) (arguing that because legal decisionmakers are unable to determine this with any accuracy, internal compliance-based liability regimes tend to both underdeter misconduct and impose socially wasteful costs on organizations).

22. Khanna, *supra* note 8, at 1228.

23. See Krawiec, *supra* note 21, at 536-37.

24. *Id.* at 491-92.

This is not to imply that accurate determinations by courts and agencies regarding whether internal compliance structures are cosmetic or real are impossible. Presumably, given sufficient amounts of time and money, reliable determinations as to the quality of internal compliance could be made. However, as a society, we have shown no willingness to dedicate the extraordinary resources to courts, prosecutors, and agencies that would be necessary to perform this function. Moreover, given the lower costs and greater effectiveness of an appropriately designed strict vicarious liability regime, this refusal is probably wise.

### C. Composite Regimes

Composite regimes are organizational liability regimes that combine elements of both strict vicarious liability and negligence. In their most common form, composite liability regimes assign liability based on a strict liability standard but apportion sanctions based on a negligence standard.<sup>25</sup> Although the OSG is typically offered as an example of such a regime, as discussed in Part III of this Article, large segments of the U.S. legal regime relating to organizational liability for agent misconduct are best characterized as composite regimes. Others, despite their theoretical similarity to strict vicarious liability regimes, are actually negligence regimes, due to prosecutorial and agency discretion and judicially crafted exceptions to the strict vicarious liability rule.

Despite the popularity of composite regimes among legal scholars and government actors, as discussed in Part IV of this Article, little evidence exists to support the theory that composite liability regimes that incorporate organizational internal compliance structures into the sanction calculation deter organizational misconduct. In fact, a growing body of empirical evidence casts doubt on the effectiveness of such regimes.

These results should not be entirely surprising. Composite regimes, at least in practice, present all of the same incentive problems discussed in connection with negligence regimes. In other words, negligence-based organizational liability regimes are criticized for a failure to force organizations to fully internalize the costs of their harmful activities. This same criticism, however, can be leveled at composite regimes. Strict liability regimes, after all, only force the internalization of costs if the appropriate sanction is applied.<sup>26</sup> By reducing

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25. Arlen & Kraakman, *supra* note 6, at 717 (referring to such regimes as “mixed liability regimes”).

26. This optimal sanction is equal to the harm caused divided by the probability of detection. See A. Mitchell Polinsky & Steven Shavell, *Should Employees Be Subject to Fines and Imprisonment Given the Existence of Corporate Liability?*, 13 INT’L REV. L. & ECON. 239 (1993).

the applicable sanctions based on a factor—the presence of internal compliance structures—unrelated to either the amount of harm or the probability of detection, the composite regime moves away from the optimal sanction, reducing the extent to which the sanctioned organization is forced to internalize the costs of its harmful conduct.<sup>27</sup>

In addition, negligence-based organizational liability regimes are criticized for, at least in practice, failing to provide incentives for the adoption of the optimal level and type of internal compliance structures. This same criticism, however, can and should be leveled at composite regimes. As under the negligence-based regime, courts and agencies may err in setting the standard by including too few, too many, or an inappropriate type of internal compliance structures in the due care standard. Furthermore, because courts and agencies lack sufficient information regarding the effectiveness of internal compliance structures, they are likely to err in determining whether a particular organization has met the standard in any given case and, in any event, are unlikely to possess the ability to differentiate symbolic or cosmetic compliance structures, designed primarily to avoid liability rather than to deter misconduct, from genuine ones.<sup>28</sup>

### III. UNITED STATES LAW AS A COMPOSITE LIABILITY REGIME

This Part demonstrates that, although the OSG is correctly held out as the paradigm of a composite liability regime, large and important segments of U.S. law are best characterized as composite regimes.<sup>29</sup> Others, despite their theoretical similarity to strict vicarious liability regimes, are actually negligence regimes due to prosecutorial and agency enforcement discretion and judicially crafted exceptions from the strict vicarious liability standard. In both cases, the determination of whether the organization has met the standard of due

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27. Presumably, composite regimes that reward organizations for the presence of internal compliance structures do so on the assumption that such structures increase the probability of detection, and legal scholars defend composite regimes on exactly this basis. Arlen & Kraakman, *supra* note 6, at 733. As discussed in Part IV of this Article, however, when internal compliance structures are cosmetic, rather than real, and legal decision-makers are unable to tell the difference, internal compliance structures cannot be expected to reduce misconduct or increase the probability of detection.

28. Krawiec, *supra* note 21, at 541 (arguing that not only are courts unable to make this distinction but that a review of the caselaw demonstrates that, in many cases, they do not even try).

29. On January 12, 2005, the Supreme Court ruled that the Federal Sentencing Guidelines should be interpreted by judges as merely advisory, rather than mandatory, to avoid violating criminal defendants' Sixth Amendment rights. *United States v. Booker*, 125 S. Ct. 738 (2005). Although it is unclear how this ruling will impact organizational sentencing, many corporate lawyers are advising clients to continue treating the OSG as if it were mandatory. Gary Fields, *Ruling on Sentencing Guidelines May Also Affect Corporate Crime*, WALL ST. J., Jan. 17, 2005, at A4 (quoting one corporate counsel as stating that, "[a]s far as corporations are concerned, the compliance guidelines are not advisory, they are still mandatory" (internal quotation marks omitted)).

care is determined by reference to the presence of internal compliance structures. Part III.A of this Article defines the term “internal compliance structures” and illustrates the type of internal compliance structures that are most prevalent in U.S. organizations. Part III.B describes the role of these internal compliance structures in the U.S. legal regime by characterizing a broad array of laws as either composite or negligence-based liability regimes that incorporate internal compliance structures into the organizational due care assessment.

#### A. *Internal Compliance Structures Defined*

The internal compliance structures adopted by most organizations are quite similar and are based primarily on two legal sources: the minimum steps for an effective internal compliance system set out in the OSG<sup>30</sup> and equal employment opportunity (EEO) law.<sup>31</sup> For example, the centerpiece of any internal compliance program is a written ethics or conduct code that sets forth the ostensible limits of acceptable agent conduct.<sup>32</sup> Most large organizations also have written EEO policies that confirm the organization’s commitment to nondiscriminatory hiring, firing, and promotion policies. Many conduct and EEO codes also detail mechanisms of code enforcement, such as internal reporting and information-gathering procedures, policies regarding the investigation of reported violations, whistleblowing procedures and policies regarding the protection of whistleblowers from retaliation, and internal procedures and sanctions for conduct code violations.<sup>33</sup>

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30. Marie McKendall et al., *Ethical Compliance Programs and Corporate Illegality: Testing the Assumptions of the Corporate Sentencing Guidelines*, 37 J. BUS. ETHICS 367, 370 (2002).

31. EEO law includes a variety of statutes, rules, and regulations addressing workplace discrimination. The most important of these are Title VII of the Civil Rights Act of 1964, 42 U.S.C. § 2000e-2(a)(1) (2000), the Age Discrimination in Employment Act of 1967, 29 U.S.C. §§ 621-34 (2000), the Americans with Disabilities Act, 42 U.S.C. §§ 12,101-12,213 (2000), the rules, regulations and interpretations of the Equal Employment Opportunity Commission, and a variety of state statutes. See Elizabeth Chambliss & Lauren B. Edelman, *Sociological Perspectives on Equal Employment Law* (unpublished manuscript, on file with author).

32. See SENTENCING GUIDELINES, *supra* note 18, § 8B2.1. Over ninety percent of *Fortune 500* corporations and over seventy-five percent of other large corporations report having an ethics or conduct code. Andrew Brien, *Regulating Virtue: Formulating, Engendering and Enforcing Corporate Ethical Codes*, 15 BUS. & PROF. ETHICS J. 21, 21 (1996); Gary R. Weaver et al., *Corporate Ethics Practices in the Mid-1990’s: An Empirical Study of the Fortune 1000*, 18 J. BUS. ETHICS 283 (1999).

33. Brien, *supra* note 32, at 21; Richard S. Gruner, *Developing Judicial Standards for Evaluating Compliance Programs: Insights from EEO Litigation*, in 1 CORPORATE COMPLIANCE 2002, at 159, 169 (PLI Corporate Law & Practice Course, Handbook Series No. B-1317, 2002).

Second, effective internal compliance requires that conduct and EEO codes be communicated to the organization's employees and other agents. Common mechanisms for such dissemination include training programs, organization newsletters, employee manuals, and organizational websites.<sup>34</sup> In the EEO context, this communication often takes the form of "diversity" or harassment training.

Third, organizations must have monitoring and auditing systems reasonably designed to detect prohibited conduct by organizational agents.<sup>35</sup> Fourth, most organizational compliance programs contain a reporting mechanism that allows employees to report violations of the organization's conduct code or of laws and regulations without fear of retaliation by others within the organization.<sup>36</sup> This includes internal grievance procedures designed to allow employees to express concerns regarding discriminatory conduct. Finally, specific, high-level personnel within the organization must be assigned responsibility for oversight of compliance with the organization's conduct or ethics code.<sup>37</sup>

### *B. Internal Compliance Structures and Organizational Due Care*

As widely noted, the OSG in many ways represents the prototypical composite liability regime. For all practical purposes, the OSG requires organizations to adopt internal compliance structures by reducing to as little as one-twentieth or increasing by as much as four hundred percent the original base fine faced by organizations convicted of a federal crime based on a variety of mitigating or aggravating factors, including the presence of organizational internal compliance structures.<sup>38</sup> Assuming the absence of any aggravating factors, such as involvement in the violation by high-level personnel, the presence of "effective" internal compliance structures will result in a reduction of the organization's fine by up to sixty percent.<sup>39</sup>

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34. See SENTENCING GUIDELINES, *supra* note 18, § 8B2.1(b)(4)(A).

35. *Id.* § 8B2.1(b)(5)(A).

36. *Id.* § 8B2.1(b)(5)(C).

37. *Id.* § 8B2.1(b)(2)(B). In addition, the *U.S. Sentencing Guidelines Manual* lists as minimum steps for an effective internal compliance system requirements that the organization use due care not to delegate authority to agents with a propensity for illegal conduct, that the organization take all reasonable steps to respond appropriately to the violation and prevent future similar violations once the offense is discovered, and that the code of conduct be consistently enforced. *Id.* §§ 8B2.1(b)(3), (6), (7).

38. Other culpability factors include tolerance of or participation in the violations by high-level personnel, the organization's prior history of similar misconduct, organizational cooperation in the investigation, voluntary self-reporting of the offense, and whether the organization accepted responsibility for the illegal conduct. *Id.* § 8C2.5.

39. *Id.* § 8C2.5(f)(1). Under the Organizational Sentencing Guidelines, effective internal compliance structures are those that are "reasonably designed, implemented, and enforced so that [they] generally [will be] effective in preventing and detecting criminal conduct. The failure to prevent or detect the instant offense does not necessarily mean that



Because the OSG was one of the first major legal regimes to make the transition from strict vicarious liability to an internal compliance-based standard, it is an extraordinarily important segment of the internal compliance-based legal regime. However, the OSG internal compliance-based approach to organizational misconduct was quickly emulated in other legal fields. As a result, today a wide variety of civil, criminal, and regulatory provisions encourage the adoption of internal compliance structures through duty-based vicarious liability regimes.

For example, both the Environmental Protection Agency (EPA) and the Department of Health and Human Services (HHS) incorporate the OSG composite liability concept by allowing reduced civil penalties and, in some cases, no criminal penalties for organizations with effective internal compliance structures.<sup>40</sup> Furthermore, the HHS guidelines for determining the existence of an effective internal compliance program are fashioned directly after the OSG's minimum steps for an effective compliance program.<sup>41</sup> In addition, the Justice Department follows what amounts to a negligence-based organizational liability regime that considers organizations' internal compliance structures in deciding whether to criminally charge organizations for the acts of their employees and agents.<sup>42</sup> Similarly, state attorneys general follow a negligence approach by considering organizational internal compliance structures in making enforcement decisions.<sup>43</sup>

The judiciary has also employed compliance-based liability standards in a variety of legal contexts that amount to the creation of a negligence-based organizational liability regime. For example, internal compliance structures may be relevant to a determination of

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the program is not generally effective." *Id.* § 8B2.1(a)(2). The manual goes on to list the minimum steps that the organization must have taken in order to qualify for a reduced sentence. See *supra* notes 32-37 and accompanying text for a discussion of the minimum steps.

40. Incentives for Self-Policing: Discovery, Disclosure, Correction and Prevention of Violations, 65 Fed. Reg. 19,618, 19,625 (Apr. 11, 2000) (statement of policy); see also OFFICE OF INSPECTOR GENERAL, DEPT OF HEALTH & HUMAN SERVS., FRAUD PREVENTION AND DETECTION: COMPLIANCE GUIDANCE, at <http://oig.hhs.gov/fraud/complianceguidance.html> (last visited Feb. 7, 2005) [hereinafter HHS GUIDELINES] (providing links to compliance program guidance for, among others, pharmaceutical manufacturers, ambulance suppliers, nursing facilities, and hospitals).

41. See HHS GUIDELINES, *supra* note 40. The Office of the Inspector General of HHS has also required the adoption of internal compliance structures by organizations settling health care fraud charges. See Thomas E. Bartrum & L. Edward Bryant, Jr., *The Brave New World of Health Care Compliance Programs*, 6 ANNALS HEALTH L. 51, 56 (1997).

42. Memorandum from the Deputy Attorney General, U.S. Department of Justice, to All Component Heads and United States Attorneys, U.S. Department of Justice (June 16, 1999), <http://www.usdoj.gov/criminal/fraud/policy/Chargingcorps.html> (last updated Mar. 9, 2000).

43. Junda Woo, *Self-Policing Can Pay Off for Companies*, WALL ST. J., Sept. 8, 1993, at B5.

whether an employee's illegal or tortious conduct was undertaken with an intent to benefit the organization and thus determine organizational civil punitive or criminal liability. Organizations may be able to demonstrate that an employee's conduct was not undertaken with an intent to benefit the organization through evidence that the organizational defendant had in place ethics codes prohibiting the relevant conduct and compliance programs ostensibly designed to detect violations.<sup>44</sup>

Corporate and securities law also contain elements of composite or negligence-based organizational liability regimes that provide an incentive for the adoption of internal compliance structures. Section 15(b)(4)(E) of the Securities Exchange Act, for example, authorizes the SEC to suspend or revoke the registration of any broker/dealer that "has failed reasonably to supervise, with a view to preventing violations of the provisions of [the securities or commodities laws], another person who commits such a violation, if such other person is subject to his supervision."<sup>45</sup> This requirement is deemed met so long as procedures reasonably designed to detect and prevent violations have been implemented.<sup>46</sup>

The Delaware corporate law approach to claims that a board of directors has failed to adequately monitor the corporation's employees and activities closely resembles an internal compliance-based approach to liability by holding directors liable for a breach of the duty of care when a failure to implement internal compliance structures results in organizational misconduct.<sup>47</sup> Although this liability risk may be slight, it appears that corporate boards—at the urging of le-

44. See, e.g., *United States v. Beusch*, 596 F.2d 871, 878 (9th Cir. 1979) (suggesting that "a corporation *may* be liable for acts of its employees done contrary to express instructions and policies, but that the existence of such instructions and policies may be considered in determining whether the employee in fact acted to benefit the corporation"); *In re the Exxon Valdez*, No. A89-0095-CV, 1995 WL 527990, at \*2 (D. Alaska Jan. 27, 1995) (upholding jury instructions that "you must consider whether the actions of employees were in violation of direct . . . policies of the defendant corporations").

45. 15 U.S.C. § 78o(b)(4)(E) (2000).

46. *Id.* § 78o(b)(4)(E)(i). Similar provisions are contained in the Commodity Exchange Act and in the Self-Regulatory Organization (SRO) rules. See, e.g., NASD Conduct Rule 3010, NATIONAL ASSOCIATION OF SECURITIES DEALERS MANUAL (CCH) 4831 (2004) (requiring NASD members to establish and maintain a system to supervise employees); NYSE RULE 342.21, 2 NEW YORK STOCK EXCHANGE GUIDE (CHH) ¶ 2342 (2004) (requiring that trades be subjected to review procedures); Chi. Bd. Options Exch. Rules 4.2, 9.8, CHICAGO BOARD OPTIONS EXCHANGE GUIDE (CCH) ¶¶ 2082, 2308 (2004); 17 C.F.R. § 166.3 (2000). See generally Lawrence A. Cunningham, *The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism, Other Ills*, 29 J. CORP. L. 267 (2004) (discussing the diffusion of internal controls, particularly in the financial fraud area).

47. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959, 970 (Del. Ch. 1996) (holding that in order to receive business judgment rule protection, directors must "exercise a good faith judgment that the corporation's information and reporting system is in concept and design adequate to assure the board that appropriate information will come to its attention in a timely manner as a matter of ordinary operations").

gal professionals—may have overestimated the risk of personal liability.<sup>48</sup>

However, the legal arena that arguably has most ardently embraced the composite and negligence-based organizational liability approach and, consequently, has had the greatest impact on the adoption of internal compliance structures is EEO law, especially the law governing workplace harassment. EEO law incorporates standards of organizational due care into organizational liability determinations in at least three ways.

First, internal compliance structures (especially EEO hiring, promotion, and termination policies; grievance procedures; and diversity education programs) may operate as a defense against punitive damages in claims of intentional discrimination by allowing organizations to demonstrate good-faith efforts to comply with EEO law.<sup>49</sup> Although in many cases the defendant's compliance structures have been found inadequate to insulate the employer from punitive damages, other defendants have managed to successfully invoke their internal compliance structures as a shield against punitive damages.<sup>50</sup>

Second, the employer's EEO-related internal compliance structures may be examined—along with other circumstantial evidence—to determine whether the employer harbored discriminatory intent.<sup>51</sup> In other words, because employers today rarely leave a “smoking gun” that plaintiffs can invoke to demonstrate overt animus, plaintiffs and defendants alike may rely on circumstantial evidence, in-

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48. Because “only a sustained or systematic failure of the board to exercise oversight” such as “an utter failure to attempt to assure a reasonable information and reporting system exists” leads to director liability, the risk of personal liability to directors is probably slight. *Id.* at 971. Corporate boards, however, seem to treat the risk as real. See Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 819-20 (2001) (arguing that boards of directors have overestimated the threat of personal liability under *Caremark*).

49. *Kolstad v. Am. Dental Ass'n*, 527 U.S. 526 (1999) (holding that employers who are able to demonstrate good-faith efforts to comply with EEO law may avoid punitive damages for the discriminatory acts of agents acting within the scope of their employment).

50. See, e.g., *Bryant v. Aiken Reg'l Med. Ctrs., Inc.*, 333 F.3d 536, 548-49 (4th Cir. 2003) (holding that a hospital could not be liable to African-American employees for punitive damages because the hospital undertook widespread antidiscrimination efforts, including its creation of a hospital-wide antidiscrimination policy and its implementation of a grievance policy and diversity training program; thus, it could not be vicariously liable for its managerial employees' discriminatory decisions); *Jaudon v. Elder Health, Inc.*, 125 F. Supp. 2d 153, 172 (D. Md. 2000) (finding that the defendant employer had demonstrated a good-faith effort to comply with Title VII because it had “published, maintained, and distributed sexual harassment, open door, and equal opportunity policies”).

51. Vicki Schultz, *Telling Stories About Women and Work: Judicial Interpretations of Sex Segregation in the Workplace in Title VII Cases Raising the Lack of Interest Argument*, 103 HARV. L. REV. 1749, 1789-92 (1990) (discussing the use at trial of evidence of internal compliance structures, especially affirmative action policies, to establish the lack of interest defense in sex discrimination cases).

cluding the presence or lack of EEO hiring, promotion, and termination policies, diversity training, and the like, in order to demonstrate or disprove intentional discrimination.

Finally, the employer's internal compliance structures may be relevant to a determination of liability in any hostile environment harassment claim, especially supervisor hostile environment harassment of which the employer was unaware.<sup>52</sup> Employers face liability for hostile environment harassment under three different standards. First, for coworker hostile environment harassment, the employer is judged under a negligence standard and is liable for all harassment of which it knew or should have known and negligently failed to correct. Antiharassment policies, employee training designed to prevent harassment, and formal harassment complaint procedures may all constitute evidence that the employer was not negligent in failing to discover the harassment.<sup>53</sup> Similarly, these same EEO-compliance structures may be employed to demonstrate that, despite the plaintiff employee's complaints of harassment, knowledge cannot be imputed to the employer.<sup>54</sup>

Second, with regard to supervisor hostile environment harassment of which the employer was aware, the employer may be held liable for its own negligence in failing to properly respond to the harassment. The implementation of internal grievance procedures, anti-

52. Hostile environment harassment occurs when the employer's behavior is so severe or pervasive that, although there is no tangible harm, such as job loss or decreased pay, the behavior nonetheless alters the terms or conditions of employment in violation of Title VII. *Burlington Indus., Inc. v. Ellerth*, 524 U.S. 742, 752 (1998). The Supreme Court has also recognized "tangible employment actions," which involve "a significant change in employment status, such as hiring, firing, failing to promote, reassignment with significantly different responsibilities, or a decision causing a significant change in benefits," made on the basis of the employee's membership in any Title VII protected class. *Id.* at 761. Because the employer faces strict liability for all tangible employment actions, *id.* at 762-63, however, the employer's internal compliance structures should not be relevant to a finding of liability in tangible employment actions.

53. See, e.g., *Newtown v. Shell Oil Co.*, 52 F. Supp. 2d 366, 372 (D. Conn. 1999) (stating that an employer must provide an avenue for complaints in order to avoid liability for a negligent failure to know of existing harassment); *Velez v. City of New Jersey*, 817 A.2d 409, 414 (N.J. Super. Ct. App. Div. 2003) (holding that "an employer may be held liable for sexual harassment under a theory of negligence based upon 'its failure to have in place well-publicized and enforced anti-harassment policies, effective formal and informal complaint structures, training, and/or monitoring mechanisms'" (quoting *Lehmann v. Toys 'R' Us, Inc.*, 626 A.2d 445, 463 (N.J. 1993))).

54. See, e.g., *Madray v. Publix Supermarkets, Inc.*, 208 F.3d 1290, 1298-99 (11th Cir. 2000) (holding that because the employer's well-publicized harassment policy specified the proper channels for harassment complaints and the plaintiff did not follow those channels, knowledge of the plaintiff's harassment could not be imputed to the defendant employer); *Giuliani v. Stuart Corp.*, 512 N.W.2d 589, 595 (Minn. Ct. App. 1994) ("When companies institute written policies established to deal intelligently with allegations of sexual harassment, it is more likely that management will be informed of any impropriety occurring within the company. Companies that fail to institute such policies will naturally find themselves vulnerable to the likelihood that knowledge will be imputed to them.").

harassment policies, and diversity training may all constitute evidence of a proper response to the harassment.<sup>55</sup>

The cases in which the employer's harassment policies and procedures will be most relevant, however, are cases of supervisor hostile environment harassment of which the employer was unaware. In such cases, the employer is held vicariously liable unless it can establish a two-part affirmative defense: "(a) that the employer exercised reasonable care to prevent and correct promptly any sexually harassing behavior, and (b) that the plaintiff employee unreasonably failed to take advantage of any preventative or corrective opportunities provided by the employer or to avoid harm otherwise."<sup>56</sup>

In adopting the two-pronged affirmative defense, the Supreme Court declined to require antiharassment policies and compliance procedures as a matter of law and never stated that such policies, standing alone, are sufficient to insulate employers from liability for supervisor hostile environment harassment. The Court did, however, highlight the importance of antiharassment policies and internal complaint procedures in establishing the first prong of the defense, stating that

[w]hile proof that an employer had promulgated an antiharassment policy with complaint procedure is not necessary in every instance as a matter of law, the need for a stated policy suitable to

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55. See, e.g., *Idusuyi v. Tenn. Dep't of Children's Servs.*, No. 00-6324, 2002 WL 220640, at \*4 (6th Cir. Feb. 11, 2002) (holding that the employer was entitled to judgment as a matter of law on its affirmative defense because it had a policy prohibiting sexual harassment, a complaint procedure that the plaintiff failed to use, and a two-hour training session on sexual harassment); *Smith v. First Union Nat'l Bank*, 202 F.3d 234, 244 (4th Cir. 2000) ("An employer's adoption of an effective anti-harassment policy is an important factor in determining whether it exercised reasonable care to prevent any sexually harassing behavior."); *Brown v. Perry*, 184 F.3d 388, 396 (4th Cir. 1999) (stating that if "there is no evidence that an employer adopted or administered an anti-harassment policy in bad faith or that the policy was otherwise defective or dysfunctional, the existence of such a policy militates strongly in favor of a conclusion that the employer 'exercised reasonable care to prevent' and promptly correct sexual harassment" (quoting *Faragher v. City of Boca Raton*, 524 U.S. 775, 808 (1998))); *Citroner v. Progressive Cas. Ins. Co.*, 208 F. Supp. 2d 328, 341 (E.D.N.Y. 2002) (holding that the employer exercised reasonable care to prevent racial harassment because it had adopted an "antiharassment policy with a complaint procedure, the Code of Conduct and Open Door Policy").

56. *Faragher*, 524 U.S. at 807; see also *Ellerth*, 524 U.S. at 764 (adopting the same standard). The second prong of the Supreme Court's test has been criticized at length by legal commentators and social scientists, who argue that victims of sexual harassment rarely utilize internal complaint procedures for a variety of reasons that are entirely reasonable. See, e.g., Linda Hamilton Krieger, *Employer Liability for Sexual Harassment—Normative, Descriptive, and Doctrinal Interactions: A Reply to Professors Beiner and Bisom-Rapp*, 24 U. ARK. LITTLE ROCK L. REV. 169, 181-85 (2001) (noting that survey data reveals that only two to fifteen percent of sexual harassment victims utilize employers' internal complaint procedures for reasons that include the following: beliefs that informal avenues are more effective; fear of blame, retaliation, or not being believed; and concerns regarding the effectiveness of internal complaint procedures).

the employment circumstances may appropriately be addressed in any case when litigating the first element of the defense.<sup>57</sup>

Many lower courts, however, seem to have gone much further, treating EEO-related internal compliance structures as both necessary and sufficient conditions for liability avoidance. For example, some lower courts have treated antiharassment policies and internal complaint procedures as, in and of themselves, legally sufficient to establish the reasonableness of the employer's attempts to prevent or correct harassment.<sup>58</sup> Similarly, many lower courts have seemed to treat internal compliance structures as a necessary condition for liability avoidance, ruling that employers without such structures cannot establish the affirmative defense.<sup>59</sup>

Although the true extent to which EEO-related internal compliance structures result in systematic differences in the rate and amount of employer liability is an empirical question that has not fully been answered, two points are clear.<sup>60</sup> First, legal compliance professionals have cleverly, but predictably, packaged EEO internal compliance structures into absolute necessities for employers hoping to avoid huge liabilities.<sup>61</sup> Second, there has been an increasing em-

57. *Ellerth*, 524 U.S. at 745; see also *Faragher*, 524 U.S. at 807.

58. See, e.g., *Perry*, 184 F.3d at 396 (stating that if "there is no evidence that an employer adopted or administered an anti-harassment policy in bad faith or that the policy was otherwise defective or dysfunctional, the existence of such a policy militates strongly in favor of a conclusion that the employer 'exercised reasonable care to prevent' and promptly correct sexual harassment" (quoting *Faragher*, 524 U.S. at 807)); *Citroner*, 208 F. Supp. 2d at 341 (holding that the employer exercised reasonable care to prevent racial harassment because it had adopted an antiharassment policy and a complaint procedure); see also Susan Bisom-Rapp, *Fixing Watches with Sledgehammers: The Questionable Embrace of Employee Sexual Harassment Training by the Legal Profession*, 24 T. JEFFERSON L. REV. 125, 141 (2002) (discussing the role of harassment training in lower court decisions after *Ellerth* and *Faragher*).

59. See, e.g., *Molnar v. Booth*, 229 F.3d 593, 601 (7th Cir. 2000) (holding, as a matter of law, that defendant employer "could never show that it had exercised reasonable care to prevent and correct promptly any harassing behavior" because "it had no policy specifically aimed at sexual harassment," only a nondiscrimination policy).

60. Lauren Edelman provides some evidence on this point in an empirical study conducted shortly after the decision in *Meritor Savings Bank v. Vinson*, 477 U.S. 57, 72 (1986), which replaced the existing standard of strict vicarious liability with a duty-based liability standard. Lauren B. Edelman et al., *The Endogeneity of Legal Regulation: Grievance Procedures as Rational Myth*, 105 AM. J. SOC. 406, 440 (1999). At the time of the study, only 116 cases raising the grievance procedure affirmative defense had been decided since *Meritor*. *Id.* at 440. Of those 116 cases, ninety-one percent indicated that a well-crafted internal grievance procedure would insulate the employer from liability, and in thirty-six of those ninety-one percent of cases, the employer's grievance procedures did insulate the company from liability. *Id.* Furthermore, Edelman found that courts were becoming increasingly willing to defer to employers' grievance procedures when assessing liability. *Id.* at 442. If true, the percentage of cases in which the employer's EEO internal compliance structures provide insulation from liability could be much higher today.

61. See, e.g., Gruner, *supra* note 33, at 163 (stating that "the liability standards in the EEO field . . . make compliance program quality the key to reducing certain forms of employer liability"); Ellen McLaughlin & Carol Merchasin, *Training Becomes Important Step*

phasis during litigation on the employer's internal compliance structures, with plaintiffs' lawyers and the Equal Employment Opportunity Commission seeking to determine how much money the employer has spent on such structures, the content of training sessions, and the expertise of diversity trainers and human resources personnel.<sup>62</sup>

#### IV. DETERRENCE UNDER INTERNAL COMPLIANCE-BASED LIABILITY REGIMES

Unfortunately, the empirical evidence regarding the role of internal compliance structures in reducing organizational misconduct provides little reason to approach with enthusiasm the U.S. legal system's movement to internal compliance-based organizational liability regimes. Surprisingly little empirical evidence exists regarding the effectiveness of internal compliance structures in deterring organizational misconduct—a disturbing fact given the legal regime's heavy reliance on such structures as a liability determinant. Even more disturbing, however, is the fact that the evidence that does exist is decidedly mixed, with many of the most recent and methodologically sound studies finding no significant correlation between the most widely used internal compliance structures and reduced organizational misconduct.

This Part analyzes the empirical evidence regarding three types of internal compliance structures on which the U.S. legal regime places special reliance: ethics or conduct codes, the OSG-recommended internal compliance structures, and diversity or harassment training. As will be shown, there is insufficient empirical evidence to conclude that any of these mechanisms deter organizational misconduct.

##### A. *Ethics Codes*

Despite the pervasiveness of ethics codes in corporate America and the importance ascribed to them by the U.S. legal regime, little evidence exists to support the theory that ethics codes modify employee behavior. Although some studies do find a significant relationship between ethics codes and employee conduct, they are plagued with methodological problems, such as a failure to query respondents on or identify modified behavior due to ethics codes (as opposed to merely asking respondents whether they believe that ethics codes are

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*to Avoid Liability*, NAT'L L.J., Jan. 29, 2001, at B10 (“[E]ngaging in quality training in conjunction with a well-written policy will likely translate into successfully meeting the good-faith defense of *Kolstad*.”); Bisom-Rapp, *supra* note 58, at 139 (quoting training advocates and attorneys as stating that *Ellerth* and *Faragher* require harassment training and that such training will insulate employers from liability).

62. McLaughlin & Merchasin, *supra* note 61.

an important factor affecting behavior), a reliance on hypothetical dilemmas in lab settings (as opposed to observing actual conduct in an employment setting), and a sole reliance on self-reporting.<sup>63</sup>

Furthermore, these findings are contradicted by a large number of studies finding no significant relationship between ethics codes and employee conduct.<sup>64</sup> Typical of these is a recent study in which respondents were unable to provide specific examples of instances in which employees had altered their behavior due to ethics codes, overwhelmingly indicated that their employers' conduct codes had not altered their conduct, and asserted that they had never referred to their employers' conduct codes.<sup>65</sup>

Of course, ethics codes are only one type of internal compliance structure and, moreover, are a very superficial one. Perhaps researchers have been unable to document a link between ethics codes and ethical conduct because supporting compliance structures, such as those required by the OSG, are necessary to deter organizational misconduct.

### B. *The OSG*

Unfortunately, very little research has attempted to verify whether the assumption underlying the OSG (that internal compliance structures such as those recommended in the *U.S. Sentencing Guidelines Manual* reduce the incidence of organizational miscon-

63. See, e.g., Alan Kitson, *Taking the Pulse: Ethics and the British Cooperative Bank*, 15 J. BUS. ETHICS 1021 (1996) (interviews with seventeen bank managers); Donald L. McCabe et al., *The Influence of Collegiate and Corporate Codes of Conduct on Ethics-Related Behavior in the Workplace*, 6 BUS. ETHICS Q. 461 (1996) (questionnaire to 328 college graduates); Margaret Anne Pierce & John W. Henry, *Computer Ethics: The Role of Personal, Informal, and Formal Codes*, 15 J. BUS. ETHICS 425 (1996) (questionnaire responses from 356 data-processing management professionals).

64. See, e.g., Jeff Allen & Duane Davis, *Assessing Some Determinant Effects of Ethical Consulting Behavior: The Case of Personal and Professional Values*, 12 J. BUS. ETHICS 449 (1993) (questionnaire survey of 207 national business consultants); Joseph L. Badaracco, Jr. & Allen P. Webb, *Business Ethics: A View from the Trenches*, CAL. MGMT. REV., Winter 1995, at 8 (interviews with thirty middle managers); Arthur P. Brief et al., *What's Wrong with the Treadway Commission Report? Experimental Analyses of the Effects of Personal Values and Codes of Conduct on Fraudulent Financial Reporting*, 15 J. BUS. ETHICS 183 (1996) (questionnaires and experiment with nearly 400 executives and controllers); Victor J. Callan, *Predicting Ethical Values and Training Needs in Ethics*, 11 J. BUS. ETHICS 761 (1992) (questionnaires from 226 state government employees); Margaret Anne Cleek & Sherry Lynn Leonard, *Can Corporate Codes of Ethics Influence Behavior?*, 17 J. BUS. ETHICS 619 (1998) (questionnaires from 150 graduate and undergraduate business students). However, many of these studies suffer from the same methodological problems that beset those studies finding a significant relationship between ethics codes and employee conduct.

65. M. Schwartz, *The Nature of the Relationship Between Corporate Codes of Ethics and Behaviour*, 32 J. BUS. ETHICS 247, 253 (2001) (concluding that although ethics codes may have the potential to alter employee behavior, "this appears to take place on very rare occasions").



duct) withstands empirical testing. In fact, only three large-scale studies seek systematically to test the assumptions of the OSG recommendations.<sup>66</sup> None of the studies supported the hypothesis that the OSG-recommended internal compliance structures deter illegal conduct.

Indeed, two of the studies found unanticipated positive correlations between internal compliance structures and legal violations. The study authors attributed these findings to the possibility that internal compliance structures, such as those recommended by the OSG, may serve primarily a window-dressing function designed only to reduce legal liability.<sup>67</sup>

### C. Diversity and Harassment Training

Finally, due to Supreme Court and lower court interpretations of EEO law, diversity training (including harassment training) has become an increasingly common type of internal compliance structure. A 1998 study by the Society for Human Resource Management, for example, found that seventy-five percent of *Fortune 500* firms and thirty-six percent of other firms have a diversity training program of some sort.<sup>68</sup>

Nonetheless, there is little empirical support for the proposition that diversity training reduces discriminatory conduct. In a recent working paper, Katerina Bezrukova and Karen Jehn of the Wharton School reviewed twenty empirical studies published in major management, psychological, and sociological journals and concluded that “[h]aving reviewed the available empirical studies on the effects of

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66. See M. Cash Mathews, *Codes of Ethics: Organizational Behavior and Misbehavior*, in 9 RESEARCH IN CORPORATE SOCIAL PERFORMANCE AND POLICY 107, 108-09, 125 (William C. Frederick & Lee E. Preston eds., 1987) (examining the incidence of civil and administrative actions taken by four federal regulatory agencies against 485 corporations from 1973 through 1980 and concluding that “there is little relationship between codes of conduct [and their enforcement mechanisms] and corporate violations”); McKendall et al., *supra* note 30 (implementing a longitudinal study finding that the presence of OSG-recommended compliance structures do not reduce the incidence of OSHA violations); Marie A. McKendall & John A. Wagner, III, *Motive, Opportunity, Choice, and Corporate Illegality*, 8 ORG. SCI. 624 (1997).

67. Mathews, *supra* note 66, at 125-26 (finding a positive correlation between certain aspects of conduct code content—such as codes that require compliance affidavits by employees or that mention “maintaining the reputation of the corporation”—and the number of legal violations and concluding that “[p]erhaps executives in law-abiding corporations do not feel the need to convince others of their ‘good reputation’”); McKendall et al., *supra* note 30, at 380 (finding a positive correlation between the OSG-recommended internal compliance structures and the incidence of willful and repeat OSHA violations and concluding that, because willful and repeat violations are the type most likely to include senior management involvement or knowledge, organizations may be using the OSG-recommended internal compliance structures to hide management involvement in, or reduce organizational liability for, purposeful illegal activity).

68. Richard S. Allen & Kendyl A. Montgomery, *Applying an Organizational Development Approach to Creating Diversity*, 30 ORGANIZATIONAL DYNAMICS 149, 149 (2001).

diversity training programs in corporations and on campuses it is obvious that it is too soon to draw any comprehensive conclusions.”<sup>69</sup> Although much of the empirical research reviewed by Professors Bezrukova and Jehn identified improvements in diversity training participants’ awareness of diversity issues,<sup>70</sup> only one of the studies documented sustained attitudinal or behavioral changes.<sup>71</sup>

Similarly, in the most comprehensive study of diversity training and other EEO compliance measures ever undertaken, Alexandra Kalev, Frank Dobbin, and Erin Kelley combine survey information on affirmative action and diversity programs from more than 800 American employers with annual federal data on their workforce composition from 1971 to 1999.<sup>72</sup> As a general rule, organizations

69. Katerina Bezrukova & Karen A. Jehn, *The Effects of Diversity Training Programs* 16 (July 2001) (unpublished manuscript, on file with author).

70. *Id.* at 10-11; see also Heidi Tarr Henson, *Gauging the Outcomes of Organizational Diversity Implementations: The Intersection of Attitudes, Awareness and Behavior*, 60 DISSERTATION ABSTRACTS INT’L 2325 (2000) (finding that diversity training achieved an awareness of diversity issues but did not result in attitudinal changes); Dick Wallace Kracht, *Diversity Training Among Manufacturing Companies: Reaction and Learning in a For-Profit and Not-For-Profit Work Environment*, 59 DISSERTATION ABSTRACTS INT’L 2345 (1999) (finding an increase in perceived learning among 141 employees after diversity training); Dana Yavette Law, *An Evaluation of a Cultural Diversity Training Program*, 59 DISSERTATION ABSTRACTS INT’L 2468 (1998) (finding improved awareness of diversity issues in training group relative to control group); Jean A. Mausehund et al., *Diversity Training: Effects of an Intervention Treatment on Nonverbal Awareness*, BUS. COMM. Q., Mar. 1995, at 27 (finding a positive link between diversity training and awareness of non-verbal factors in interpersonal communications between people from different cultures); David L. Tan et al., *Changes in Attitude After Diversity Training*, TRAINING & DEV., Sept. 1996, at 54 (finding a significant increase in diversity awareness in 739 managers after diversity training workshops).

71. See Bezrukova & Jehn, *supra* note 69, at 11-13. Compare Taylor Cox, Jr., *The Multicultural Organization*, ACAD. MGMT. EXECUTIVE, May 1991, at 34, 45 (finding that “Race Relations Competence Workshops” resulted in more positive attitudes toward African Americans and better interracial relations among workshop participants), with Sara Rynes & Benson Rosen, *What Makes Diversity Programs Work?*, H.R. MAG., Oct. 1994, at 67 (surveying 785 members of the Society for Human Resource Management and finding positive short-term impact of diversity training on attitudes but less positive long-term benefits), Diane Marie Govern, *The Effect of Diversity Awareness Training on Oral Presentation Ratings*, 58 DISSERTATION ABSTRACTS INT’L 5681 (1998) (finding no correlation between diversity training and ratings of oral presentations by black and white police sergeant candidates), and Henson, *supra* note 70, at 2325 (finding no attitudinal change in respondents from diversity training). Bezrukova and Jehn reviewed five studies that tested the impact of diversity training programs on college campuses. Bezrukova & Jehn, *supra* note 69, at 12. Three of the studies found a small positive correlation between diversity training and attitudes toward ethnic minorities. However, the authors attributed this variation to self-selection bias, rather than to a real change in attitudes. *Id.* at 12-13.

Further compromising the effectiveness of diversity training are two factors: first, the backlash that may result; and, second, the attempt to “sterilize” diversity training sessions in anticipation of the fact that statements made may be admitted as evidence during litigation. Krawiec, *supra* note 21, at 515 nn.96-97 (discussing the evidence on backlash and sterilization of training sessions).

72. Alexandra Kalev, Frank Dobbin & Erin Kelly, *Two to Tango: Affirmative Action, Diversity Programs and Women and African-Americans in Management 2* (unpublished draft), *avail-*

that implemented diversity training programs aimed at individuals did not significantly improve managerial diversity and, in fact, tended to significantly decrease the odds of women in management positions.<sup>73</sup> Although the authors did find that some affirmative action and diversity measures (especially those programs designed to “couple” rhetoric regarding diversity goals with activities designed to promote diversity) had significant, positive impacts on the odds of women and minorities in management, particularly at employers that are government contractors, they conclude that diversity measures designed to counter managerial bias, including diversity training, are least effective.<sup>74</sup>

In the end, Kalev, Dobbin, and Kelly conclude that at least some types of EEO internal compliance structures can enhance diversity, if coupled with legal accountability.<sup>75</sup> Their study demonstrates, however, how much we have yet to learn about the impacts of EEO compliance structures on different demographic groups and the circumstances under which even the most promising EEO compliance structures can be expected to combat discrimination. In the rapid move to internal compliance-based organizational liability, however, such distinctions appear to have been uniformly ignored.

As extensively discussed by Professor Susan Bisom-Rapp, the empirical evidence regarding the effectiveness of sexual harassment training is equally sparse.<sup>76</sup> As noted by two researchers in the field,

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able at [http://www.wjh.harvard.edu/~dobbin/cv/unpublished/2004\\_aapractices\\_kalev.pdf](http://www.wjh.harvard.edu/~dobbin/cv/unpublished/2004_aapractices_kalev.pdf) (last visited Feb. 7, 2005).

73. *Id.* at 28. With respect to all employers, diversity training had a significant, negative impact on the odds of black women in management positions and no significant impact on the odds of white women and black men in management positions. *Id.* at 53 tbl.2. However, when the data are broken down into the impact of diversity training at government contractors (who are subject to affirmative action obligations) versus noncontractors, diversity training among the latter is shown to have a significant, negative impact on the odds of both white and black women in management positions, while failing to significantly impact the odds of black men. *Id.* at 54 tbl.3. In contrast, among employers that are government contractors, diversity training had a significant, positive impact on the odds of white women in management positions, while failing to impact the odds of black men or black women. *Id.*

74. *Id.* at 28-29, 31, 37. Many diversity measures impacted different demographic groups differently. For example, a program or measure might improve the odds of white women in management while at the same time negatively impacting or failing to significantly impact the odds of black men in management. *Id.* at 53 tbl.2, 54 tbl.3. However, as a general rule, measures designed to combat the “decoupling” of diversity rhetoric from action (such as affirmative action plans, diversity committees, and diversity staff positions) enhanced managerial diversity more than other measures did. *Id.* at 28. In addition, the effectiveness of different measures varied across type of employer: diversity measures tended to be more effective at government contractors, who are subject to affirmative action obligations, than at noncontractors. *Id.* at 30-32.

75. *Id.* at 38.

76. Susan Bisom-Rapp, *An Ounce of Prevention Is a Poor Substitute for a Pound of Cure: Confronting the Developing Jurisprudence of Education and Prevention in Employment Discrimination Law*, 22 BERKELEY J. EMP. & LAB. L. 1, 31-38 (2001) [hereinafter Bi-

“[T]he unpleasant empirical truth is that almost nothing is known about the effects of sexual harassment education and training programs.”<sup>77</sup> Given the dearth of research on the effects of sexual harassment training, many social scientists are alarmed at the unwavering commitment of employers and compliance professionals to harassment training.<sup>78</sup>

Moreover, the existing research on the effects of harassment training fails to support the hypothesis that harassment training alters employee conduct. Although some studies do support the notion that harassment training increases trainees’ awareness of potential instances of harassment, many researchers doubt that the training has long-term effects on attitudes or behavior.<sup>79</sup>

#### D. Summary

In sum, the data regarding the effectiveness of internal compliance-based organizational liability regimes is both preliminary and disturbing. First, the fact that the U.S. legal regime has so quickly transitioned to internal compliance-based liability regimes based on such limited and conflicting evidence is troubling. Existing studies are insufficient in number, methodology, and scope to warrant such a move. Nonetheless, this trend should not be surprising, given the political influence of those who benefit most from an internal compliance-based liability regime—organizational defendants and the legal compliance professionals who serve them.

Perhaps more importantly, the evidence that does exist regarding the effectiveness of internal compliance-based liability regimes suggests that many types of widely used internal compliance structures currently considered to demonstrate good-faith organizational attempts to comply with the law are ineffective at reducing organizational misconduct. Even the Kalev, Dobbin, and Kelly study, which concludes that EEO internal compliance structures can enhance EEO compliance under some circumstances,<sup>80</sup> demonstrates the dangers of an ill-conceived internal compliance-based liability regime. If that regime rewards organizations even for those compliance measures that decouple compliance rhetoric from compliance activity or

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som-Rapp, *Ounce*] (reviewing some existing studies); Susan Bisom-Rapp, *Bulletproofing the Workplace: Symbol and Substance in Employment Discrimination Law Practice*, 26 FLA. ST. U. L. REV. 959, 967-76 (1999) (arguing that many employers adopt minimally disruptive symbolic compliance policies and procedures that result in little, if any, substantive change in the employment environment); Bisom-Rapp, *supra* note 58, at 142-44.

77. Robert S. Moyer & Anjan Nath, *Some Effects of Brief Training Interventions on Perceptions of Sexual Harassment*, 28 J. APPLIED SOC. PSYCHOL. 333, 334 (1998).

78. Bisom-Rapp, *supra* note 58, at 142-43 (pointing out two reasons why it may be dangerous to implement such training without sufficient information).

79. *Id.* at 143-44.

80. *See supra* notes 72-75 and accompanying text.

that have been shown to be of limited effectiveness, then such a regime may fail to accomplish—and may even thwart—the goal of reducing organizational misconduct.<sup>81</sup>

In short, given the theoretical problems inherent in internal compliance-based liability regimes discussed in Part II of this Article and the large and politically powerful interest groups that stand to benefit from such a regime, defenders of the move to internal compliance-based organizational liability systems should bear the burden of proving the effectiveness of internal compliance structures in reducing organizational misconduct. The analysis of the available empirical evidence detailed in this Part indicates that this burden has not been met.

## V. EXPLAINING THE ORGANIZATIONAL LIABILITY REGIME

Why does the law place so much reliance on factors, such as internal compliance structures, that appear to have little impact on the incidence of organizational misconduct? This Part explores two possible explanations: (1) an overreliance on principal-agent models of organizational misconduct and (2) public-choice explanations.

### A. *Principal-Agent Models of Misconduct*

One potential explanation for the legal regime's heavy reliance on internal compliance structures as a liability determinant is an overreliance on principal-agent models of organizational misconduct.<sup>82</sup> In other words, current legal theory largely assumes that misconduct within organizations results from the acts of single, independent agents who disregard the preferences of shareholder principals and their representatives—the board of directors and senior management.<sup>83</sup> In the more so-

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81. The Kalev, Dobbin, and Kelly study also demonstrates that even when internal compliance structures provide some positive results, they may be accompanied by unintended negative consequences. For example, some diversity measures appeared to benefit one demographic group at the expense of another, although both groups were the ostensible beneficiaries of the measures. See Kalev, Dobbin & Kelly, *supra* note 72, at 33, 53 tbl.2, 54 tbl.3 (finding that some diversity measures increase the odds of management positions for one minority demographic group, while decreasing it for one or more other minority demographic groups).

82. See, e.g., Arlen, *supra* note 2, at 834 (“These agents are rational self-interested utility maximizers who commit crimes in order to benefit themselves. In pursuit of his own self-interest an agent may commit a crime that incidentally benefits the corporation, but this is not its purpose.”); Kevin B. Huff, *The Role of Corporate Compliance Programs in Determining Corporate Criminal Liability: A Suggested Approach*, 96 COLUM. L. REV. 1252, 1288-89 (1996); Julie Rose O’Sullivan, *Professional Discipline for Law Firms? A Response to Professor Schneyer’s Proposal*, 16 GEO. J. LEGAL ETHICS 1, 19 n.82 (2002) (criticizing the view of organizational misconduct as the behavior of a single, errant agent).

83. In the majority of large organizations in which organizational misconduct is detected, active participation in or direct knowledge of the misconduct is rarely attributable to senior management and even more rarely to the board of directors.

phisticated version of this argument, even when misconduct is undertaken in order to enhance corporate profitability or performance, the primary motivation is to promote or safeguard the careers of the agents undertaking the misconduct.<sup>84</sup>

If the law overrelies on principal-agent models of organizational misconduct, then one can see why the legal system might place too much emphasis on internal compliance structures as a liability determinant. If organizational misconduct is simply an agency cost problem, then internal compliance structures—such as internal monitoring and reporting, employee training, and conduct codes—might reduce such problems by increasing the ease with which shareholder principals (through senior management and boards of directors) can monitor employee and mid-level management agents.<sup>85</sup>

Unfortunately, however, organizational misconduct is much more complicated than this. The simple principal-agent model of organizational misconduct embodied in much legal theory conflates the concepts of what sociologists refer to as *organizational misconduct*—conduct undertaken at least in part to benefit the organization—and *occupational misconduct*—conduct undertaken solely to benefit the perpetrator and from which the organization derives no benefit.<sup>86</sup> Indeed, the organization may actually be the victim of occupational misconduct, as in the case of embezzlement, for example.

Because the agent derives no direct benefit from organizational misconduct, the personal benefits from such actions must derive from increased pay, status, or job security—benefits resulting from the appearance of organizational profitability caused by the misconduct.<sup>87</sup> Unless organizational agents systematically miscalculate the probability that organizational misconduct will positively impact the bottom line, then, by definition, their conduct must create real or apparent profits. Real profits in excess of real costs will, of course, always benefit shareholder principals. In addition, the creation of *apparent* profits will sometimes benefit shareholder principals. Therefore, as discussed below, the category of actions that represent

84. Jonathan R. Macey, *Agency Theory and the Criminal Liability of Organizations*, 71 B.U. L. REV. 315, 319 (1991).

85. By focusing on the costs and benefits of organizational misconduct to shareholders, I do not mean to imply that other organizational stakeholders are unaffected by such actions. Indeed, as demonstrated by recent events at Enron and Arthur Andersen, often low-level employees, creditors, and other stakeholders far removed from the misconduct in question are greatly harmed by organizational misconduct.

86. See *supra* note 1 for sources defining organizational misconduct.

87. See Adrian E. Tschoegl, *The Key to Risk Management: Management*, in RISK MANAGEMENT: CHALLENGE AND OPPORTUNITY 103 (Michael Frenkel et al. eds., 2000) (arguing that the academic finance and management literature has failed to develop a sufficient understanding of organizational misbehavior because it is overly focused on agency cost explanations when, in many of the most high-profile misconduct examples, the agent's incentives were aligned with those of his or her firm, at least in the beginning).

attempts to increase shareholder-principal welfare may be larger than is typically assumed. These actions thus are not properly characterized as principal-agent problems.

Specifically, a simple agency cost model of organizational misconduct is incomplete in at least two ways. First, a model of organizational misconduct that treats agent misdeeds as the feat of a lone individual actor ignores the role played by the organizational system in shaping that conduct. Second, organizational misconduct may benefit organizational profitability and performance (and thus shareholder welfare) in subtle and difficult-to-quantify ways, which means that organizational management (even when acting as the loyal agents of shareholder owners) may have reasons to tolerate such behavior that are not immediately obvious.

### 1. *Organizational Environment*

For many years now, researchers who study human behavior have been aware of the powerful role played by environment, including organizational environment, in shaping individual perceptions and actions. Yet many legal scholars, and the legal system itself, steadfastly ignore any responsibility by those who create that climate for the acts of errant agents, except to the extent that other organizational actors were actually aware of or contributed to the misconduct.

Yet, senior management, through the organizational climate that it creates, plays an important role in shaping agent conduct. Although senior management shapes the organizational environment (and thus employee conduct) in many ways, at least three mechanisms have been extensively studied: organizational culture, incentive and reward systems, and management's commitment to ethical conduct.<sup>88</sup> For example, a climate in which employees are encouraged to pursue or are rewarded for pursuing the bottom line even at the expense of breaking laws or the company's conduct code is more likely to produce agents who violate laws and conduct codes.<sup>89</sup> Simi-

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88. Other individual (that is, personal values), organizational (for example, organization size, decentralization, and financial distress), and industry (for example, concentration) factors have also been shown to impact organizational misconduct rates. *See, e.g.*, McKendall & Wagner, *supra* note 66, at 644 (finding that organizational size, structure, complexity, and industry concentration are significant factors impacting the incidence of corporate illegality); McKendall et al., *supra* note 30, at 368, 376 (discussing earlier studies that proposed that illegal activity is more likely in firms facing financial pressure and finding that lower firm profitability is positively associated with firm OSHA violations).

89. *See, e.g.*, Allen & Davis, *supra* note 64, at 456 (finding that corporate culture and reward systems—rather than mere ethics codes—impact employee behavior); Anita Jose & Mary S. Thibodeaux, *Institutionalization of Ethics: The Perspective of Managers*, 22 J. BUS. ETHICS 133, 138 (1999) (finding that 98.8% of managers surveyed ranked top management support and that 93% ranked corporate culture as more important than other factors such as conduct codes and training programs in encouraging ethical corporate conduct).

larly, lower-level employees are likely to take their cues regarding what behavior is acceptable from senior management and coworkers. Agents who believe that management's commitment to the observance of laws and organizational rules is symbolic rather than real are more likely to disregard those laws and rules.<sup>90</sup>

Finally, the compensation and reward system employed by management may greatly affect employee behavior. Rewards and punishments that are performance-based and fail to properly account for the method by which performance goals are attained are likely to result in more violations than a reward and punishment system that more carefully accounts for the means by which performance goals are attained.<sup>91</sup>

I am not asserting that, as a general rule, organizational liability regimes should attempt to account for factors related to the incidence of organizational misconduct—such as organizational culture, incentive and reward systems, and management's commitment to ethical actions—by directly incorporating them into liability, sanctioning, or prosecutorial determinations.<sup>92</sup> Like determinations regarding the effectiveness of internal compliance structures, an analysis of these factors by legal decisionmakers is likely to be difficult, costly, and fraught with errors.<sup>93</sup> Nor am I attempting to exonerate culpable in-

90. See *supra* note 12 for sources discussing the importance of managerial attitudes and behavior in deterring organizational misconduct.

91. Allen & Davis, *supra* note 64, at 456 (finding that organizational reward systems significantly impact employee behavior); Lynne L. Dallas, *A Preliminary Inquiry into the Responsibility of Corporations and Their Officers and Directors for Corporate Climate: The Psychology of Enron's Demise*, 35 RUTGERS L.J. 1, 34-40 (2003) (discussing organizational reward and compensation systems).

92. Lawmakers have on several occasions demonstrated an awareness that factors such as organizational culture and reward systems may contribute to organizational misconduct. See, e.g., U.S. SENTENCING COMM'N, REPORT OF THE AD HOC ADVISORY GROUP ON THE ORGANIZATIONAL SENTENCING GUIDELINES 54 (2003) [hereinafter AD HOC REPORT] (urging organizations to "promote an organizational culture that encourages a commitment to compliance with the law"), available at [http://www.usc.gov/corp/advgrprpt/AG\\_Final.pdf](http://www.usc.gov/corp/advgrprpt/AG_Final.pdf) (last visited Feb. 7, 2005); News Release, SEC, SEC Chairman Levitt Receives Compensation Committee's Report Highlighting Industry 'Best Practices'; Calls on Entire Industry to Review Closely (Apr. 10, 1995) (warning that the compensation system used by many broker-dealers provides incentives to churn customer accounts and recommend unsuitable investments), available at 1995 WL 154267.

93. There are likely to be some instances where the connection between organizational incentive systems and organizational misconduct is quite clear. One commonly cited example is the complaint brought against Sears, Roebuck & Company by consumers and attorneys general in more than forty states. See Lynn Sharp Paine, *Managing for Organizational Integrity*, HARV. BUS. REV., Mar.-Apr. 1994, at 106, 107. In an attempt to revive lagging sales in its automotive service centers, Sears management imposed minimum work quotas, productivity incentives, product-specific sales quotas, paid its automotive service salesmen and mechanics with commissions based on sales, and exerted considerable pressure on automotive center employees to perform more work. *Id.* Predictably, many employees responded by defrauding customers through sales of unnecessary parts and services. *Id.* at 108. Sears eventually settled the suits for sixty million dollars. *Id.*



dividual actors by suggesting that a focus on the environment that contributed to their misconduct is warranted. Instead, my goal is simply to demonstrate the extraordinary amount of influence that the organization (through senior management) has on the level of misconduct in its ranks—an influence that is obscured by perceptions of organizational misconduct as an agency cost problem stemming from the acts of individual deviant agents.

## 2. *Misconduct and Organizational Performance*

In addition, many legal scholars assume, either implicitly or explicitly, that many forms of agent misconduct provide no potential benefits to the organization itself. My goal in this Part, however, is to provide several examples of conduct typically thought to provide no organizational benefits and to demonstrate the circumstances under which this assumption may be false. I do not offer conclusive proof that such misconduct positively impacts the bottom line; the research in this area is too preliminary to warrant such a conclusion. Instead, my goal is simply to induce greater skepticism toward the claim that these actions necessarily reflect the isolated misconduct of a single or small group of deviant agents who have succeeded—despite management’s best efforts—to violate laws or company policies.

Some incidents of agent misconduct provide such obvious potential benefits for the firm that the inevitable organizational disavowals of such conduct as the acts of a deviant or “rogue” employee should be viewed with immediate skepticism.<sup>94</sup> The most recent variation on this scenario has arisen in connection with the recent mutual fund scandal. For example, in early November 2003, state and federal authorities charged seven former Prudential employees with securities fraud in connection with mutual fund market-timing trades on behalf of large hedge fund clients but did not charge Prudential or its senior management team. The brokers claimed, however, that both management and the firm’s compliance department were fully aware of the trades and rewarded the brokers handsomely for the fees they brought in.<sup>95</sup>

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94. Paine, *supra* note 93, at 106 (noting that business “executives are quick to describe any wrongdoing as an isolated incident, the work of a rogue employee,” but that “unethical business practice involves the tacit, if not explicit, cooperation of others and reflects the values, attitudes, beliefs, language, and behavioral patterns that define an organization’s operating culture”).

95. David Barboza, *Brokers Say Prudential Approved Trading*, N.Y. TIMES, Nov. 8, 2003, at C1. According to the Massachusetts Securities Division, charges may be brought against Prudential if it appears that high-level executives knew about or sanctioned the illicit trades. *Id.* As previously stated, however, such direct knowledge of or participation in organizational misconduct by senior management is extremely rare. Instead, the far more typical situation occurs when management creates an environment in which such conduct is encouraged and rewarded. Often, the most that can be concluded is that management

Other forms of organizational misconduct, however, may provide less obvious organizational benefits. This Part discusses three examples of agent misconduct that, at first blush, seem to provide no potential benefits for shareholder principals: “rogue” trading, discrimination, and financial fraud.

(a) *Rogue Trading*

“Rogue,” or unauthorized, trading may appear to be a classic example of occupational—as opposed to organizational—misconduct that causes only harm to the corporate enterprise, as evidenced by the many large and highly publicized rogue trading losses throughout the years. This perception of rogue-trading as isolated incidences of occupational misconduct is reinforced by the presence of extensive written conduct codes and costly compliance programs apparently designed to deter unauthorized trading. However, the same environment that gives rise to rogue trading may also foster other traits—for example, greed, independence, and risk-taking—that result in more profitable traders.<sup>96</sup> As a result, shareholder principals may be willing to tolerate some rogue-trading losses, so long as they are offset by the benefits of a more profitable trading floor.

First, traders tend to have a heightened sense of materialism, because the trading floor climate is designed to foster such an attitude.<sup>97</sup> Rather than rewarding successful traders with impressive titles or moves up the career ladder, the trading floor hierarchy tends to consist only of traders who earn more money for the firm and receive higher bonuses, versus traders who earn less.<sup>98</sup>

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set up a system that allowed or encouraged the misconduct to take place, then took steps to remain willfully ignorant of the behavior. *See, e.g., id.* (discussing vacations, bonuses, and management praise bestowed on the indicted brokers due to the large commissions earned on their hedge fund accounts).

96. *See* Kimberly D. Krawiec, *Accounting for Greed: Unraveling the Rogue Trader Mystery*, 79 OR. L. REV. 301, 316 (2000) (arguing that some financial institutions have made a conscious decision to foster an organizational climate that gives rise to at least some rogue trading, because to do so may maximize trading floor profits, and thus management compensation and status). The problem is likely exacerbated by a variety of behavioral factors, including the tendency to trust those whom we have trusted in the past. Because the events that give rise to large rogue-trading losses involve serial decisionmaking and substantial sunk costs, supervisors and others within the firm may tend toward an irrational escalation of commitment. *Id.*

97. MITCHEL Y. ABOLAFIA, *MAKING MARKETS: OPPORTUNISM AND RESTRAINT ON WALL STREET* 18, 30 (1996). “Money is more than just the medium of exchange; it is a measure of one’s ‘winnings.’ It provides an identity that prevails over charisma, physical attractiveness, or sociability as the arbiter of success and power on the bond trading floor. The top-earning trader is king of the mountain.” *Id.* at 30.

98. Krawiec, *supra* note 96, at 329.

Second, only individuals comfortable with taking large risks are attracted to, and survive in, trading floor jobs.<sup>99</sup> The compensation structure at most trading institutions, which is based almost exclusively on trading profits earned in the current fiscal year, exacerbates this attitude by sending a message that short-term profitability will be rewarded even if incurred at the cost of taking greater risks.<sup>100</sup> The high number of largely unsuccessful attempts by financial institutions to revise traders' compensation packages indicates that managers of financial institutions are aware of the potentially perverse incentives being created but have yet to find a mechanism for eradicating them that is compatible with encouraging the most profitable trading strategies.<sup>101</sup>

Finally, traders tend to be self-reliant and entrepreneurial, operating in an independent and often uncooperative environment. As a result, traders may view their primary obligation as maximizing the value of their own account and, thus, feel little duty to supervise those around them for potential violations of trading rules.<sup>102</sup>

Although these traits may contribute to rogue traders who violate the firm's risk and loss limits, firms may tolerate—and even encourage—those traits because such tolerance also may create more prof-

99. The impact of organizational environment and selection processes on individual risk-taking attitudes and behavior has been a subject of study for many researchers. See, e.g., James G. March & Zur Shapira, *Managerial Perspectives on Risk and Risk Taking*, 33 MGMT. SCI. 1404 (1987). March and Shapira explain that

[a]lthough [managers] undoubtedly vary in their individual propensities to take risks, those variations are obscured by processes of selection that reduce the heterogeneity among managers and encourage them to believe in their ability to control the odds, by systems of organizational controls and incentives that dictate risk taking behavior in significant ways, and by variations in the demand for risk taking produced by the context within which choice takes place.

*Id.* at 1414.

100. Krawiec, *supra* note 96, at 330; *When Words Are Not Bonds: Wall Street Pay*, ECONOMIST, Feb. 19, 1994, at 90 (stating that Wall Street "bonuses account for at least 75% of total remuneration").

101. For example, after its own rogue-trading scandal in 1994, Salomon Brothers attempted to revise its compensation system by providing investment bankers, traders, and other employees with as much as half their pay in Salomon Brothers stock at a fifteen percent discount, which could not be sold for five years. Michael Siconolfi, *Salomon Looks at Backing Out of Pay Plan*, WALL ST. J., Apr. 25, 1995, at C1. After the announcement, Salomon lost twenty of its two hundred managing directors, including several top traders. *Id.* The plan was discontinued. *Id.*; see also *Pay Dirt: Salomon Brothers*, ECONOMIST, July 1, 1995, at 67. Attempts at such revisions by other financial institutions have met with a similar fate. See *Bonus Points*, ECONOMIST, Apr. 15, 1995, at 71 (discussing efforts at various financial services firms to restructure their compensation systems in an effort to reduce agency costs and unauthorized activities).

102. See ABOLAFIA, *supra* note 97, at 28-29; Gordon L. Clark, *Rogues and Regulation in Global Finance: Maxwell, Leeson and the City of London*, 31 REGIONAL STUD. 221, 226 ("The firm deliberately sets-off their traders one against the other, and from the firm's own resources so that each trader's performance can be directly compared; group-based or team-based organizational modes of trading are eschewed at this level of the firm in favour of a model which can identify and reward the best and the brightest.").

itable traders. For example, a recent comparison of U.S. and Japanese trading floors shows that U.S. trading firms tend to follow a “market control” pattern in which traders are given high authority, few risk or loss limits, and high incentive compensation.<sup>103</sup> Japanese trading firms, by contrast, tend to follow a “bureaucratic control” pattern under which traders have little discretion, strict risk and loss limits, low incentive compensation, and a high level of organizational control.<sup>104</sup> The study found that the market-control firms were significantly more profitable than their bureaucratic-control counterparts and were willing to tolerate higher levels of “acceptable risk.”<sup>105</sup> In other words, traders at market-control style firms had shared values regarding the acceptability of higher risk levels within the firm.<sup>106</sup>

(b) *Discrimination*

The notion that organizational diversity is “good for business” has become a common mantra both among organizational leaders and in the management literature.<sup>107</sup> Accordingly, discrimination may appear at first blush a simple matter of individual employee deviance that cannot properly be characterized as organizational misconduct.<sup>108</sup> Unfortunately for those with hopes for a more diverse and in-

103. Srilata Zaheer, *Acceptable Risk: A Study of Global Currency Trading Rooms in the US and Japan*, in PERFORMANCE OF FINANCIAL INSTITUTIONS: EFFICIENCY, INNOVATION, REGULATION 462, 472, 489-91 (Patrick T. Harker & Stavros A. Zenios eds., 2000).

104. *Id.*

105. *Id.* at 490.

106. *Id.* at 489-90. Interestingly, the market-control firms did not have significantly higher levels of actual risk. *Id.* at 490. This may not tell us much about the propensity for rogue trading, however. By definition, traders attempt to hide unauthorized trades from the formal control system, meaning that it may not have shown up in the study. Because the Zaheer study was not designed to and did not measure the incidence of trading violations within the firm, it cannot be used as evidence regarding the comparative levels of actual rogue trading within the two types of firms. However, the findings on profitability and acceptable risk levels are supportive of the notion that market-control-style firms may have a propensity for both higher profitability and higher levels of trading violations.

107. See *Grutter v. Bollinger*, 539 U.S. 306, 330-31 (2003) (“[M]ajor American businesses have made clear that the skills needed in today’s increasingly global marketplace can only be developed through exposure to widely diverse people, cultures, ideas, and viewpoints.” (citing to amici curiae briefs of 3M Corp. and General Motors Corp.)); Robin J. Ely & David A. Thomas, *Cultural Diversity at Work: The Effects of Diversity Perspectives on Work Group Processes and Outcomes*, 46 ADMIN. SCI. Q. 229, 229 (2001) (discussing advice in management literature that diversity enhances workgroup performance); David B. Wilkins, *From “Separate Is Inherently Unequal” to “Diversity Is Good for Business”: The Rise of Market-Based Diversity Arguments and the Fate of the Black Corporate Bar*, 117 HARV. L. REV. 1548, 1571-91 (2004) (discussing the widespread attachment to the belief that diversity enhances corporate profitability and competitiveness).

108. This attitude is reflected in the early caselaw involving workplace discrimination. See, e.g., *Miller v. Bank of America*, 418 F. Supp. 233, 234 (N.D. Cal. 1976) (“The issue before the Court is whether Title VII was intended to hold an employer liable for what is essentially the isolated and unauthorized sex misconduct of one employee to another.” (footnote omitted)); *Corne v. Bausch & Lomb, Inc.*, 390 F. Supp. 161, 163 (D. Ariz. 1975) (stat-

tegrated American workforce, the empirical research indicates that the effect of diversity on organizational performance is complicated and uncertain and that diversity provides both benefits and costs depending on context, time frame, and the type of diversity in question.<sup>109</sup>

For example, researchers have studied the effects of two types of diversity—diversity with respect to “underlying attributes” and diversity with respect to “observable attributes”—on several different measures of workgroup performance, including outcomes, processes, and individual perceptions and satisfaction.<sup>110</sup> Diversity on underlying attributes—such as education, technical abilities, tenure in the organization, socioeconomic background, personality characteristics, or personal values—has been found in some studies to positively impact outcomes by expanding the set of possibilities considered and discussed, leading to more creative solutions to organizational problems.<sup>111</sup> At the same time, however, some studies have found that diversity on underlying attributes negatively affects workgroup processes by imposing costs, such as increased turnover and more formal, less frequent communication among workgroup members.<sup>112</sup> Some studies have found these process losses to be offset, however, by increased contact with members outside of the workgroup, resulting in a broader range of ideas considered by the workgroup.<sup>113</sup>

In contrast, the results of research on the impact of observable attributes such as race, ethnicity, age, and gender provide grounds for more pessimism about the effects of diversity on workgroup performance. For example, demographically heterogeneous groups have performed both better and worse than demographically homogenous groups in terms of workgroup outcomes, sometimes considering a greater number and diversity of alternatives in a decisionmaking

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ing that a supervisor’s harassing conduct appeared to be “nothing more than a personal proclivity, peculiarity or mannerism”).

109. Ely & Thomas, *supra* note 107, at 229; Frances J. Milliken & Luis L. Martins, *Searching for Common Threads: Understanding the Multiple Effects of Diversity in Organizational Groups*, 21 ACAD. MGMT. REV. 402, 405-12 (1996) (summarizing the research on the impact of workgroup diversity on performance); Katherine Y. Williams & Charles A. O’Reilly, III, *Demography and Diversity in Organizations: A Review of 40 Years of Research*, in 20 RESEARCH IN ORGANIZATIONAL BEHAVIOR 77 (Barry M. Staw & L.L. Cummings eds., 1998) (reviewing over eighty studies by psychologists, economists, sociologists, anthropologists, communication and education researchers, and organizational scholars).

110. Milliken & Martins, *supra* note 109; Williams & O’Reilly, *supra* note 109, at 93-114.

111. See Milliken & Martins, *supra* note 109, at 409-12 (summarizing the literature). Researchers consider it important, however, that the majority of studies finding positive outcome effects of diversity are laboratory studies rather than field studies. See Williams & O’Reilly, *supra* note 109, at 79.

112. Williams & O’Reilly, *supra* note 109, at 94-96.

113. *Id.* at 94-98.

task and sometimes not.<sup>114</sup> Furthermore, some studies have shown that, to the extent any creativity benefits do emerge from demographically heterogeneous groups, such benefits are likely to emerge only after the group has been together for some time.<sup>115</sup>

In addition, any positive impact on the outcome variable may be overshadowed by the negative impacts of demographic diversity on the process variable. In other words, to the extent that any outcome benefits may emerge from workgroup heterogeneity, they may be outweighed by the higher transaction costs of managing a demographically diverse workforce. As a general rule, more demographically diverse workgroups experience higher turnover rates, greater absenteeism of the dissimilar group members, lower levels of integration and communication, and lower levels of satisfaction and identification with the group. In addition, individuals who are dissimilar from their supervisors on demographic variables tend to receive lower performance evaluations.<sup>116</sup> As noted by Frances Milliken and Luis Martins, “[t]he consistency of these findings suggests . . . that groups and organizations will act systematically to drive out individuals who are different from the majority, unless this tendency to drive out diversity is managed.”<sup>117</sup>

In a recent paper, Professor Donald Langevoort provides a different theory that, if true, also predicts a lack of organizational incentives for the creation of a diverse workforce. Langevoort cogently argues that the mechanisms by which middle managers are hired, tested, and promoted within many firms reward the presence of psychological traits—including overconfidence, risk taking, and “grease”—that are more commonly found in white males than in other demographic groups.<sup>118</sup> If this is true, then corporate America’s mechanisms for selecting top managers may result in more profitable companies that exclude women and minorities from their upper ranks and impose other negative externalities on society through the choice of business decisions that they make.

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114. Milliken & Martins, *supra* note 109, 405-409; Williams & O’Reilly, *supra* note 109, at 102-14.

115. Milliken & Martins, *supra* note 109, at 407; Williams & O’Reilly, *supra* note 109, at 112.

116. Milliken & Martins, *supra* note 109, at 405-08; Williams & O’Reilly, *supra* note 109, at 103, 106, 113.

117. Milliken & Martins, *supra* note 109, at 420; *see also* Devon W. Carbado & Mitu Gulati, *The Law and Economics of Critical Race Theory*, 112 YALE L.J. 1757, 1788 (2003) (book review) (arguing that “greater employee homogeneity decreases the transaction costs of managing a [diverse] workforce”).

118. Donald C. Langevoort, *Diversity and Discrimination from a Corporate Perspective: Grease, Grit and the Personality Types of Tournament Survivors*, 61 WASH. & LEE L. REV. (forthcoming 2004) (manuscript at 15-16, 19-20, on file with author).

According to Langevoort, many companies organize middle managers into work teams that must solve some set of problems and then negotiate with non-team members within the firm the perception of how the team has performed.<sup>119</sup> Typically, middle managers are rotated through different workgroups and evaluated on both a team and individual basis.<sup>120</sup> Accordingly, rising to the top of the management pool requires iterated success—more likely if the individual is confident and willing to take risks<sup>121</sup>—and necessitates a psychological makeup referred to by researchers as “High Machiavellianism,” or “high-Mach.”<sup>122</sup>

Both self-confidence and the tendency to take risks are believed to vary across gender, racial, and ethnic lines.<sup>123</sup> Langevoort argues that the third trait required for managerial success—grease—is also more likely to be present in the dominant demographic group. He hypothesizes that “greasy” people—those high-Mach individuals who are able to effortlessly make strong in-group connections when required and yet defect when it is in their self-interest—are likely to succeed in the managerial tournament.<sup>124</sup> By contrast, “gritty” people—those who are unable to perform this routine successfully—will not.<sup>125</sup> If the process of serially forming, and then dropping, strong in-group connections is facilitated by homogeneity, the mere fact of being different from the dominant majority may insert grit into the process. In other words, members of racial, gender, or cultural minority groups may be grittier simply by virtue of being different, unless they are

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119. *Id.* (manuscript at 12).

120. *Id.*

121. *Id.* (manuscript at 15-16). Self-confidence is positively associated with the ability to persuade others, greater persistence, and a willingness to take risks. *Id.* (manuscript at 15); SIMON GERVAIS ET AL., THE POSITIVE ROLE OF OVERCONFIDENCE AND OPTIMISM IN INVESTMENT POLICY (Rodney L. White Ctr. for Fin. Research, Working Paper No. 15-02, 2002), available at <http://finance.wharton.upenn.edu/~rlwctr/papers/0215.pdf> (last visited Feb. 7, 2005); Daniel Kahneman & Dan Lovallo, *Timid Choices and Bold Forecasts: A Cognitive Perspective on Risk Taking*, 39 MGMT. SCI. 17, 27-29 (1993) (arguing that optimistic bias in organizational judgments leads to risk taking). In any large organization where getting ahead is based on iterated success of the nature described here, some percentage of “lucky risk-takers” are likely to distinguish themselves both from the unlucky risk-takers (who presumably fall out of the tournament early) and those who play it safe (thereby lasting in the tournament up to some point, but ultimately underperforming the lucky risk-takers). Langevoort, *supra* note 118 (manuscript at 15).

122. Langevoort, *supra* note 118 (manuscript at 18). High-Mach individuals possess the ability to cooperate and display intense in-group loyalty when necessary, while behaving in an aggressively competitive manner to out-group members. *Id.* (manuscript at 17-18). Importantly, high-Mach individuals are able to seamlessly defect and switch to a new in-group when self-advancement so dictates. *Id.* (manuscript at 18); see also Samuel Bowles et al., *The Determinants of Earnings: A Behavioral Approach*, 39 J. ECON. LITERATURE 1137, 1161-62 (2001).

123. Langevoort, *supra* note 118 (manuscript at 16).

124. *Id.* (manuscript at 19).

125. *Id.*

willing and able to successfully mimic the behavior of white males.<sup>126</sup> Langevoort argues that, although this may be efficient within the firm structure, “senior executive suites . . . overpopulated by high-Mach risk-takers, filled with hubris, adept at self-deception, and empty of strong ethical grounding” may create troubling negative externalities associated with the kind of business decisions they make.<sup>127</sup>

Similarly, the exclusion of certain demographic out-groups from the organization has historically been used by some corporations to inculcate employee loyalty and pride or to increase employee productivity. For example, southern textile mills once explicitly refused to hire African Americans in order to create a sense of privilege in their white workers.<sup>128</sup> This sense of privilege was then employed to justify the mills’ low wages and unsafe working conditions.<sup>129</sup>

In addition, Ford Motor Company purposely excluded women from assembly line work during the early twentieth century. In so doing, the company was able to create an image of assembly-line work as masculine, calling into question the manhood of employees who could not meet target production levels and paying those who could a wage that, in the words of one Ford manager at the time, would help them “to be better men.”<sup>130</sup> Although changed social mores and the advent of antidiscrimination laws have presumably induced organizations to abandon such practices as a conscious or explicit mechanism for incentivizing labor, the research on workgroup homogeneity discussed above suggests that organizations may still derive benefits from the exclusion of demographic out-group members.

I do not mean to suggest that organizations are free to create a completely homogenous workforce or that senior management consciously or intentionally excludes on the basis of race or gender simply to improve cooperation and loyalty among employees. Both legal and societal constraints militate against such behavior. In addition, I do not claim to have offered any “proof” that discriminatory behavior positively affects firm profits. As already noted, the state of research in this field is not sufficiently developed to support such a conclusion.

126. *Id.* (manuscript at 20); see also Devon W. Carbado & Mitu Gulati, *Working Identity*, 85 CORNELL L. REV. 1259 (2000); Naomi Ellemers et al., *Sticking Together or Falling Apart: In-Group Identification as a Psychological Determinant of Group Commitment Versus Individual Mobility*, 72 J. PERSONALITY & SOC. PSYCHOL. 617 (1997).

127. Langevoort, *supra* note 118 (manuscript at 22-23).

128. DAVID L. CARLTON, *MILL AND TOWN IN SOUTH CAROLINA, 1880-1920* (1982); NAOMI R. LAMOREAUX ET AL., *BEYOND MARKETS AND HIERARCHIES: TOWARD A NEW SYNTHESIS OF AMERICAN BUSINESS HISTORY* 28 (Nat’l Bureau of Econ. Research, Working Paper No. 9029, 2002).

129. LAMOREAUX ET AL., *supra* note 128, at 28.

130. *Id.* at 28-29; Wayne A. Lewchuk, *Men and Monotony: Fraternalism as a Managerial Strategy at the Ford Motor Company*, 53 J. ECON. HIST. 824, 843 (1993).



Instead, my goal is simply to call into question the automatic assumption that behaviors such as those discussed in this Part represent pure occupational misconduct that provides no organizational benefits, as opposed to organizational misconduct that provides subtle but tangible benefits to the organizational enterprise. If these behaviors do provide such benefits, then the legal regime's assumption that internal compliance structures ostensibly designed to curb agent misconduct will suffice to correct this behavior is erroneous.

(c) *Financial Fraud*

Financial fraud is particularly difficult to categorize, as the creation of false profitability may benefit shareholder principals under some circumstances and not in others. Some instances of financial fraud undoubtedly harm shareholders. Indeed, in many cases, defrauding shareholders is the ultimate goal of the fraudulent scheme. In addition, when financial fraud is engaged in for the purpose of concealing poor management or creating the illusion that some division is profitable when it is actually a drain on organizational resources and should be sold, shareholders are harmed.<sup>131</sup>

At the same time, however, some well-known instances of financial fraud were the result of attempts by organizational management to create the appearance of profitability in order to derive some benefit—for example, outside funding—that would augment shareholder wealth. For instance, alleged Kidder Peabody “rogue trader” Joseph Jett contended that Kidder management had full knowledge of and encouraged his fictitious trades because they created the temporary illusion that Kidder's trading operations were profitable. This allowed Kidder to obtain a large loan from Union Bank of Switzerland that Kidder badly needed to provide operating capital.<sup>132</sup>

Similarly, part of the asserted rationale for Enron's false financial statements was that revealing the truth about its financial condition would result in a credit-rating downgrade, severely hampering its ability to conduct its derivatives business and undermining Enron's profitability and share price.<sup>133</sup> In addition, Enron's fraudulent reporting regarding its trading floor operations was reportedly undertaken to enhance its share price. In other words, the allegation is that Enron smoothed the volatility of its trading floor profits, thus

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131. This is true even if a short-term shareholder owning stock only in that company would benefit from an inflated stock price. Because most shares in large companies are owned by diversified shareholders who trade securities fairly actively, portfolio value should be enhanced by accurate reporting, even if the value of an individual stock would be temporarily enhanced by false reporting.

132. *In re Kidder Peabody Sec. Litig.*, 10 F. Supp. 2d 398, 417 (S.D.N.Y. 1998).

133. See William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1323-24 (2002).

making the company appear less risky than it was and, correspondingly, enhancing share price.<sup>134</sup>

### B. Public Choice Reasons

In prior work, I have presented evidence that public choice theory may explain some of the legal system's extreme reliance on internal compliance structures as a liability determinant.<sup>135</sup> According to the interest group branch of public choice theory, well-organized interest groups are able to extract benefits from the government while imposing the costs on less organized groups, typically broad-based segments of the general public, such as consumers.<sup>136</sup>

It may seem surprising that business interests—one of the most organized, effective, and well-financed interest groups involved in the political process—have not defeated the development of organizational liability provisions (and the recent proliferation of organizational criminal liability provisions, in particular). Given the success that business interests frequently demonstrate in defeating the implementation of legal rules that they consider onerous, organizational liability provisions thus present—at first glance—a bit of a mystery. In other words, why have business interests not blocked the passage of organizational liability provisions such as those discussed in this Article?

Although several potential explanations are plausible, one obvious answer is that organizational liability provisions are not as costly to business organizations as they may at first appear.<sup>137</sup> Although business interests and those who could face personal liability for organizational violations (such as boards of directors under *In re Caremark International Inc. Derivative Litigation*<sup>138</sup>) would presumably prefer to suffer no organizational liability for the conduct of employee agents, a legal regime that conditions or mitigates liability on the ba-

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134. Frank Partnoy, *A Revisionist View of Enron and the Sudden Death of "May,"* 48 VILL. L. REV. 1245, 1260 (2003); see also Patrick Barta & John D. McKinnon, *Freddie Mac Have Understated Profits by up to \$4.5 Billion*, WALL ST. J., June 26, 2003, at C1 (discussing disclosures by Freddie Mac that it violated accounting rules and, in some cases, understated profits in order to smooth volatility in earnings).

135. See Krawiec, *supra* note 21.

136. George J. Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971). Another branch of public choice theory, voting theory, is based on the work of Kenneth Arrow and holds that determinations based on majority rule may give rise to random or shifting outcomes, a process known as "cycling." KENNETH J. ARROW, SOCIAL CHOICE AND INDIVIDUAL VALUES (2d ed. 1963).

137. Organizational liability provisions may also reflect an agency cost problem. If the presence of organizational liability results in a lower probability of personal liability for corporate officers and directors, then organizational liability may represent an attempt by officers and directors to deflect their personal liability onto organizational defendants. Khanna, *supra* note 8, at 1253-55.

138. 698 A.2d 959 (Del. Ch. 1996).

sis of internal compliance structures—while expensive and wasteful—is far less onerous than actually altering current business practices or paying damages for agent misconduct. As a result, when the public outcry for constraints on organizational misconduct becomes too loud for lawmakers to ignore, business interests may agree to heightened organizational liability in exchange for a “safe harbor” in the form of mitigation based on internal compliance structures.<sup>139</sup>

At the same time, legal compliance professionals benefit immensely—both financially and in terms of their importance and status within organizations—from a legal regime that conditions liability on the presence of internal compliance structures. Perhaps for this reason, legal compliance professionals have been at the forefront of the push to adopt internal compliance structures, sometimes overstating to a significant degree both the risks of a failure to adopt such structures and the benefits of having such structures in place.<sup>140</sup>

Although both business organizations and legal compliance professionals have had a substantial impact on the development of internal compliance-based legal regimes in the United States, the two groups have made that impact in different ways. For example, business organizations (including the Business Roundtable) lobbied hard for an internal compliance-based mitigation of sentences under the OSG.<sup>141</sup> By contrast, legal compliance professionals appear to have satisfied their agenda more indirectly and have played a particularly important role in the development of judicially crafted internal compliance-based liability standards.

The judicial recognition of internal compliance-based liability defenses follows a particular pattern that highlights the important role played by legal compliance professionals in the development of common law compliance-based organizational liability standards. First, the tendency of legal compliance professionals to overstate both a new legal risk and their ability to contain that risk through internal

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139. See Khanna, *supra* note 5, at 102-03 (querying why business interests have not managed to extract such a safe harbor). This public outcry may be especially likely to occur following the disclosure of a series of corporate misdeeds during a weak economic period. *Id.* at 104. For example, commentators have explained the political climate leading to the passage of the Securities Act of 1933, the Securities Exchange Act of 1934, and the Sarbanes-Oxley Act of 2002 on exactly these grounds. See, e.g., *id.*

140. See Krawiec, *supra* note 21 (describing this literature); Bisom-Rapp, *supra* note 58, at 134-40 (describing this trend in connection with sexual harassment training); Bisom-Rapp, *Ounce*, *supra* note 76, at 13-15 (same).

141. William S. Lofquist, *Legislating Organizational Probation: State Capacity, Business Power, and Corporate Crime Control*, 27 LAW & SOC'Y REV. 741, 746 tbl.2 (1993) (providing figures on the lobbying activity of the Business Roundtable, National Association of Manufacturers, Chamber of Commerce, numerous corporations, and other interested public and private groups in connection with the OSG); McKendall et al., *supra* note 30, at 370 (discussing pressure from the business community to adopt guidelines that account for organizations' internal compliance efforts).

compliance structures has been well documented.<sup>142</sup> Several studies, for example, have documented the extent to which legal and management journals overstated the legal benefits of internal grievance procedures in defending against liability in sexual harassment suits and the need for personnel practices designed to minimize employer liability in wrongful discharge suits.<sup>143</sup> Second, business organizations (either unaware of, or disinterested in, the fact that the rendered advice is incorrect) adopt the legal compliance professionals' recommendations.<sup>144</sup> Third, when faced with liability decisions, courts look to industry standards to determine whether the organization has met its duty to avoid the harm in question.<sup>145</sup> As a result, the recommendations of internal compliance professionals become a part of the liability determination and deviations from them result in costly liability determinations.

At the same time, the solutions to perceived legal problems recommended by legal compliance professionals are more palatable to management, because they disrupt managerial discretion and current business practice as little as possible. An internal compliance-based regime thus may represent an equilibrium agreement among business interests, legal compliance professionals, and lawmakers that satisfies public demands for regulation while doing little to disrupt business practices and enhancing the profitability and impor-

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142. See Krawiec, *supra* note 21, at 529 (discussing the evidence on this); Donald C. Langevoort & Robert K. Rasmussen, *Skewing the Results: The Role of Lawyers in Transmitting Legal Rules*, 5 S. CAL. INTERDISC. L.J. 375 (1997).

143. See generally Lauren B. Edelman et al., *Professional Construction of Law: The Inflated Threat of Wrongful Discharge*, 26 LAW & SOC'Y REV. 47 (1992) (studying the extent to which personnel, legal academic, and legal practitioner journals overstate the legal risk of wrongful discharge suits); Edelman et al., *supra* note 60 (studying the impact that legal compliance professionals had on the development of grievance procedures as a legal defense under sexual harassment law); Frank Dobbin & Erin Kelly, *A Tale of Two Sectors: The Spread of Anti-Harassment Remedies Among Public and Private Employers* 3 (unpublished manuscript, on file with author) (studying the role played by personnel professionals in the development and acceptance of internal grievance procedures as a defense to organizational liability in sexual harassment cases and concluding that "the legal remedy to harassment was clearly fashioned by a group with a professional interest in promoting that remedy").

144. See Dobbin & Kelly, *supra* note 143, at 40 (stating that the courts did not lead the development of legal rules governing the role of grievance procedures as a defense in sexual harassment suits but instead followed what the corporations were doing at the behest of personnel professionals); Edelman et al., *supra* note 60, at 451 (documenting the diffusion of internal grievance procedures within organizations prior to the legitimation of the defense by the courts).

145. Dobbin & Kelley, *supra* note 143, at 40 (noting that the courts followed and legitimated what business organizations had been doing—adopting internal grievance procedures—rather than fashioning a remedy on their own); Edelman et al., *supra* note 60, at 440 (noting that, eventually, the Supreme Court legitimated the originally erroneous legal advice that personnel professionals had rendered regarding grievance procedures by establishing them as part of a two-part affirmative defense).

tance of another powerful interest group—legal compliance professionals.

## VI. THE CHOICE OF VICARIOUSLY LIABLE PARTY

This Article has, for the most part, addressed only the role of organizational liability for agent misconduct. Under some circumstances, however, cogent arguments can be made that senior management or board liability should supplement or substitute for the organization as the vicariously liable party. Although this Article does not reject such a possibility, the obstacles to and problems with this approach should be briefly noted.

First, the limited assets of organizational agents is a commonly asserted rationale for organizational-level liability in the first place.<sup>146</sup> Although senior managers and board members may have deeper pockets than lower-level violators, the harm caused by many acts of organizational misconduct is nonetheless likely to exceed most individuals' assets, leading to a failure to fully internalize the costs of misconduct and, therefore, an underdeterrence of organizational misconduct.<sup>147</sup>

In addition, imposing liability—especially criminal liability—on an individual who did not actively participate in and was unaware of the misconduct in question is a rare, but not unheard of, move in the American legal regime.<sup>148</sup> As a result, fairness concerns are likely to compel courts to impose this type of individual liability only in the most egregious cases, such as when the court is convinced that management knew about or recklessly determined to remain unaware of ongoing misconduct. If this is so, then most of the benefits of vicarious liability will be lost and organizational liability will remain a necessary tool to deter organizational misconduct. Nonetheless, further research into the choice of vicariously liable party is needed.

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146. See *supra* note 6.

147. Although director and officer liability insurance policies may pay for many vicarious liability judgments against officers and directors, because the firm typically pays the bulk of these premiums, deterrence may still be undermined.

148. Daryl J. Levinson, *Collective Sanctions*, 56 STAN. L. REV. 345, 348 (2003) (noting that, although collective sanctions may seem natural in tribal or clan-based societies, in “modern, liberal societies, however, where the relevant moral unit is the individual, punishing groups for the misdeeds of individuals will be regarded with deep skepticism”); Adam Liptak, *The World: My Brother's Keeper; Is the Group Responsible for the Individual's Crime?*, N.Y. TIMES, Feb. 8, 2004, § 4, at 5. In contrast, many other cultures hold individuals or groups—for example, family members or fellow villagers—who are not connected to the misconduct responsible on the theory that such groups or individuals may be better positioned to identify and punish culpable individuals and may be motivated to do so by the threat of collective liability. Levinson, *supra*, at 348 (“Group members might be punished not because they are deemed collectively responsible for wrongdoing but simply because they are in an advantageous position to identify, monitor, and control responsible individuals, and can be motivated by the threat of sanctions to do so.”); Liptak, *supra*.

## VII. CONCLUSION

In closing, I should emphasize not only this Article's conclusions but also what it does *not* conclude. Specifically, it is not the contention of this Article that internal compliance structures can never play a role in deterring organizational misconduct. Indeed, internal compliance structures—in the hands of a competent and committed management team—may play a central role in the organization's preventive approach to organizational misconduct, depending on the size and structure of the specific organization.<sup>149</sup> In addition, by emphasizing the important role played by organizational culture and management commitment to ethical behavior in deterring misconduct, I am not advocating a legal regime in which courts, agencies, or prosecutors attempt to directly evaluate those factors in assessing organizational liability for agent misconduct. As with internal compliance structures, legal decisionmakers are unlikely to possess sufficient information to evaluate the quality and effectiveness of these factors in any reliable way. As a result, I conclude that the U.S. legal regime's move away from strict vicarious liability to internal compliance-based liability is unjustified by either theory or empirical evidence.

At the same time, the obstacles to a return to strict vicarious liability are strong and are both theoretical and political. As a theoretical matter, so long as legal academics and legal decisionmakers continue to view organizational misconduct as a principal-agent problem which can be fully addressed through better policing and ignore the subtle, but tangible, benefits that may flow to the organizational enterprise from such conduct, the legal system will continue to gravitate toward solutions that provide incentives for "policing," without ever addressing the root causes of organizational misconduct.

As a political matter, the current legal regime may exist not because it effectively addresses organizational misconduct, but because it satisfies the needs of a variety of powerful interest groups, including business organizations and legal compliance professionals, while

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149. See generally Kalev, Dobbin & Kelly, *supra* note 72. Very small, centralized organizations may find formal internal compliance structures unnecessary and prohibitively expensive. Perhaps for this reason, small businesses have expressed some concern that they are disadvantaged by the OSG requirements, although firm size is taken into account in the sentencing guidelines. See SENTENCING GUIDELINES, *supra* note 18, § 8B2.1, cmt. n.2(C). It is unclear, however, whether many small firms would gain the benefit of the OSG mitigation provisions, even in the absence of the internal compliance provisions of the Guidelines. This is because many small organizations sentenced under the Guidelines are ineligible for sentence mitigation, due to top-management knowledge of or participation in the misconduct. John R. Steer, *Changing Organizational Behavior—The Federal Sentencing Guidelines Experiment Begins to Bear Fruit*, in 1 CORPORATE COMPLIANCE 2002, at 113, 131 (PLI Corporate Law & Practice Course, Handbook Series No. B-1317, 2002).

at the same time addressing the occasional (though increasingly frequent) public outcry for constraints on organizational misbehavior.

