

Working Paper

A Business Ethics Perspective on Sarbanes Oxley and the Organizational Sentencing Guidelines

David Hess

Stephen M. Ross School of Business
at the University of Michigan

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A BUSINESS ETHICS PERSPECTIVE ON SARBANES OXLEY & THE ORGANIZATIONAL SENTENCING GUIDELINES

David Hess*

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* JD, PhD; Bank One Corporation Assistant Professor of Business Administration, Stephen M. Ross School of Business, University of Michigan. A revised version of this paper will be published in the *Michigan Law Review*, volume 105, issue 8.

Introduction

Fraudulent activity within the workplace is widespread. One recent survey¹ found that five percent of respondents had witnessed “falsification or misrepresentation of financial records” within the past year.² Another provides evidence that this number is three times as great for those specifically involved in accounting and finance.³ The costs of such abuses are tremendous. The Association of Certified Fraud Examiners’ 2006 Report to the Nation on Occupational Fraud and Abuse estimates that companies are losing approximately five percent of their revenue to occupational fraud,⁴ which equals \$652 billion each year.⁵

Congress enacted the Sarbanes Oxley Act to restore public trust in the markets. Among its ways of achieving this, Sarbanes Oxley attempts to improve organizational ethics by defining codes of ethics as including the promotion of “honest and ethical

1. This survey had a sample size of 3,015 responses, which included respondents that varied in employer size and industry, job position, tenure, and other characteristics. Ethics Resource Center, **National Business Ethics Survey: How Employee View Ethics In their Organizations 1994–2005 99–107** (2005) [hereinafter NBES] (providing a description of the methodology and the characteristics of the respondents and their organizations).

2. NBES, supra note 1, at 25. This number was unchanged from the NBES survey in 2003. Id.

3. **KPMG Forensic, Integrity Survey 2005–2006 4** (2006) (available online at <http://www.404institute.com/>). For an overview of the techniques firms use to manage earnings, see Mark W. Nelson et al., How are Earnings Managed? Examples from Auditors, 17 *Accounting Horizons* 17 (2003).

4. The ACFE defines occupational fraud as, ““The use of one’s occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization’s resources or assets.” Association of Certified Fraud Examiners, 2006 **Report to the Nation on Occupational Fraud and Abuse 6** (2006) (available online at: <http://www.acfe.com/fraud/report.asp>). The report further classifies occupation fraud into the categories of: asset misappropriation (theft of the organization’s assets), corruption (an employee using their position in an organization to obtain a benefit contrary to their duty to that organization), and fraudulent statements (falsifying financial statements to make the organization look more profitable than it is). Id. at 10–11.

5. Id. at 4 and 8.

conduct,” requiring disclosure on the codes that apply to senior financial officers,⁶ and including provisions to encourage whistle blowing.⁷ The Securities Exchange Commission’s implementing rules expand the disclosure requirement on code of ethics to include codes that apply to the Chief Executive Officer and further develop the definition of a code of ethics.⁸ In addition, Sarbanes Oxley mandated that the United States Sentencing Commission review the Organizational Sentencing Guidelines (OSG).⁹ As a result of this review,¹⁰ the Commission modified the OSG to redefine an “effective” compliance program as one that includes efforts to “promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law.”¹¹ Following the lead of Sarbanes Oxley, the New York Stock Exchange (NYSE) and the

6. Sarbanes Oxley section 406 (a) (requiring corporations “to disclose whether or not, and if not, the reason therefor, such issuer has adopted a code of ethics for senior financial officers, applicable to its principal financial officer and comptroller or principal accounting officer, or persons performing similar functions.”). Corporations are also required to disclose “any change in or waiver of the code of ethics for senior financial officers.” Sarbanes Oxley section 406(b).

7. See Sarbanes Oxley section 301(4) (requiring audit committees to establish procedures for employees to submit concerns about questionable accounting practices); Sarbanes Oxley section 806 (providing for protection of employee whistle blowers).

8. Final Rule: Disclosure Required by sections 406 and 407; Exchange Act Release Nos. 33-8177; 34-47235, 17 C.F.R. §§228, 229 & 249 (23rd January, 2003). The final definition of a code of ethics requires:

- “written standards that are reasonably designed to deter wrongdoing and to promote:
- Honest and ethical conduct, including the ethical handling of actual or apparent conflicts of interest between personal and professional relationships;
 - Full, fair, accurate, timely, and understandable disclosure in reports and documents that a registrant files with, or submits to, the Commission and in other public communications made by the registrant;
 - Compliance with applicable governmental laws, rules and regulations;
 - The prompt internal reporting to an appropriate person or persons identified in the code of violations of the code, and
 - Accountability for adherence to the code.”

9. Sarbanes Oxley § 805(a)(5); see also §§ 905 and 1104. Sarbanes Oxley required that the Sentencing Commission review the guidelines to ensure they were “sufficient to deter and punish organizational criminal misconduct.” Sarbanes Oxley § 805(a)(5)

10. Prior to Sarbanes Oxley, the U.S. Sentencing Commission was already planning a review of the guidelines due to the ten-year anniversary of the Guidelines. News Release, U.S. Sentencing Comm’n, Sentencing Commission Convenes Organizational Guidelines Ad Hoc Advisory Group (Feb. 21, 2002) (available online at: <http://www.ussc.gov>).

11. U.S. Sentencing Guidelines Manual § 8B2.1(a) (2004).

NASDAQ both adopted listing requirements that compel firms to adopt and disclose codes of ethics for all directors, officers, and employees of the company.¹²

Many managers challenge such attempts to “legislate” ethical behavior, even if they recognize the importance of proactively managing the ethical environment of their firms.¹³ Some commentators argue that the methods used to attempt to improve a firm’s ethical behavior—codes of conduct and compliance programs—are ineffective and costly.¹⁴ Others claim that due to the ability of firms to adopt a compliance program without actually changing the firm’s operations, these mechanisms may actually lead to more illegal or unethical behavior.¹⁵

This paper assesses the ability of the above changes to reduce the incidence of fraud and to increase the reporting of financial misconduct. Approaching these issues in Part I, I look specifically at the individual decision-makers within the organization and the ethical problems they face. For the purposes of this paper, that decision is whether or not to participate in fraudulent activity or to blow the whistle on those that do.¹⁶ To

12. Securities and Exchange Commission, NASD and NYSE Rulemaking: Relating to Corporate Governance, Release No. 34-48745 (November 4, 2003) (available online at: <http://www.sec.gov/rules/sro/34-48745.htm>).

13. See Letter from Robert S. Fine, General Counsel of Johnson & Johnson to the Advisory Group on Organizational Guidelines, May 16, 2002, at 2 (available online at: http://www.ussc.gov/corp/pubcom_302/PC_302.htm) (“it would be profoundly wrong . . . to require that every organization include ethics as part of its compliance program”).

14. Kimberly D. Krawiec, Cosmetic Compliance and the Failure of Negotiated Governance, 81 **Wash. U. L. Q.** 487, 491 (2003) [hereinafter Krawiec Cosmetic Compliance].

15. William S. Laufer, Corporate Liability, Risk Shifting, and the Paradox of Compliance, 54 **Vand. L. Rev.** 1343, 1405–07 (1999).

16. The Association of Certified Fraud Examiners’ report finds that frauds are detected more often by tips (i.e., whistle blowers) than by audits (internal or external) or internal controls. Association of Certified Fraud Examiners, supra note 4, at 28–29 (finding that 34% of frauds were discovered by tips, and at least 64% of those tips were from employees (an additional 18% of tips were from anonymous sources, which likely included at least some employee tips)). For public corporations, tips accounted for 40% of detected frauds. Id. at 33. Tips are especially important for uncovering fraud committed by high level executives, who can more easily avoid internal controls than lower level employees. Id. at 29. Almost half of the cases of owner or executive fraud were detected by employees. Id. at 29. The pre-Sarbanes-Oxley fraud report also showed the importance of employee tips relative to internal controls or external audits. Association of Certified Fraud Examiners, 2002 **Report to the Nation on Occupational Fraud and Abuse 11** (2002) (available online at: <http://www.acfe.com/fraud/report.asp>) [hereinafter ACFE 2002].

understand the individual's decision, I use of the Theory of Planned Behavior (TPB). The TPB is a widely tested theory from the field of social-psychology. It is a parsimonious model but has significant power in explaining variations in intentions. The simplicity of the model also makes it useful for understanding and explaining the various studies that have been conducted on ethical behavior in organizations.

In Part II, I move upward to the level of the organization and examine its influence on the employee's intentions and behaviors. Part II.A reviews the research on managing ethics and compliance programs, while Part II.B analyzes compliance programs through the TPB. With that understanding, Part III takes another step back to consider how legislation such as Sarbanes Oxley, or the Organizational Sentencing Guidelines, does and can influence corporations to take actions that will improve the ethical behavior of their employees.

I. Understanding Individual Ethical Decision Making in Organizations: The Theory of Planned Behavior

Icek Ajzen developed the Theory of Planned Behavior (TPB)¹⁷ based on the earlier Theory of Reasoned Action (TRA) that he developed with Martin Fishbein.¹⁸ The TPB claims that there are three determinants of a person's intentions, which then determine a person's actual behavior.¹⁹ First, there is a person's attitude toward the behavior, which is a measure of the person's evaluation of the behavior as "good" or

17. See generally Icek Ajzen, The Theory of Planned Behavior, 50 **Organizational Behavior and Human Decision Processes** 179 (1991).

18. See generally **Martin Fishbein & Icek Ajzen, Belief, Attitude, Intention, and Behavior: An Introduction to Theory and Research** (1975). The Theory of Planned Behavior is an extension of the Theory of Reasoned Action, with the difference being the addition of the "perceived behavioral control" determinant. Lisa Beck & Icek Ajzen, Predicting Dishonest Behaviors using the Theory of Planned Behavior, 25 **J. of Research in Personality** 285, 286 (1991)

19. Beck & Ajzen, supra note 18, at 286. There may be moderating variables that affect the relationship between a person's intentions and their actual behaviors. See Icek Ajzen, Nature and Operations of Attitudes, 52 **Annual Rev. of Psych.** 27, 46-47 (2001).

“bad.”²⁰ The antecedents of attitudes include both behavioral beliefs about the action and outcome evaluations. Behavioral beliefs are the expected consequences of a behavior (e.g., a belief that an act will increase my job security) and outcome evaluations are the actor’s assessment of those consequences (e.g., a belief that it is good to have job security).²¹ Second, a subjective norm refers to the social pressure a person feels from important others to perform or refrain from performing the behavior and to the person’s motivation to comply with those pressures.²² Third, there is the actor’s perceived behavioral control, which is a measure of the person’s ability to perform the behavior, based on their past experience, competence, and any expected obstacles they may face.²³ Although each determinant will have an impact on a person’s intentions towards a behavior, the relative importance of each determinant will vary based on the circumstances and the behavior studied. For example, two employees, each with a positive attitude towards whistle blowing, may engage in different behaviors if they face different social pressures in their environment.

To improve the above model, Ajzen has suggested the inclusion of moral obligation as an additional determinant of intentions in situations where ethical behavior is involved.²⁴ Moral obligations refer to a duty or obligation that “is sanctioned by one’s

20. Ajzen, supra note 17, at 188; Beck & Ajzen, supra note at 286.

21. Annetta M. Gibson & Albert H. Frakes, Truth or Consequences: A Study of Critical Issues and Decision Making in Accounting, 16 **J. of Bus. Ethics** 16, 165 (1997).

22. Ajzen, supra note 17, at 195. The antecedent to subjective norms are normative beliefs. *Id.* at 189, 195–96.

23. Ajzen, supra note 17, at 182–84; Beck & Ajzen, supra note 18 at 286. The antecedents to perceived behavioral control are control beliefs. Ajzen, supra note 17, at 189, 196 (noting also that control beliefs can be based on the observation of the experience of others). Perceived behavioral control should also have a direct impact on behavior. *Id.* at 184–85. It should also be noted that with the TPB, each determinant is expected to influence the other determinants. See Id. at 182 (providing a figure representing TPB and indicating the reciprocal influences of the determinants).

24. Ajzen, supra note 17, at 188.

conscience as right.”²⁵ In addition to one’s own moral belief system, these moral obligations can come from laws, professional codes of ethics, and other similar sources.²⁶ Researchers have included this determinant in empirical studies: most find it a useful addition to the model, but some find that moral obligation functions primarily as an additional determinant of a person’s attitude.²⁷

Overall, hundreds of studies on a wide variety of issues have confirmed the value of the TPB (and the TRA).²⁸ However, only a handful of studies have used these theories in studying organizational members’ decisions in business ethics situations.²⁹ The studies, reviewed briefly in the next section, generally find strong support for these theories’ usefulness in understanding unethical behavior and whistle blowing. In addition, various other studies on organizational ethics that did not specifically use the TPB are directly relevant for helping us to understand how organizations’ influence these determinants both positively and negatively.

25. Nancy B. Kurland, Sales Agents and Clients: Ethics, Incentives, and a Modified Theory of Planned Behavior, 49 **Human Relations** 51, 59 (1996) [hereinafter Kurland, Sales Agent].

26. Id.

27. Mark Conner & Christopher J. Armitage, Extending the Theory of Planned Behavior: A Review and Avenues for Further Research, 28 **J. of Applied Soc. Psych.** 1429, 1442–44 (1998)

28. For a review of these studies, see Conner & Armitage, supra note 27. For an introduction to the research methodologies, see Jillian J. Francis et al., Constructing Questionnaires Based on the Theory of Planned Behavior (2004) (available online at: <http://www.rebeqi.org/?pageID=40&ItemID=86>). To measure intentions and the predictor variables of intentions, researchers construct questionnaires that ask respondents both direct and indirect questions related to the variable of interest. Id. at 9.

29. On the potential and challenges of using the Theory of Reasoned Action for business ethics empirical research, see generally Donna M. Randall, Taking Stock: Can the Theory of Reasoned Action Explain Unethical Conduct?, 11 **J. of Bus. Ethics** 873 (1989).

A. *Fraud and Whistle Blowing in TPB Studies*

Studies using the TPB³⁰ have looked at the intentions of public accountants³¹ and Chief Financial Officers to engage in fraud,³² and managers to violate GAAP.³³ These studies all find support for the TPB model in predicting intentions, and also find that among the determinants, attitudes have the greatest impact on intentions.³⁴ In one study, the researchers were able to manipulate the three determinants with a positive or negative influence, which then affected the actor's intention.³⁵ For example, the researchers manipulated attitude by telling the research subjects that the corporation specifically encouraged (or discouraged) the GAAP violation used in the study.³⁶ Although the above studies generally did not include the moral obligation determinant, Kurland's³⁷ studies on the intention of insurance sales agents to disclose information to prospective buyers³⁸

30. For the purposes of this paper, the term TPB will also include studies that use the TRA.

31. Howard F. Buchan, Ethical Decision Making in the Public Accounting Profession: An Extension of Ajzen's Theory of Planned Behavior, 61 **J. of Bus. Ethics** 165 (2005); Gibson & Frakes, supra note . Buchan treats the firm's ethical climate as a separate determinant of intentions, as opposed to influencing the subjective norms determinant. Buchan, supra, at 169–170. In addition, Buchan includes a variable for moral sensitivity for moral obligation. Id. at 168. The vignettes used in the study by Buchan included actions such as billing personal expenses to the firm or breaking client confidentiality to benefit to the firm. Buchan, supra note at 178–79. The vignettes in the Gibson and Frakes study included situations clearly against the Code of Professional Conduct (e.g., a conflict of interest) and situations that could possibly be justified under a very liberal interpretation of the Code (e.g., accepting business you were not qualified to perform). Gibson & Frakes, supra note 21, at 164–65 & 167.

32. Nancy Uddin & Peter R. Gillett, The Effects of Moral Reasoning and Self-Monitoring on CFO Intentions to Report Fraudulently on Financial Statements, 40 **J. of Bus. Ethics** 15 (2002).

33. Tina D. Carpenter & Jane L. Reimers, Unethical and Fraudulent Financial Reporting: Applying the Theory of Planned Behavior, 60 **J. of Bus. Ethics** 115 (2005).

34. Buchan, supra note 31, at 175; Gibson & Frakes, supra note 21, at 166; Carpenter & Reimers, supra note at 34, 125; see also Uddin & Gillett, supra note 32, at 19–20 & 30 (finding that attitudes had a greater impact on the intention to commit fraud than did subjective norms for both low and high moral reasoners and high and low self-monitors). However, with all the studies on TRA and TPB, there are measurement issues, and the possibility that the structure of the questionnaire and the questionnaire process itself may influence the relative importance of the determinants. See Shmuel Ellis & Shaul Arieli, Predicting Intentions to Report Administrative and Disciplinary Infractions: Applying the Reasoned Action Model, 52 **Human Relations** 947, 962 (1999).

35. Carpenter & Reimers, supra note 33, at 124.

36. Id. at 122.

37. Kurland, Sales Agent, supra note 25; Nancy B. Kurland, Ethical Intentions and the Theories of Reasoned Action and Planned Behavior, 25 **J. of Applied Soc. Psych.** 297 (1995) [hereinafter Kurland, Ethical Intentions].

38. The study involved agents' intentions to disclose information on sales commission and product quality to prospective buyers. Kurland, Sales Agent, supra note 25, at 62.

found that moral obligation was the strongest predictor of intentions.³⁹ It is also important to note that individual agent characteristics (such as experience level and professional accreditation) and commission did not have significant impacts on intentions.⁴⁰

With respect to whistle blowing, there are two studies testing the TPB. First, Randall and Gibson found general support for the TPB,⁴¹ including the moral obligation determinant.⁴² Similar to the studies above, they also found that attitude had a stronger impact on intent than did subjective norms.⁴³ To help illustrate how the TPB is applied, we can take a closer look at the items that make-up the determinants. For example, of the items making up the attitude variable used in the study, the outcome measure of protecting the safety of patients was independently significant.⁴⁴ In other words, the real potential to improve the health of a patient gave the nurses a positive attitude towards whistle blowing. With respect to normative beliefs, the relevant others that were independently significant were family members, fellow nurses, and doctors that the nurse works with directly.⁴⁵ The views of top management, supervisory nurses, or the nursing professionals in general were not independently significant.⁴⁶

39. Kurland, Ethical Intentions, *supra* note 37, at 305–306, 309. She found support for the all determinants. Kurland, Sales Agent, *supra* note 25, at 67. Perceived behavioral control contributed the least explanatory power, though the author notes problems with reliability of the perceived behavioral control scale she used in the study. Kurland, Ethical Intentions, *supra* note 37, at 307–308.

40. Kurland, Sales Agent, *supra* note 25, at 66–67. However, the design of the study's questionnaire may have influenced those results. *Id.* at 67n.11. In addition, the organization Kurland studied attempted to hire and retain only those sales agents that were not commission-driven. *Id.* at 68.

41. Donna M. Randall & Annetta M. Gibson, Ethical Decision Making in the Medical Profession: An Application of the Theory of Planned Behavior, 10 *J. of Bus. Ethics* 111 (1991).

42. *Id.* at 117–19. The vignettes used in the study varied whether the scenario indicated that the doctor or nurse simply made a mistake or was incompetent and had made many similar mistakes in the past. *Id.* at 114. The study found that nurses were equally likely to report nurses or doctors, but more likely to report errors based on incompetence. *Id.* at 118.

43. *Id.* at 117–18. The perceived control variable was not significant, but there was little variation in the variable, making it of limited use in the study. *Id.* at 118.

44. *Id.* at 117–18.

45. *Id.* at 117–18.

46. *Id.* at 117–18. Other studies, however, have found that supervisor support is positively related to whistle blowing intentions, though there is less evidence for a relationship with whistle blowing behavior (and it may be a negative relationship). Jessica R. Mesmer-Magnus & Chockalingam

In a second study, Ellis and Arieli⁴⁷ used the TRA to study officers in the Israeli Defense Forces and their intentions to report misconduct by an officer of a higher rank than themselves.⁴⁸ They found a close connection between attitude and subjective norms, but overall found that subjective norms were a significantly better predictor of intention to report misconduct.⁴⁹ In addition, it is important to note that other studies, not using the TPB, have found evidence that moral obligations (based on role obligations) and attitudes influence whistle blowing intentions or behavior.⁵⁰

B. Summary

Based on the TPB, if someone is considering taking actions that she knows is likely to misrepresent financial information, then her decision will be influenced by: her attitude towards the act, the social pressures to engage in the act, her perceived behavioral control over being able to successfully complete the act, and her sense of moral obligation. The same is true for someone trying to decide if she should report a co-worker's or a manager's fraudulent activity to the company's ethics hotline, a supervisor, or ombudsperson.

Viswesvaran, Whistleblowing in Organizations: An Examination of Correlates of Whistleblowing Intentions, Actions, and Retaliation, 62 **J. of Bus. Ethics** 277, 286–87 (2005).

47. Ellis & Arieli, supra note 34.

48. Id. at 954.

49. Id. at 959 and 962.

50. Mesmer-Magnus & Viswesvaran, supra note 46, at 285–86 (providing a meta-analytic examination of 26 studies on whistle blowing). Evidence of the influence of attitudes and their antecedent beliefs included an employee's approval of whistle blowing and the belief that whistle blowing was in one's best interest. Id. at 285. The ethical climate of the organization—which can capture some of the social pressures influencing normative beliefs—was also a consistent predictor of whistle blowing beliefs and intentions. Id. at 286–87. An additional study, not included in the review by Mesmer-Magnus and Viswesvaran, found that the belief that “nothing could be done to remedy the situation” was the main reason given by observers of wrongdoing that chose not to report it. Near et al., Does Type of Wrongdoing Affect the Whistle-Blowing Process?, 14 **Bus. Ethics Q.** 219, 238 (2004). This provides further support for the importance of the attitude determinant.

The review of whistle blowing studies by Mesmer-Magnus and Viswesvaran challenges the idea that intentions to blow the whistle strongly predict actual whistle blowing behavior. Mesmer-Magnus & Viswesvaran, supra note 46, at 292; but see Bart Victor et al., Peer Reporting of Unethical Behavior: The Influence of Justice Evaluations and Social Context Factors, 12 **J. of Bus. Ethics** 253, 257–59 (1993) [hereinafter Victor et al., Peer Reporting] (finding that intention to whistle blow was the strongest predictor of actual whistle blowing behavior).

The studies discussed above provide support for the use of the TPB in predicting individuals' intentions in situations involving organizational fraud and whistle blowing. In general, attitudes are a stronger predictor than subjective norms, but that relationship changes based on the behavior studied and the variables seem to influence each other. There was less support for the perceived behavioral control variable, but that seems to be explained either by measurement issues in the research design or by the actors' beliefs that they have complete control over the behavior (e.g., the nurses in the Randall and Gibson study may believe that reporting misconduct does not require any special "skills, abilities, time, will power, or opportunity."⁵¹) The next section provides a review of the empirical evidence on managing ethics in organizations and combines those findings with the TPB model to understand how the organization can influence these determinants.

II. Managing Ethics in Organizations

A. *Corporate Compliance Programs and Ethical Behavior*

The goal of a code of conduct and compliance programs is to ensure that (1) employees act lawfully and in ways consistent with the values and rules embodied in the code; (2) employees report behavior that is inconsistent with the code; and (3) the company takes actions to prevent the non-compliant behavior from occurring again.⁵² Although voluntarily adopted compliance programs have almost universal support, critics challenge the role they play in corporate criminal law.⁵³ Section 1 reviews the criticism that compliance programs are ineffective. Section 2 reviews the empirical studies on implementation and finds that there is growing evidence that properly implemented

51. Randall & Gibson, *supra* note 41, at 119.

52. See Mark S. Schwartz, *Effective Corporate Codes of Ethics: Perceptions of Code Users*, 55 *J. of Bus. Ethics* 323, 325 (2004) [hereinafter Schwartz, *Effective Corporate Codes*] (discussing "code effectiveness").

53. Krawiec *Cosmetic Compliance*, *supra* note 14, at 488–89.

compliance programs have a positive impact on various behaviors that—as explained by the Theory of Planned Behavior in Part B—will lead to less fraud and more whistle blowing.

1. *Criticism of Mandatory Compliance Programs*

Because a firm can significantly reduce or even escape liability for having an “effective” compliance program, including a code of ethics, under the OSG, compliance programs are essentially mandated by the law.⁵⁴ However, critics complain that there is no evidence that ethics codes and compliance programs actually reduce illegal behavior.⁵⁵ Support for these arguments comes from empirical studies that find no relationship between codes and ethical behavior.⁵⁶ A recent review of studies on codes of ethics shows that approximately half of the studies found that codes were effective in reducing unethical behavior, and half did not find a significant relationship.⁵⁷ Thus, these studies do not establish clear support for whether or not codes of ethics directly reduce unethical behavior.

Many of these studies simply look at the presence or absence of a code of ethics or compliance program, without attempting to understand how the codes are used by employees within the organization.⁵⁸ With respect to codes of conduct, the view of these

⁵⁴ See U.S. Sentencing Comm’n, Report of the Ad Hoc Advisory Group on Organizational Sentencing Guidelines 31-32 (Oct. 7, 2003) (<http://www.uscc.gov/corp/advgrp.htm>) (discussing the potential for directors to be in violation of their duty of care if they do not take advantage of the reduced penalty possibilities under the OSG by adopting a compliance program).

⁵⁵ *Id.* at 491.

⁵⁶ With respect to fraudulent financial reporting, see 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. of Bus. Ethics* 183, 190–91 (1996) (finding that in a laboratory study using a role play exercise that the presence of a code of conduct had no impact on the decision to engage in fraudulent financial reporting).

⁵⁷ Schwartz, Effective Corporate Codes, *supra* note 52, at 325; see also Mark S. Schwartz, The Nature of the Relationship between Corporate Codes of Ethics and Behavior, 32 *J. of Bus. Ethics* 247, 249–50 (2001) [hereinafter Schwartz, Nature]. (providing a table that reviews the studies on codes of ethics published before 2000 based on research methodology and study sample).

⁵⁸ See, e.g., Brief et al., *supra* note 56.

researchers and commentators seems to be that the code simply operates as a rule-book that employees read and then follow accordingly.⁵⁹ In practice, however, employees use codes in many different ways. For example, an employee may already know that a certain action is “wrong” without the information provided in the code, but the code can provide support for that employee to resist improper requests from supervisors or co-workers.⁶⁰ In other situations, the code may simply serve to raise general awareness about ethical issues in the firm or encourage an employee to seek the advice of others.⁶¹ Overall, codes of ethics work in both direct and indirect manners to shape employee behavior.⁶² Although codes may not directly lead to less illegal behavior, as Schwartz states, “it is hard to imagine how ethics could be made an integral part of a company’s business practices without at least adopting a code of ethics.”⁶³

Just as critics argue that codes of ethics pushed on firms by the law are simply ignored within the firm, critics also argue that compliance programs are simply “window dressing” used by organizations to obtain favorable treatment under the OSG but having

59. See, Schwartz, *Nature*, *supra* note 57, at 258 (2001).

60. *Id.* at 256 (using the metaphor of a “shield” to describe one way that a code may influence employee behavior).

61. *Id.* at 255–56 (using the metaphors of a “magnifying glass” and a “sign-post” to describe ways that a code may influence employee behavior). It may also be the case that codes of ethics serve different functions for different types of employees. For example, employees committed to behaving ethically may use the code to support their positions, while those employees that do not feel a strong moral obligation to behave ethically may be deterred from unethical behavior due to sanctions for violating the code. Janet S. Adams et al., *Codes of Ethics as Signals for Ethical Behavior*, 29 *J. of Bus. Ethics* 199, 201 (2001).

62. In addition to the three metaphors described in notes 60 and 61 and accompanying text, Schwartz provides five other metaphors that describe how codes of ethics may influence employee behavior in indirect and direct manners. Schwartz, *Nature*, *supra* note 57, at 256. His conclusions are based on interviews with fifty-seven individuals at four large Canadian companies. *Id.* at 251. Likewise, in an empirical study, Trevino and Weaver measured effectiveness of an ethics program not just by reduced unethical behavior, but also by ethics awareness, increased willingness of employees to discuss and seek advice on ethical issues, and other indirect influences on behavior. Gary R. Weaver & Linda Klebe Trevino, *Compliance and Values Oriented Ethics Programs: Influences on Employees’ Attitudes and Behavior*, 9 *Bus. Ethics Q.* 315, 319 (1999).

63. Schwartz, *Effective Corporate Codes*, *supra* note 52, at 324. In the NBES survey only 0.4 percent of employees were in an organization that had a strong ethical culture and no formal program. NBES, *supra* note 1, at 94. This provides some evidence that a formal program helps support the development of an ethical culture. *Id.* at 94.

little impact on reducing illegal behavior.⁶⁴ As with codes of conduct, however, the firm's implementation of the compliance program is significantly more important than simply whether or not a firm has adopted one.

2. *The Implementation of Compliance Programs: Compliance-Based versus Integrity-Based Programs*

Starting with Lynn Sharp Paine's 1994 article Managing for Organizational Integrity, management researchers regularly distinguish between compliance-based programs and integrity-based programs.⁶⁵ A firm using a compliance-based program focuses its efforts on deterrence through threat of detection and punishment for violations of the law or code of conduct.⁶⁶ A firm using an integrity-based approach, on the other hand, focuses its efforts on establishing legitimacy with employees through internally developed organizational values and self-governance.⁶⁷ For example, whereas a compliance-based program focuses on teaching employees the laws and rules they must comply with, an integrity-based program focuses on integrating ethics into employees' decision making and inspiring them to live up the company's ethical ideals.⁶⁸

With an integrity-based program, obeying the law "is viewed as a positive aspect of organizational life, rather than an unwelcome constraint imposed by external

64. Krawiec *Cosmetic Compliance*, supra note 14, at 491–92. For an empirical study supporting this claim, see Marie McKendall et al., Ethical Compliance Programs and Corporate Illegality: Testing the Assumptions of the Corporate Sentencing Guidelines, 37 *J. of Bus. Ethics* 367, 375–76 (2002) (finding that compliance programs consistent with the organizational sentencing guidelines had no impact on the incidence of OSHA violations). For an empirical study on the effectiveness of codes of conduct at reducing white collar crime, see Karen Schnatterly, Increasing Firm Value Through Detection and Prevention of White Collar Crime, 24 *Strategic Mgmt J.* 587, 590, 603 (2003) (finding that a "stronger and more complex" code of conduct reduces white collar crime).

65. Lynn Sharp Paine, Managing for Organizational Integrity, *Harvard Bus. Rev.*, March/April 1994, at 106, 110–111.

66. Id. at 110.

67. Id. at 111; Andrew Brien, Regulating Virtue: Formulating, Engendering and Enforcing Corporate Ethical Codes, 15 *Bus. & Prof. Ethics J.* 21, 32–33 (2001) (stating that employees can be motivated to comply with codes of ethics by either enforcement mechanisms (i.e., fear of consequences for non-compliance) or engendering mechanisms (i.e., internalization of the code)).

68. Weaver & Trevino, supra note 62, at 317–18; Paine, supra note 65, at 113.

authorities.”⁶⁹ This is consistent with research pioneered by Tom Tyler which shows that obedience to the law is based on a sense of moral obligation to legitimate laws, rather than solely on threats of punishment.⁷⁰ In general, an integrity-based program is focused on creating a corporate culture where employees feel comfortable discussing ethical issues, they are rewarded for responsible behavior, and leadership demonstrates its commitment to ethics by personally living up to the company’s standards and incorporating those values into strategic decisions.⁷¹

Although Paine based her original article on just a handful of case studies, subsequent research has confirmed that an integrity-based program is more effective than a compliance-based program in reaching positive outcomes for the firm. For example, Weaver and Trevino⁷² found that all compliance programs had a positive impact on employees’ awareness of ethical issues, willingness to seek advice, decision-making, and reduced observed unethical behavior.⁷³ The perception by employees that a compliance program was integrity-based, however, was a stronger predictor of those outcomes⁷⁴ and also was associated with employees’ willingness to report misconduct,⁷⁵ employee commitment to the firm, the belief that it is acceptable to submit “bad news” to management, and the belief that you can live by your personal values at work.⁷⁶ Likewise, a separate study found that a compliance-oriented program had positive results

69. Paine, supra note 65, at 111.

70. Paine, supra note 65, at 111. *See also*, Brien, supra note 67, at 25–26 (comparing codes of ethics to laws and stressing the importance of legitimacy and consent of the governed).

71. Paine, supra note 65, at 112.

72. Weaver & Trevino, supra note 62, at 326

73. Id. at 328.

74. Id. at 329–30.

75. This finding was further found to require both a compliance and integrity-based approach. Id. at 328.

76. Id. at 325 and 328

with respect to similar outcomes, but that an integrity-based program was more effective in bringing about those results.⁷⁷

Compliance-based programs and integrity-based programs are not mutually exclusive. Recent research suggests that a successful program will have elements of each.⁷⁸ A key factor is to find the right balance and not to overemphasize the compliance aspect.⁷⁹ There is, however, a third way to implement a compliance program, which is simply to protect top management from liability. That is a program that employees believe management implemented for the sole purpose of supporting a claim that any misconduct was caused by a rogue employee violating the company's rules and best efforts to control misconduct.⁸⁰ In those situations, compliance programs are ineffective, and potentially counterproductive, in achieving positive outcomes and positive intentions toward ethical behavior.⁸¹

77. Linda Klebe Trevino et al., Managing Ethics and Legal Compliance: What Works and What Hurts, 41 *Calif. Mgmt. Rev.* 131, 138–39 (1999) [hereinafter Trevino et al., What Hurts]. The authors based their study on the following specific outcomes: observed unethical/illegal behavior, awareness of ethical/legal issues, seeking advice, delivering bad news to management, reporting violations, improved decision making, and commitment to the organization. *Id.* at 132–35.

78. Weaver & Trevino, *supra* note 62, at 330. *See also*, Brien, *supra* note 67, at 34–35 (arguing that failing to use enforcement mechanisms makes a compliance program “not credible,” but solely using such mechanisms “fails to foster organizational virtue” and “is, ultimately, self-defeating.”).

79. Paine, *supra* note 65, at 111. *See also* Weaver & Trevino, *supra* note 62, at 330 (stating “when a values orientation is strong, compliance activities can be perceived as part of an overall system of support for ethical behavior. Without a strong values orientation, however, compliance activities may be perceived to be part of a system aimed only at detecting misconduct.”); Brien *supra* note 67, at 38 (arguing that enforcement should only be used against those “who cannot be reformed through engendering programs alone” and the enforcement mechanisms (e.g., surveillance) should only be targeted at “known weak spots and reported problem areas”) and 39–41 (comparing enforcement of ethics codes to Ayres and Braithwaite’s regulatory enforcement pyramid). For a more general discussion of trying to find the right balance between rule-based compliance and more aspirational, ethics-based approaches, see Hess et al., The 2004 Amendments to the Federal Sentencing Guidelines and Their Implicit Call for a Symbiotic Integration of Business Ethics, 11 *Fordham J. Corp. & Fin. L.* 725, 746–57 (2006) (providing a discussion of three distinct, but related, ways of building trust in organizations).

80. Trevino et al., *supra* note 77, at 138.

81. *Id.* at 136–37. (finding, for example, that employees are less comfortable delivering bad news or seeking advice on ethical issues when they perceive that the compliance program is designed only to protect management).

Additional support for the above findings comes from surveys conducted by KPMG⁸² and the Ethics Resource Center.⁸³ KPMG’s survey found significant differences between firms that implemented a compliance program consistent with an “effective” program under the OSG and firms that had a compliance program without all of the elements of an effective program.⁸⁴ The differences—reported in Table 1—show significantly more positive behavioral beliefs towards ethical behavior in organizations with complete compliance programs. As discussed more fully below, according to the TPB, these beliefs should translate into reduced fraudulent behavior and increased whistle blowing behavior.

Table 1⁸⁵

	Company <i>with</i> complete compliance program (Percent agreeing with the statement)	Company <i>without</i> complete compliance program (Percent agreeing with the statement)
Senior executives sets an appropriate “tone at the top”	84%	29%
Senior executives value integrity over short-term goals	82%	28%
People feel motivated and empowered to “do the right thing”	90%	51%
People feel comfortable raising ethics concerns	85%	36%
People apply the right values to their decisions	90%	53%

82. KPMG conducted their survey between November 2004 and March 2005. **KPMG Forensic**, *supra* note 3, at 23. They mailed out 6,797 surveys and received 4,056 responses from people employed by firms of various sizes and in a wide range of industries. *Id.* at 23–26.

83. NBES, *supra* note 1.

84. **KPMG Forensic**, *supra* note 3, at 13–14 (2006) (available online at <http://www.404institute.com/>). The KPMG study does not specifically mention the OSG. Also, the study does not provide information on whether or not there are other significant differences between the two groups of firms that may affect the employees’ responses (e.g., company size, industry).

85. Source: KPMG, *supra* note 3, at 14–19.

	Company <i>with</i> complete compliance program (Percent agreeing with the statement)	Company <i>without</i> complete compliance program (Percent agreeing with the statement)
There is minimal willingness to tolerate misconduct	84%	35%
There is minimal opportunity to engage in misconduct	80%	30%
Rewards are based on ends, not the means to achieve the ends	41%	57%
Would you feel comfortable reporting misconduct to a supervisor	88%	48%
If you reported misconduct, do you believe you would be satisfied with the outcome	68%	22%

Similar to KPMG’s survey, The Ethics Resource Center’s National Business Ethics Survey (NBES) compiled information on firms’ compliance programs,⁸⁶ but it also went further and looked at the organizations’ cultures. The NBES measured culture by surveying respondents on the presence of “ethics related actions” within an organization. Ethics related actions measure respondents’ beliefs that fellow employees, supervisors, and management are willing to discuss ethical issues, support responsible conduct, serve as good examples of ethical conduct, and engage in other similar actions.⁸⁷ Overall, they found that culture has a greater impact than a formal program on outcomes such as observed misconduct, reporting of misconduct, and perceived ability to handle

86. The NBES identified six key elements of a formal compliance program based on the Organizational Sentencing Guidelines. Those elements are: (1) written standards; (2) ethics training; (3) mechanisms to provide employees with desired ethics advice or information; (4) anonymous reporting of misconduct; (5) discipline for those violating company standards; and (6) including ethical conduct in performance reviews. NBES, *supra* note 1, at 47.

87. *Id.* at 61.

misconduct if faced with such a situation.⁸⁸ In addition, the NBES showed that the presence of a formal program had a greater impact in organizations with a weak ethical culture.⁸⁹

B. Organizational Ethics and the Theory of Planned Behavior

Given this general understanding of the importance of implementation, we can now take a closer look at the potential impact of compliance programs on the beliefs that form employees' intentions on ethical behavior under the TPB. These sections examine each determinant of intentions—attitudes, subjective norms, perceived behavioral control, and moral obligations—in turn. It should be noted that these determinants influence each other and factors listed under one determinant may also affect other determinants. For example, subjective norms can influence intentions directly, or they can influence the beliefs that form an individual's attitude.⁹⁰ After reviewing the available research on each individual determinant, section 5 summarizes how compliance programs improve employees' intentions, encouraging ethical behavior.

1. Improving Attitudes

As discussed earlier, a person's attitude towards a behavior depends on his or her beliefs about what outcomes will follow from an action (behavioral beliefs) and the actor's evaluation of those outcomes as good or bad (outcome evaluations). If an employee does not expect that an action will create the desired result, then the employee will have a negative attitude toward the behavior. Thus, it is not surprising that when witnesses of misconduct are asked why they did not report the wrongdoing, they

88. Id. at 79.

89. Id. at 79.

90. Vallerand et al., Ajzen and Fishbein's Theory of Reason Action as Applied to Moral Behavior: A Confirmatory Analysis, 62 **J. of Personality and Soc. Psych.** 98, 108 (1992).

commonly respond that they did not think anything would be done (or could be done) to fix the problem.⁹¹

In the National Business Ethics Survey, forty-five percent of respondents that had witnessed some type of misconduct chose not to report it.⁹² The most common reason respondents gave for not reporting was the belief that no corrective action would be taken.⁹³ Fifty-nine percent of respondents selected this as an important factor in their decision.⁹⁴ By contrast, those that indicated that they reported misconduct believed it was the right thing to do (99.5 percent), but they also believed that corrective action would be taken (79 percent).⁹⁵ In addition to not believing the behavior would produce a desired outcome, non-reporting respondents had a negative attitude towards whistle blowing due to their fear of retaliation (46 percent) and a belief that retaliation could happen because they doubted that their reporting really would be anonymous (39 percent).⁹⁶

Although potential whistle blowers may have negative attitudes due to a fear of retaliation, others may have a negative attitude towards doing “the right thing” due to a fear of withheld rewards. The most likely sources for rewards are through performance reviews, incentive compensation systems, and promotions. Employees are more likely to develop a positive attitude towards behavior that the organization rewards, even if it is

91. Near et al., *supra* note 50, at 238 (finding that “nothing could be done to remedy the situation” was the main reason given by observers of wrongdoing that chose not to report it).

92. NBES, *supra* note 1, at 28. Twenty-six percent of respondents stated that they had witnessed some form of “misconduct.” *Id.* at 16. This number rises to 52 percent when the respondents are provided with a list of examples of misconduct to choose from, as opposed to simply being asked about “misconduct” generally. *Id.* at 16–17.

93. *Id.* at 29.

94. *Id.*

95. *Id.* at 28. The other factors selected by respondents included the belief that they had the support of management (75 percent) or co-workers (75 percent); that they could report the incident anonymously (63 percent); and that no one else would or could report the incident (49 percent). *Id.* The percentages exceed 100 percent because respondents were asked to select all factors that apply. *Id.*

96. *Id.* at 29. The other factors selected by respondents included the belief that someone else would report the misconduct (24 percent) and the fact that they simply did not know who to contact (18 percent).⁹⁶

unethical behavior.⁹⁷ If the incentive plan only recognizes the employee's end numbers, then the employee will be punished to the extent that lower numbers are the result of following the rules. On the other hand, if an employee believes that she is being rewarded for the means of achieving a result, and not just the ends, she will have a more positive attitude towards following the company's code of conduct and her own ethical values. An organization does not necessarily have to reward ethical behavior to improve attitudes, but it assures an employee that she will not be punished for behaving ethically.⁹⁸ Through their own experience and the observation of the treatment of others, employees gain evidence that they are not "suckers" for following the rules while others that do not are able to achieve superior outcomes.⁹⁹

In addition to the strong impact of reward systems, many argue that the business environment in general can cause individuals to behave less ethically than they otherwise would.¹⁰⁰ For example, one study found that changing the name of a social dilemma game from the "community game" to the "Wall Street Game" cut cooperative behaviors in half.¹⁰¹ In this study, the framing of the problem likely influenced the basis of players' outcome evaluations which in turn shaped their attitudes toward cooperation. Thus, negative attitudes toward cooperative behavior are always lurking in the background and must be proactively managed by the firm. That is, if defection is the default in business

97. Carpenter & Reimers, *supra* note 33, at 118. For example, in their study, Carpenter and Reimers were able to manipulate the attitude variable by changing what behaviors they told subjects that management encouraged. *Id.* at 122–24.

98. See Adams et al., *supra* note 61, at 207.

99. Victor et al., *Peer Reporting*, *supra* note 50, at 262.

100. Adams et al., *supra* note 61, at 208.

101. Lee Ross & Donna Shestowsky, *Empirical Legal Realism: A New Social Scientific Assessment of Law and Human Behavior*, 97 *Nw. U. L. Rev.* 1081, 1099–1100 (2003). In social dilemma games actors have individual incentives not to cooperate with the group (to defect), but when they do so, the collective outcome is suboptimal. In other words, those that do not cooperate are free-riding on the efforts of those that do.

organizations, then managers must take affirmative steps to change the framing of the problem and the structuring of rewards to engender positive attitudes.

2. *Changing Social Pressures*

The famous Asch studies dramatically illustrate the role of social pressures on organizational decision-making. In these experiments, subjects were asked to complete a simple line length matching exercise, which they could do easily when alone.¹⁰² However, when the subjects attempted to complete the exercise in a room with others that were all giving the same incorrect answer, the subjects consistently gave into social pressures and also selected the wrong line more than one-third of the time.¹⁰³ Thus, even when the subjects are sure they know the correct response, social pressures can create uncertainties about previous beliefs and even change behaviors.

In large business organizations, the pressures to conform and the uncertainty surrounding any decision can be significantly greater than in Asch's studies. Inexperienced managers must rely on local norms for guidance in periods of uncertainty,¹⁰⁴ which can lead to the continuation of wrongful activity. As one employee in a risk-management position at Enron stated:

If your boss was [fudging], and you have never worked anywhere else, you just assume that everybody fudges earnings. . . . Once you get there and you realized how it was, do you stand up and lose your job? It was scary. It was easy to get into 'Well, everybody else is doing it, so maybe it isn't so bad.'¹⁰⁵

102. Solomon E. Asch, *Opinions and Social Pressure*, in **Readings About The Social Animal** 13, 16 (Elliot Aronson ed., 1995). When completing the exercise alone, subjects gave the correct answer 99 percent of the time. *Id.*

103. *Id.*

104. For example, in situations of lying to customers or blowing the whistle to avoid physical harm to others, important referent others such as family members should strongly influence subjective norms. However, in situations involving complicated organizational issues with unclear standards of behavior, normative beliefs are likely to be strongly shaped by those you most closely work with.

105. John A. Byrne, *The Environment was Ripe for Abuse*, *Bus. Wk.*, Feb. 25, 2002, at 118.

In the Enron case, as in the Asch studies, the individual's thought that the act was wrong was overridden by social pressures to conform to local norms of behavior.

In other situations, a clear norm on behavior may not yet have emerged. For example, in Ellis and Arieli's study of whistle blowing in the military, the authors found that there was not a clear organizational norm of reporting misconduct among the officers.¹⁰⁶ Thus, when the officers faced a whistle blowing decision, they looked to others for guidance, which led to subjective norms having greater influence than attitudes on intentions.¹⁰⁷ In these situations, a norm of unethical behavior has the chance to develop and spread through social pressures until it becomes the unquestioned standard.

To reduce such potentially negative social influences, the specific content of the code of conduct should help reduce the uncertainty surrounding the rules and values that guide employees. However, the social norms of the organization will still have significant influence on how the code is actually used in the organization. For example, Adam and Rachman-Moore found that employees believed that the social norms of the organization were significantly more important for influencing their commitment to the organization's values and rules than training programs.¹⁰⁸ These norms teach employees how the code of ethics actually works in practice and what are the true values of the firm.

Social pressures can also have a positive influence on ethical behavior. One way the firm can manage these social pressures is through codes of ethics. For example, a study by Adams and colleagues found that employees in firms with ethics codes viewed

106. Ellis & Arieli, *supra* note 34, at 962.

107. *Id.* at 962–63.

108. Avshalom M. Adam & Dalia Rachman-Moore, *The Methods Used to Implement an Ethical Code of Conduct and Employee Attitudes*, 54 *J. of Bus. Ethics* 225, 235 (2004). This is not to say, however, that formal training programs are unimportant, as the authors discovered in their more in-depth interviews with employees of the organization they studied. *Id.* at 238–40.

their fellow organizational members as being more ethical,¹⁰⁹ viewed the company as more supportive of ethical behavior, and were less likely to believe that they faced pressure to behave unethically.¹¹⁰ This was true even though most employees could not recall the contents of their company's code of ethics.¹¹¹ In addition, the code had a positive impact on attitudes by making it more likely for an employee to believe that they would be satisfied with the outcome of an ethical dilemma they faced.¹¹² These results are consistent with the results of the KPMG survey reported in Table 1. Note, for example, that 84 percent of employees in companies with a complete compliance program stated that misconduct was not tolerated by others in the workplace, compared to just 35 percent of employees with a less complete code.¹¹³

3. Control Systems and Control Beliefs

Perceived behavioral control involves both internal and external factors. Internal factors include an employee's belief in their level of competence to carry out (or refuse requests to carry out) fraudulent activity or courage to report observed misconduct to management. External factors relate to the obstacles in the actor's way. For example, knowing that auditors will review your financial statements should reduce your belief that you could successfully falsify documents.

Although audits are perhaps the most well-known control, they are of course not foolproof, and they do not always significantly reduce an employee's perceived

109. Adams et al., supra note 61, at 204 & 206. This includes top management, supervisors, peers, and subordinates. Id.

110. Id. at 204 & 206.

111. Id. at 208

112. Id. at 204 & 206.

113. KPMG, supra note 3, at 19.

behavioral control.¹¹⁴ In addition, simply increasing the aggressiveness of existing audits may do little to improve their deterrent effect.¹¹⁵

More aggressive monitoring in general is also more problematic than many believe. Langevoort, for example, identifies several behavioral tendencies that frustrate effective monitoring by supervisors¹¹⁶ and argues that third-party auditing is less effective and significantly more costly than most people realize.¹¹⁷ Monitoring with improperly designed sanctions may also be counterproductive. For example, Tenbrunsel and Messick found that the presence of a monitoring system with sanctions for non-compliance caused employees to view a social dilemma as a business decision (i.e., in terms of expected payoffs) rather than as a problem involving ethical issues to be resolved.¹¹⁸ Then, when the penalties for misconduct were too low or there was little likelihood of detection, there was more wrongful behavior than when there was no sanctioning system in place.¹¹⁹ Excessive monitoring can also reduce trust, or displace intrinsic motivations (moral obligations under the TPB) with extrinsic motivations (decision-making based on self-

114. See Arnold Schneider & Neil Wilner, A test of audit deterrent to financial reporting irregularities using the randomized response technique, 65 **Accounting Rev.** 668, 679–80 (1990). The authors found support for the deterrent effect of having either an internal or external audit—which suggests employees perceived less control—but the deterrent effect only applied in situations where the employee had limited financial incentives to engage in fraud and the fraud was of a type that was expected to gain auditor attention (e.g., a material misstatement involving a clear and obvious violation of GAAP). *Id.* at 670–71, 679–80.

115. Wilfred C. Uecker et al., Perception of the internal and external auditor as a deterrent to corporate irregularities, 56 **Accounting Rev.** 465, 477–78 (1981) (finding that an increase in perceived aggressiveness of internal or external auditing had no additional deterrent effect on the decision to materially overstate net income).

116. Donald C. Langevoort, Monitoring: The Behavioral Economics of Corporate Compliance with Law, 2002 **Colum. Bus. L. Rev.** 71, 85–90 (2002).

117. Langevoort, *supra* note 116, at 93–100; Lawrence A. Cunningham, Appeal and Limits of Internal Controls to Fight Fraud, Terrorism, Other Ills, 29 **J. Corp. L.** 267, 270 (2004). (summarizing his conclusions by stating: “auditors know controls and audits are inherently limited processes, while lawyers invest more confidence that these processes can assure substantive results. The resulting expectations gap adds pressure to use more controls and audits that simultaneously promote the appearance of control and reduce actual control.”).

118. Ann E. Tenbrunsel & David M. Messick, Sanctioning Systems, Decision Frames, and Cooperation, 44 **Admin. Sci. Q.** 684, 685 (1999).

119. *Id.* at 695–96.

interested cost-benefit analyses).¹²⁰ Thus, not only is a control system both costly and less effective than many people expect, but it may also have a negative effect on the other determinants of intentions to act ethically under the TPB.

A corporation's culture can also have a significant impact on employees' perceived behavioral control. Many employees face strong pressures from leadership to engage in unethical behavior¹²¹ and even though they have a negative attitude towards the behavior they feel that they have no other alternative but to obey.¹²² This is illustrated by the well-known Milgram experiments, where subjects gave what they believed to be life-threatening electric shocks to other study participants because an authority figure ordered them to do so.¹²³ Research in accounting and auditing has empirically verified the ability of authority figures to use obedience pressure to force subordinates to violate professional standards.¹²⁴ Although the Milgram experiments may be interpreted as removing actors from the TPB, as they are simply submitting to legitimate authority and not acting upon

120. See Langevoort, supra note 116, at 96–99; see generally **Bruno S. Frey, Not Just For the Money** (1997) (discussing the relationship between extrinsic and intrinsic motivations and their impact on personal motivation); but see Angela L. Coletti, The Effect of Control Systems on Trust and Cooperation in Collaborative Environments, 80 **Accounting Rev.** 477 (2005) (finding that control systems can improve trust).

121. NBES found that ten percent of employees felt pressure to violate the law or their companies' standards. NBES, supra note 1, at 41. Of those, 20 percent indicated that they feel such pressure "all the time" and another 24 percent indicated "fairly often." Id. The source of those pressures was primarily top management (indicated by 36 percent of respondents) and middle management (39%). Id. at 43.

122. See Kurland, Ethical Intentions, supra note 37, at 308.

123. **Stanley Milgram, Obedience to Authority** (2004 Classics edition). In the Milgram experiments, subjects were ordered to give a "learner" increasingly greater shocks each time the learner gave a wrong answer. Even as the learner pounded on the wall in protest (the learner was not visible to the subject in the original experiment) and eventually fell silent with the higher voltage shocks, the subjects continued to shock the learner on the experimenter's orders, with 65% of the subjects administering the highest possible shock (labeled as "XXX"). Milgram at 32–35.

124. See Davis et al., The Effect of Obedience Pressure and Perceived Responsibility on Management Accountants' Creation of Budgetary Slack, 18 **Behavioral Research in Accounting** 19 (2006); DeZoort et al., An investigation of obedience pressure effects on auditors' judgments, 6 **Behavioral Research in Accounting** 1 (1994).

their intentions,¹²⁵ for our purposes, the basic lessons are clearly relevant. Many organizations have a corporate culture that emulates the Milgram experiment by seeking to reinforce and strengthen hierarchal control by expecting employees to simply “do what they are told” and not consider other alternatives.¹²⁶ Not surprisingly, employees in corporations with such cultures observe more unethical behavior, and they are less willing to discuss ethical issues, deliver bad news to supervisors, or report violations.¹²⁷

4. *Managing Moral Obligations*

An individual’s sense of moral obligations to follow the company’s code of conduct clearly depends upon individual differences in ethical values, but it also depends upon factors within the organization’s control.¹²⁸ Procedural justice within the organization is a primary way that firms can foster positive moral obligations towards its rules. Procedural justice refers to the fairness of the implementation of a company’s policies and procedures both formally and informally.¹²⁹

125. Milgram, supra note 123, at 132–43; DeZoort et al., supra note 124, at 7–8; David M. Messick & Rafal K. Ohme, Ethical Aspects of Social Psychology, in **Power and Influence in Organizations** 197 (Roderick M. Kramer and Margaret A. Neale, eds., 1998).

126. Trevino et al., The Ethical Context in Organizations: Influences on Employee Attitudes and Behaviors, 8 Bus. Ethics Q. 447, 460 (1998) [hereinafter Trevino et al., Ethical Context]. An illustrative example of such pressures in large organizations comes from KPMG’s process of convincing partners to develop and sell “aggressive” (and potentially illegal) tax shelters. Lynnley Browning, How an Accounting Firm Went From Resistance to Resignation, **N.Y. Times**, August 28, 2005, at A1. The person that would later become Chief Financial Officer of KPMG regularly sent out emails stating “you will do this now” in large, red font. Id. Another senior officer responded to tax partners’ questions on the appropriateness of a strategy by stating you’re “either on the team or off the team.” Id. Eventually, sixteen tax partners were charged with criminal offenses, including the author of those emails and the person quoted above. Andrew Parker, 10 more charged in KPMG tax fraud case, **Fin. Times**, October 18, 2005, at 30; Lynnley Browning, Defendants File a Flurry of Motions Challenging the KPMG Tax-Shelter Case, **N.Y. Times**, January 13, 2006, at C3.

127. Trevino et al., Ethical Context, supra note 126, at 469; Trevino et al., What Hurts, supra note 77, at 136–37, 143–44.

128. Tom R. Tyler, Promoting Employee Policy Adherence and Rule Following in Work Settings: The Value of Self-Regulatory Approaches, 70 **Brooklyn L. Rev.** 1287, 1290 (2005).

129. Daniel P. Skarlicki & Robert Folger, Retaliation in the Workplace: The Roles of Distributive, Procedural and Interactional Justice, 82 **J. of Applied Psych.** 434, 435 (1997); Victor et al., Peer Reporting, supra note 50, at 254. Employees’ perceptions of procedural justice depend on (1) the quality of the organization’s decision making procedures (e.g., use of objective evidence), (2) the quality of the organization’s treatment of people (e.g., respecting individual’s rights), (3) the company’s formal rules

Tom Tyler, the leading scholar on procedural justice in organizations, states that organizations can seek compliance with their rules either through a command-and-control approach focused on monitoring, deterrence, and punishment (consistent with the compliance-based approach discussed earlier) or a self-regulatory approach focused on an employee's internal motivations and ethical values (consistent with the integrity-based approach).¹³⁰ Tyler finds that the self-regulatory approach is more effective in gaining employee rule-following than a command-and-control approach.¹³¹ To gain the benefits of a self-regulatory approach, the organization can enhance the legitimacy of the rules through a fair process of application and as a result influence an employee's moral obligation to follow the rules.¹³² Thus, if upper management acts in a manner which shows that the company's code of ethics does not apply to them, then employees will recognize the unfairness and feel no obligation to follow the company's rules.¹³³ The organization can also improve self-regulation by encouraging employees to act upon their values, which creates congruence between the company's rules and employee values.¹³⁴ The perception of congruence between employee and company values is also influenced by procedural justice.¹³⁵

and values statements, and (4) the application of the rules and the general treatment of the employee by the local supervisor. Tyler, supra note 128, at 1309–1311. Procedural justice, as defined by these four components, is distinct from the employee's perceptions of the fairness of the outcomes of the process. Id. at 1311.

130. Tyler, supra note 128, at 1289–91; Tom R. Tyler & Steven L. Bladder, Can Businesses Effectively Regulate Employee Conduct? The Antecedents of Rule Following in Work Settings, 48 Acad. Mgmt. J. 1143, 1143–45 (2005).

131. Tyler & Bladder, supra note 130, at 1148 & 1153.

132. See Id. at 1154.

133. Tyler, supra note 126, at 1307; see also Langevoort, supra note 116, at 108–109 (noting that if employees perceive that management itself is not following the values embodied in the code of ethics, then employees will view the compliance program as unfair and have a lowered desire to comply). Employees may also respond to unfair treatment with retaliation against the employer as a way to punish the firm for unfair treatment. See generally Skarlicki & Folger, supra.

134. Id. at 1153–54.

135. Tyler, supra note 126, at 1305–1306. Tyler states that “fair organizational procedures and processes are hypothesized to foster a sense that corporate authorities are legitimate and that the organization itself possesses moral values similar to those of the individual.” Id. at 1306.

Organizations have also been successful in positively influencing intentions and behaviors by changing employees' role requirements. Studies by Victor and Trevino found that employees felt a personal obligation to report peers when the code of conduct or their specific job required this behavior.¹³⁶ Simply changing role requirements is likely not sufficient, however, as employees still must accept that responsibility.¹³⁷

5. Integrity-Based Programs and the TPB

This empirical evidence on determinants provides support for the claim that compliance programs consistent with the OSG, and most importantly integrity-based programs, can improve employees' intentions that lead to ethical behavior. First, integrity-based programs improve attitudes by creating the perception of more positive outcomes from ethical behavior. The presence of a compliance program helps potential whistle blowers believe that that they will be satisfied with the consequences of reporting.¹³⁸ Employees also will be more likely to believe that the company's reward system will not punish them for doing the right thing.¹³⁹ Integrity-based programs also influence attitudes by encouraging employees' to judge outcomes based on their own values (leading to increased compliance with a code of ethics) rather than direct them towards focusing only on their own individual payoffs.¹⁴⁰

136. Victor et al., Peer Reporting, supra note 50, at 259–260 (finding that role responsibility influenced intentions to report misconduct, which in turn influenced actual reporting behaviors); Linda Klebe Trevino & Bart Victor, Peer Reporting of Unethical Behavior: A Social Context Perspective, 35 **Acad. of Mgmt. J.** 38, 60 (1992) (finding that role responsibility influenced intentions to report misconduct, but the test design did not include actual reporting behavior).

137. Trevino & Victor, supra note 136, at 60–61.

138. See Table 1. Effective compliance programs had this impact on firms regardless of their corporate culture. NBES, supra note 1, at 82–83.

139. See Table 1 (reporting survey findings that with a complete compliance program, employees are less likely to believe that rewards are only based on ends and more likely to believe that executives value integrity over short-term goals).

140. See notes 100–101 and accompanying text (discussing how the business environment can shape an employees' framing of outcome evaluations); see notes 130–135 and accompanying text (discussing Tyler's work on procedural justice and self-regulation); Weaver & Trevino, supra note 62, at

Second, compliance programs influence subjective norms by reducing social pressure for unethical behavior¹⁴¹ and creating an environment where employees feel free to discuss ethical issues and seek advice.¹⁴² By opening up communications on ethical issues within the organization, employees are able to actively voice their opinions, and more responsible norms of behavior emerge.¹⁴³ Employees are also more likely to seek out expert advice that will give them clear answers to their ethical dilemmas, as opposed to the alternative of following the crowd in the face of uncertainty. In support of this, the NBES found that in organizations where co-workers talk about ethics and support organizational standards,¹⁴⁴ employees at all levels of the firm observe less misconduct and are less likely to be exposed to situations involving misconduct.¹⁴⁵

Third, integrity-based programs enhance an employee's perceived behavioral control to refuse to engage in fraud and to report observed misconduct. The NBES survey found that employees in a corporation with ethics training or a strong corporate culture believed they were prepared to handle any problems they may face.¹⁴⁶ Through training, they felt they had the skills and resources necessary to follow through with their intentions. Likewise, a study involving Chief Financial Officers found that training on

329–30 (finding that an integrity-based program creates the perception that you can act on your own values at work).

141. See notes 109–111 and accompanying text (citing evidence that compliance programs create the perception that the organization supports the values in the code of ethics). In addition, integrity-based programs create the perception that management and co-workers are supportive of ethical behavior.

142. See Table 1; Weaver & Trevino, *supra* note 62, at 329–30.

143. See generally Scott Sonenshein, *Business Ethics and Internal Social Criticism*, 15 *Bus. Ethics Q.* 475 (2005) (developing a theoretical model of internal social criticism).

144. These are some of the factors that the NBES refers to as “ethics related actions” or ERAs. NBES, *supra* note 1, at 60. ERAs, along with the extent to which employees believe members of their organization are held accountable for their actions, make up the index the NBES uses to classify a firm as having an ethical culture. *Id.* at 74, 76.

145. *Id.* at 89–92.

146. *Id.* at 88 (finding that 83% of employees in firms with ethics training felt well prepared to handle risk situations, compared to 66% of employees in firms without training). Employees at all levels of the firm with a stronger corporate culture felt more prepared to handle situations potentially involving misconduct. *Id.* at 89–92.

their company's code of ethics made it more likely that they used the code in strategic decisions because the training provided them with a higher level of perceived behavior control over its use.¹⁴⁷

Fourth, integrity-based programs cause employees to feel empowered to act upon their own values and moral obligations.¹⁴⁸ The employee feels in control, as the company will not discourage them from acting on their moral beliefs. And, as shown by Tyler's work, this increases an employee's moral obligation to follow company rules.¹⁴⁹

It is, of course, important to note that there are limitations to all of the empirical studies reported here. Other evidence is based on surveys conducted by non-profit organizations and accounting firms that also have significant limits, such as not controlling for other potential influencing variables.¹⁵⁰ Nonetheless the empirical evidence does strongly point in the same direction and, at a minimum, encourages additional research in this area.

III. Legislating Ethics in Organizations: Small Steps toward Reducing Fraudulent Behavior

Based on the analysis above, there is strong evidence to believe that properly implemented compliance programs can improve ethical behavior in organizations and reduce the high levels of fraud that currently exist. The conclusion by some commentators that compliance programs are a failure is premature; we are still a long way from having firms implement "effective" compliance programs. Consider for

147. John M. Stevens et al., Symbolic or Substantive Document? The Influence of Ethics Codes on Financial Executives' Decisions, 26 **Strategic Mgmt. J.** 181, 185 (2005)

148. Weaver & Trevino, supra note 62, at 329–30.

149. See supra notes 130–135 and accompanying text.

150. For a discussion of the research methodology challenges when studying ethical behavior, see generally Donna M. Randall & Maria F. Fernandes, The Social Desirability Response Bias in Ethics Research, 10 **J. Bus. Ethics** 805 (1991); Michael J. O'Fallon & Kenneth D. Butterfield, A Review of the Empirical Ethical Decision-Making Literature: 1996–2003, 59 **J. of Bus. Ethics** 375, 403–405 (2005).

example that the NBES found that only 41 percent of firms with over 10,000 employees (and 26 percent overall) had implemented all of the elements of an effective program under the OSG.¹⁵¹ In addition, only 22 percent of the organizations in their study had both all of the elements of an effective compliance program and an ethical corporate culture based on the study's criteria.¹⁵²

The analysis in this section focuses on the smaller steps that can be taken to improve the current system of compliance programs under Sarbanes Oxley and the Organizational Sentencing Guidelines. I do not address questions of whether there should be a radical change in corporate criminal liability¹⁵³ or whether Sarbanes Oxley should be repealed or drastically reformed. I also do not address larger issues that would also have a significant (but indirect) impact on ethics in corporations, such as returning corporations to a focus on long-term value¹⁵⁴ or reforming executive compensation.¹⁵⁵ Instead, the challenge I consider in this section is the role of the law in pushing firms to adopt "effective" compliance programs.

A. Why Don't Firms Adopt Integrity-Based Compliance Programs?

To understand why firms are not implementing integrity-based corporate compliance programs, we can place top management into two categories: (1) those that seek an effective compliance program but have priorities elsewhere that prevent effective

151. NBES, *supra* note 1, at 56.

152. NBES, *supra* note 1, at 94.

153. See Laufer *supra* note 15.

154. See **Dean Krehmeyer & Matthew Orsagh, *Breaking the Short-Term Cycle*** (2006) (available online at: www.corporate-ethics.org/pdf/Short-termism_Report.pdf) (providing recommendations for what CEOs, asset managers, investors, and analysts need to do to break out of the cycle of focusing only on short-term gains); **Lawrence E. Mitchell, *Corporate Irresponsibility: America's Newest Export*** (2001) (providing policy recommendations for how to refocus managers on long-term growth).

155. See **John C. Bogle, *The Battle for the Soul of Capitalism*** 25–26 (2005) (stating that excess executive compensation goes hand-in-hand with pressures for managed earning in the firm); see generally Symposium on Bebchuk & Fried's Pay Without Performance, 30 **J. of Corp. Law** (2005) (providing various perspectives on the problems of executive compensation and potential reforms).

adoption; and (2) those that adopt compliance programs simply as a form of “insurance” and therefore are uninterested in fully implementing the program beyond features easily observed by outsiders. We can refer to the first category as the misguided executives and the second category as the misleading executives.

The misguided executive believes, correctly, that internal controls are a useful deterrent to fraud. However, they are also likely to believe that the solution to any problem is simply more controls. In general, managers have a bias towards adopting compliance-based programs focused on sanctions,¹⁵⁶ which causes them to find little value in other mechanisms such as anonymous reporting hotlines and ethics training.¹⁵⁷ Likewise, prosecutors and judges reviewing programs are also likely have a bias towards more controls,¹⁵⁸ which will influence how managers implement their programs. With limited time and resources to devote to their compliance programs, it is reasonable to expect such managers to focus more of their efforts on internal controls and less on developing an integrity-based program.

The changes to the OSG that emphasize a strong ethical culture should help refocus management’s attention. However, section 404 of Sarbanes Oxley competes with

156. See Chip Heath, On the Social Psychology of Agency Relationships: Lay Theories of Motivation Overemphasize Extrinsic Incentives, 78 **Org. Behav. & Human Dec. Processes** 25 (1999) (finding that in agency situations, principals have a bias towards assuming that their agents are more motivated by extrinsic rewards (such as pay and job security), as opposed to intrinsic rewards, than they are). A 2005 survey of 95 large firms by Ernst and Young found that 53 percent of firms had increased their level of monitoring in the last 18 months and 50 percent plan to further increase their programs in the next 18 months. Ernst & Young, Corporate Regulatory Compliance Practices 28 (2005) (available online at [www.ey.com/global/download.nsf/US/Compliance_Survey_-_Corporate_Regulatory_Compliance/\\$file/CorporateRegulatoryCompliance.pdf](http://www.ey.com/global/download.nsf/US/Compliance_Survey_-_Corporate_Regulatory_Compliance/$file/CorporateRegulatoryCompliance.pdf) -). In addition, 49 percent of firms have moved to centralize their monitoring programs, and another 41 percent plan to do so in the future. Id.

157. See ACFE 2002, supra note 16, at 12 (2002) (finding that based on a scale from 1 (effective) to 8 (ineffective) managers ranked internal controls 1.62 on average, but ranked anonymous reporting and ethics training 5.02 and 4.86 respectively).

158. See Langevoort, supra note 116, at 105 and 113–14 (stating that “integrity-based systems will often deliberately be designed in such a way that they look particularly leaky” and that it is a natural reaction for judges to say in hindsight that the company could have prevented the wrongful act with additional controls).

the OSG and encourages management to focus on internal controls. Section 404 and its reporting requirements place a priority on internal controls and consume management's time.¹⁵⁹ Thus, even if the OSG legitimizes a focus on the firm's corporate culture, the demands of section 404 leave management with little time and resources to devote to those matters, and we continue to have misguided executives.

The misleading executive, on the other hand, intentionally seeks only to adopt a "paper" program and to decouple it from actual operations. These managers are aware that prosecutors are typically unable to distinguish between sincere and insincere attempts at implementing a compliance program, and therefore seek only to adopt the appearance of being a "good corporate citizen."¹⁶⁰ These managers use compliance programs as insurance to protect the firm and themselves from liability for illegal behavior that results from the true corporate culture they foster inside the firm.¹⁶¹ The remainder of this section considers potential reforms to encourage both types of managers to adopt integrity-based programs.

B. Encouraging Integrity-Based Programs

The behavior of corporations depends on both its hardware and software. Hardware refers to the firm's "structures and processes," while software refers to the "norms and culture" of the firm.¹⁶² As stated by Beinhocker, "the two sides must be consistent and mutually reinforcing to create a coherent social architecture."¹⁶³ The law is, of course, limited in its ability to shape a firm's social architecture, but it can directly

159. See Matt Krantz, More finance chiefs are dropping out, **USA Today**, March 25, 2005, at 1B (noting that more and more CFOs are quitting their jobs because of the time demands of SOX and the way it has changed the nature of their job).

160. Laufer, supra note 15, at 1405–07.

161. Id.

162. See Eric D. Beinhocker, The Adaptable Corporation, **The McKinsey Q.**, Number 2, at 77, 84 (2006).

163. Id. (referring to corporate strategy, but consistent with our discussion of integrity-based programs).

influence the firm's hardware and indirectly influence the firm's software. Influencing positive change in the firm's software through integrity-based programs should be the primary goal of any legislative intervention, including interventions involving the firm's hardware. The primary means of influencing the firm's software is through top management's commitment to an integrity-based program.¹⁶⁴

1. *Hardware Fixes*

In general, we should be reluctant to have the law mandate specific hardware features, as a one-size-fits-all approach rarely works and firms need flexibility to adapt their compliance programs to their unique situations. In addition, once the law mandates a certain structure, experimentation on new ways of doing things is at-risk of being cut-off. Certain hardware requirements, however, can potentially increase commitment to ethics and alter priorities without interfering substantially with management's need for flexibility. For example, the ethics codes requirements under Sarbanes Oxley and the SEC implementing rules provide only general guidelines and leave corporations with the flexibility to develop their own content.¹⁶⁵ Although a code of ethics as a hardware requirement can have a positive impact on intentions to behave ethically,¹⁶⁶ they require the commitment of top management to ensure that they have a significant impact. To this end, a code of ethics can be supplemented by mechanisms that require direct leadership

164. See Gary R. Weaver et al., Corporate Ethics Programs as Control Systems: Influences of Executive Commitment and Environmental Factors, 42 *Acad. of Mgmt. J.* 41, 52–53 (1999) [hereinafter, Weaver et al., Control Systems].

165. Note: The Good, The Bad, and Their Corporate Codes of Conduct: Enron, Sarbanes-Oxley, and the Problem of Legislating Good Behavior, 116 *Harv. L. Rev.* 2123, 2135–36 (2003). This article goes on to argue that the flexibility granted to firms to draft their own codes and then disclose those codes will have little effect on improving ethical behavior, and may actually be counterproductive. *Id.* at 2124–25.

166. See *supra* notes 109–112 and accompanying text (finding that the presence of a code of ethics creates the perception amongst employees that the firm supports ethical behavior and therefore improves attitudes toward that behavior); see also *supra* note 147 and accompanying text (noting a study that finds financial officers are more likely to use the company's ethics code in strategic decisions if they have had training on the code, which has a positive impact on their perceived behavioral control).

involvement, allow employees to voice concerns directly to leadership, and require companies to actively evaluate the effectiveness of their ethics programs.

The first step in focusing top management's attention on organizational ethics and legitimizing the importance of compliance programs is to require their time and attention to these matters. Many firms' initial response to the organizational sentencing guidelines was to adopt the necessary structures and processes in form, but in a manner that did little to change top management's involvement.¹⁶⁷ Many firms implemented their programs simply by tacking compliance program responsibilities onto the roles of certain officers and utilizing existing corporate structures.¹⁶⁸ For example, over half the firms in a survey conducted in the mid-1990s assigned a specific officer to be in charge of the compliance program, but 54 percent of those firms indicated that the officer spent less than 10 percent of his or her time on ethics and compliance issues.¹⁶⁹ CEOs also did not increase their involvement. Two-thirds of ethics and compliance officers indicated that their CEO had communicated with them on ethics issues no more than two times per year.¹⁷⁰ In addition,

167. The lengths to which management will go to avoid involvement in a compliance program are illustrated in Bishop v. PCS Administration, Inc., 2006 WL 1460032 (N.D.Ill.), Fed. Sec. L. Rep. P. 93,882, 24 IER Cases 1096. In Bishop, PCS appointed the plaintiff, an in-house counsel, to be the company's Compliance Officer. Id. at *3. After reading the OSG's requirements that high level personnel head the compliance program, the plaintiff suggested that someone else head the program and she would provide support. Id. This suggestion was rejected, as was her argument that the firm needed a compliance committee. Id. at *4. The plaintiff was then fired from the company, which she alleged was due to these efforts to prevent fraud. Id. at 5.

168. Gary R. Weaver et al., Corporate Ethics Practices in the Mid-1990s: An Empirical Study, 18 **J. of Bus. Ethics** 283, 283 (1999) [hereinafter, Weaver et al., Ethics Practices] (reporting the results of an empirical study finding that top management's commitment to the ethics program was the most important predictor of whether a firm would adopt a values-oriented compliance program, as opposed to a strictly compliance-oriented program); Gary R. Weaver et al., Integrated and Decoupled Corporate Social Performance: Management Commitments, External Pressures, and Corporate Ethics Practices, 42 **Acad. of Mgmt. J.** 539, 547-48 (1999) [hereinafter Weaver et al. Integrated and Decoupled] (reporting the results of an empirical study finding that top management commitment was related to a firm adopting an integrated ethics program, as opposed to a program that could be easily established for window-dressing purposes and have no actual impact on day-to-day decision making).

169. Weaver et al., Ethics Practices, *supra* note 168, at 288. Thirteen percent of the respondents indicated that the officer spends 100 percent of his or her time on ethics and compliance issues. Id.

170. Id. at 291.

one-third of CEOs had not attended a meeting with ethics as a primary focus, and an additional one-third had only attended one such meeting in the last year.¹⁷¹ A more recent survey found that less than 40 percent of US boards received ethics and compliance training.¹⁷²

In recognition of such deficiencies, the revised sentencing guidelines included provisions requiring: (1) “high-level personnel” “ensure” the effectiveness of the program; (2) leadership “be knowledgeable” about the program; (3) individuals in charge of the compliance program’s operations, such as the Chief Ethics Officer, have “direct access” to the board of directors (or a subcommittee),¹⁷³ and they should report at least annually to the board (or subcommittee) on the effectiveness of the program;¹⁷⁴ and (4) all corporate officers, including the board of directors, receive ethics training.¹⁷⁵

All such changes should go a long way in ensuring that the top management and the board of directors is not “out of touch” with the ethical environment of the organization.¹⁷⁶ In addition, Sarbanes Oxley ensures that officers and directors are fully aware of their firm’s ethical environment through its requirement that the audit committee have a mechanism in place to hear concerns about questionable behavior.¹⁷⁷ Such requirements that directly involve the functioning of the officers and directors of the firm legitimize the importance of maintaining the ethical environment of the firm and should

171. Id.

172. Ronald E. Berenbeim & Jeffrey M. Kaplan, Ethics Programs: The Role of the Board: A Global Study (Conference Board Report) 31 (2004).

173. U.S Sentencing Guidelines Manual 8B2.1(b)(2)(B).

174. U.S Sentencing Guidelines Manual Application note 2.

175. U.S Sentencing Guidelines Manual 8B2.1(b)(4).

176. Linda Klebe Trevino, Out of Touch: The CEO’s Role in Corporate Misbehavior, 70 **Brooklyn L. Rev.** 1195, 1208–1209 (2005) (citing her own research which finds “senior managers have significantly more positive perceptions of organizational ethics when compared to rank-and-file employees. . . . [they] are less likely to see ethics initiatives cynically and are more likely to perceive the internal ethical environment to be supportive of ethical conduct in the organization.”).

177. Sarbanes Oxley 301(4); see also Trevino, supra note 176, at 1208 (stating that CEOs are “out of touch” with their firms’ ethical climates because “due to fear and futility concerns, employees are unlikely to report ethical problems up the chain”).

alter the priorities of the misguided manager. Likewise, the board of directors has access to information, and incentives to digest that information, that will make them better monitors of the misleading manager.

The next step in this line of reforms should be to require an ethics committee. In the US, board level oversight of the ethics and compliance program is typically done by an audit committee.¹⁷⁸ In a recent Conference Board study, none of the corporations that responded to their survey had an ethics committee overseeing their compliance program.¹⁷⁹ By contrast, 63 percent of Japanese companies used an ethics committee.¹⁸⁰ The authors of the Conference Board report state that having a committee responsible for the compliance and ethics program of the firm allows the committee members to develop expertise on the topic and requires them to devote specific time to these issues.¹⁸¹

An additional hardware adjustment is the requirement under the OSG that firms “take reasonable steps. . . .to evaluate periodically the effectiveness of the organization’s compliance and ethics program.”¹⁸² The OSG creates a proactive obligation on firms to evaluate their programs on a regular basis, whereas the old standard only required firms to evaluate their programs in reaction to a violation.¹⁸³ This is a requirement that needs to be taken seriously by corporations, prosecutors, and judges. Any leniency granted to a firm under the OSG should require the firm to demonstrate that it has made sincere, good

178. 77% of the firms that responded to the survey used an audit committee. Berenbeim and Kaplan, supra note 172, at 13.

179. Id. at 13. Their survey included 77 large US corporations. Id. at 34. 18 percent of firms used a governance committee. Id. at 13.

180. Id.

181. Id. at 13.

182. U.S Sentencing Guidelines Manual 8B2.1(b)(5)(b).

183. Corporate Compliance Committee, ABA Section of Business Law, Corporate Compliance Survey, 60 **Bus. Lawyer** 1759, 1784 (2005).

faith attempts to evaluate the effectiveness of its programs.¹⁸⁴ Langevoort argues that the overall evaluation of compliance programs should be based on industry best practices.¹⁸⁵ I firmly agree and further argue that the use of a best practices standard is especially important for judging firms' efforts at evaluating their programs.

Evaluation of compliance programs is an area where there is a need for innovation and sharing of experiences. Finding meaningful metrics is a significant challenge. One compliance officer compares measuring the effectiveness of compliance programs to determining if building a lighthouse was an effective use of resources: "How many ships didn't crash because the lighthouse was built?"¹⁸⁶ Dallas argues that the OSG should require firms to assess their ethical climate.¹⁸⁷ Determining an ethical climate is typically done through the use of a questionnaire,¹⁸⁸ however, only 11 percent of US companies in a recent Conference Board survey used employee surveys to test the effectiveness of their programs.¹⁸⁹

2. *Software Fixes*

Hardware fixes will not work without a change in the firm's software. For example, requiring firms to provide a mechanism for anonymous reporting should improve employee attitudes toward the behavior and increase the reporting of

184. See Public Hearing Held by the Ad Hoc Advisory Group on Organizational Sentencing Guidelines, Plenary Session I, November 14, 2002, at 81–83 (testimony of Lynn Sharp Paine) (available online at: http://www.uscc.gov/corp/ph11_02/plenary1.pdf).

185. Langevoort, supra note 116, at 115.

186. Ernst & Young, *Corporate Regulatory Compliance Practices 27* (2005) (available online at [www.ey.com/global/download.nsf/US/Compliance_Survey_-_Corporate_Regulatory_Compliance/\\$file/CorporateRegulatoryCompliance.pdf](http://www.ey.com/global/download.nsf/US/Compliance_Survey_-_Corporate_Regulatory_Compliance/$file/CorporateRegulatoryCompliance.pdf)). The survey respondents were 95 firms (mostly from the Fortune 1000) in highly regulated industries (thus, firms with the resources and incentives to adopt sophisticated compliance programs). Id. at 1.

187. Id. at 61–63.

188. Id. at 23–29. See also Public Hearing Held by Ad Hoc Advisory Group, supra at 99–103 (providing commentary on the use of employee surveys and other possible metrics to determine the effectiveness of a compliance program).

189. Berenbeim & Kaplan, supra note 172, at 22. For a potential explanation of this low number, see infra notes 215–20 and accompanying text (discussing the "litigation dilemma" faced by firms).

misconduct.¹⁹⁰ However, this mechanism will do little to change attitudes if employees do not believe they will actually have anonymity.¹⁹¹ To actually change intentions, the firm must also improve the corporate culture around the hardware mechanisms, such as through an integrity-based compliance program.¹⁹² The law can encourage the development of ethical corporate culture by encouraging firms and mediating groups to work towards developing best practices. Further, the government could remove legal barriers which currently discourage the development of effective integrity-based programs.

The law can only influence a firm's culture indirectly. For example, studies by Weaver and colleagues found that regulatory pressures through the organizational sentencing guidelines influenced the scope of the corporation's compliance program (i.e., hardware mechanisms, especially those that are easily decoupled from actual operations) but not the implementation of an integrity-based program.¹⁹³ Likewise, Stevens and colleagues found that regulatory pressures were unsuccessful in encouraging financial executives to use the company's code of ethics in strategic decision making.¹⁹⁴ Conversely, pressure from market participants, such as customers, suppliers, banks, and shareholders, did make it more likely that executives would actually utilize the code of

190. For example, the study by the Association of Certified Fraud Examiners found that firms without a hotline suffered \$200,000 in losses and took 24 months to detect the fraud, compared to \$100,000 in losses and 15 months to detection for firms with a hotline. Association of Certified Fraud Examiners, supra note 4, at 35. The report does not provide data on which firms had mechanisms (such as fraud training) in addition to a hotline that would impact those numbers. The NBES did not find any significant difference between firms with and without an anonymous means of reporting in the percentage of employees stating that they reported observed misconduct. NBES, supra note 1, at 87. Firms with anonymous reporting did, however, have less observed misconduct. Id. at 86. This later finding suggests that employees contemplating wrongdoing had a lower perceived behavioral control due to the possibility of anonymous reporting (even though co-workers were not making use of the mechanism) and were therefore less likely to engage in the behavior.

191. See supra note 96 and accompanying text.

192. Weaver & Trevino, supra note 62, at 324 and 327 (finding that the reporting of misconduct required both a compliance-based and integrity-based approach).

193. Weaver et al, Integrated and Decoupled, supra note 168, at 547–48.

194. Stevens et al., supra note 147, at 188.

ethics.¹⁹⁵ Other factors that had a positive impact on the use of the code included beliefs that following the code of ethics would help create an ethical corporate culture and promote a positive image to stakeholders.¹⁹⁶ Thus, market pressures and perceived operating benefits from an ethical culture, but not regulatory pressure, are key mechanisms for getting firms to meaningfully implement their compliance programs through changes in their software.

Instructive for achieving our goal of software change is Sturm's context-based problem-solving approach to reducing employment discrimination caused by a firm's corporate culture.¹⁹⁷ Sturm's approach falls under the emerging category of regulation referred to as "new governance."¹⁹⁸ For Sturm, the law's role in encouraging the adoption of effective compliance programs is not only to provide incentives through liability avoidance, but also to provide "legitimacy, clout, and regular consideration" to issues that were "typically neglected or undervalued."¹⁹⁹ The potential for liability, however, creates a tension between actions that create economic benefits and are ethically responsible, on the one hand, and strategic actions designed to protect the firm from legal actions, on the other.²⁰⁰

195. Id. at 183, 188.

196. Id. at 189–190. The authors of the study actually treat stakeholder pressure as influencing normative beliefs. Id. at 185.

197. Susan Sturm, Second Generation Employment Discrimination: A Structural Approach, 101 **Colum. L. Rev.** 458, 475–76 (2001) (arguing that a rule-enforcement approach to discrimination "discourages . . . proactive problem solving," which is a process that identifies the "organizational dimensions of the problem, encourages organizations to gather and share relevant information, builds individual and institutional capacity to respond, and helps design and evaluate solutions that involve employees who participate in the day-to-day patterns that produce bias and exclusion.").

198. Bradley C. Karkkainen, "New Governance" in Legal Thought and in the World: Some Splitting as Antidote to Overzealous Lumping, 89 **Minn. L. Rev.** 471, 471–72 (2004); see also Orly Lobel, The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought, 89 **Minn. L. Rev.** 342 (2004) (providing an exhaustive overview of new governance regulation); Edward Rubin, The Myth of Accountability and the Anti-Administrative Impulse, 103 **Mich. L. Rev.** 2073, 2107–2108 (2005) (describing the organizational sentencing guidelines as one example of "new public governance").

199. Sturm, supra note 197, at 521.

200. Sturm, supra note 197, at 522.

To balance these tensions, Sturm recognizes the importance of key intermediary groups, such as non-governmental organizations and professional networks, to mediating the relationship between the law and organizations.²⁰¹ These actors include professionals within the company, consulting firms, lawyers, employee groups, institutional investors, and insurance companies. All of these groups have the potential to develop and then widely disseminate knowledge on best practices for implementing integrity-based programs.²⁰² Each group, however, also has incentives to work against this approach. For example, firms may not wish to share information on an ethics program that gives them a competitive advantage, and lawyers may counsel against collecting information that could be used against the firm in a lawsuit.²⁰³

Take insurance companies for example. Griffith argues that corporations should be required to disclose the premiums they pay for directors' and officers' insurance, as those premiums provide market participants with valuable information on the quality of the firm's corporate governance.²⁰⁴ In determining their premiums, insurance agents specifically ask firms about their corporate culture, such as "How does 'bad news' flow upward within the organization? Does the corporate culture encourage such news to be brought to the attention of senior management?"²⁰⁵ To the extent that insurance companies focus on these matters of managing ethical behavior and develop expertise in analyzing a firm's culture and implementation of its compliance program, firms have an incentive to adopt an integrity-based program to receive lower premiums and, more

201. Id. at 523.

202. Id. at 524–37.

203. Id. at 545; See also infra notes 215-20 (discussing the litigation dilemma faced by firms).

204. Sean J. Griffith, Uncovering a Gatekeeper: Why the SEC Should Mandate Disclosure of Details Concerning Directors' and Officers' Liability Insurance Policies, 154 U. Pa. L. Rev. 1147, 1150–51 (2006).

205. Id. at 1177–78.

importantly, to send the right signals to the market through the size of their premiums.²⁰⁶ Insurance companies, may, however, simply conduct more narrow reviews limited only to factors that reduce the probability they will have to make a pay-out for a covered claim, and they will not necessarily encourage practices that lead to the sharing of best practices.²⁰⁷ In addition, firms may be reluctant to have an insurance company conduct a complete audit, which potentially opens the firm to liability for uncorrected problems that were uncovered in the audit.²⁰⁸

Other mediating groups, with possibly a greater potential for change, can also be indirectly encouraged to play a more significant role in this area. As mentioned earlier as a hardware fix, prosecutors and judges should take seriously the OSG's requirement that firms regularly evaluate their programs. They should grant leniency only to those firms that can demonstrate that they are engaging in "best practices" to evaluate their program's effectiveness.²⁰⁹ Through this requirement, firms will likely work with mediating organizations, such as consulting firms and other compliance professionals, which will further help in the development and then dissemination of effective techniques.²¹⁰ Some movement in this area is already occurring in response to Sarbanes Oxley's ethics codes requirements and the OSG's recent requirements relating to the establishment of ethical corporate culture. For example, as of September 2006, the Society of Corporate Compliance and Ethics is offering an examination for those seeking to be a certified Compliance and Ethics Professional.²¹¹

206. See Id. at 1181–90.

207. Sturm, supra note 197, at 550–51.

208. Id. at 550–51.

209. See supra notes 182–185 and accompanying text.

210. Sturm, supra note 197, at 559.

211. Society of Corporate Compliance and Ethics, CCEP Candidate Handbook (2006) (available online at: <http://www.corporatecompliance.org>). Sturm, however, argues against such practices,

Krawiec is rightly concerned that the involvement of mediating groups may lead to compliance professionals engaging in self-interested behavior and encouraging firms to adopt unnecessary and ineffective mechanisms that serve primarily to support the importance of these groups to the organization.²¹² As Bagenstos states, best practices “would merely be the practices that are ‘best’ for . . . the intermediaries themselves.”²¹³ This tendency can be countered, however, by government encouragement and development of knowledge and data on what makes a compliance program effective and by the sharing of best practices as suggested by Sturm. Following what Lobel refers to as “legal orchestration,” government should also more actively support the stakeholder networks necessary to achieve these goals.²¹⁴

In addition to taking steps to encourage firms and mediating groups to work towards developing best practices, the government should remove or minimize the legal hurdles preventing firms from collecting and utilizing the information necessary to evaluate their software and then move towards implementing more effective compliance programs. A primary hurdle is the so-called “litigation dilemma” faced by firms.²¹⁵ If a corporation follows the requirements for an effective program under the sentencing guidelines, then the information it collects during monitoring and auditing its performance could be used against it in litigation.²¹⁶ In addition, it is becoming routine

as she believes attempts to professionalize will cut-off the development of necessary experience with new modes of thinking. Sturm, *supra* note 197, at 565.

212. Krawiec *Cosmetic Compliance*, *supra* note 14, at 528–36.

213. Samuel R. Bagenstos, *The Structural Turn and the Limits of Antidiscrimination Law*, 94 *Calif. L. Rev.* 1, 27–28 (2006).

214. Lobel, *supra* note 198, at 422–23; see also Christine Parker, *Reinventing Regulation Within the Corporation: Compliance-Oriented Regulatory Innovation*, 32 *Admin. & Soc.* 529, 555–59 (2000) (discussing the growth of compliance professionals and the structural conditions necessary for them to be effective); Susan Sturm, *The Architecture of Inclusion: Advancing Workplace Equity in Higher Education*, 29 *Harv. J.L. & Gender* 247 (2006) (providing examples of how intermediary groups are creating positive, meaningful (as opposed to symbolic) change in gender equity on university faculties).

215. U.S. Sentencing Comm’n, *supra* note 54, at 106.

216. *Id.*

for prosecutors to request that corporations waive attorney-client privilege and work-product protection to receive a reduced culpability score under the OSG.²¹⁷ These factors prevent the collection and flow of information within the firm that is necessary for the development of an effective program.²¹⁸ Especially harmful for developing integrity-based programs is that even information on employee attitudes and perceived subjective norms can be used against the firm in litigation.²¹⁹ Removing the litigation dilemma through some form of selective privilege for self-auditing²²⁰ or placing limits on the use of waivers²²¹ is necessary to allow firms to develop an understanding of their corporate culture and work towards improving the ethical intentions and behaviors of employees.

Conclusion

Although the media attention on the scandals leading up to Sarbanes Oxley was focused primarily on the Ken Lays, Jeff Skillings, and Andrew Fastows of the C-Suite, a

217. See Testimony of Henry W. Asbill before the United States Sentencing Commission Public Meeting Panel Discussion on the Attorney-Client Waiver and the Federal Sentencing Guidelines, November 15, 2005, at 2–3 (available online at: http://www.uscc.gov/AGENDAS/agd11_05.htm) (noting that 85% of respondents to a survey indicated that waiver was “suggested, pushed for, or demanded” by prosecutors in cases with which they were involved).

218. Testimony of Donald C. Klawiter before the United States Sentencing Commission Public Meeting Panel Discussion on the Attorney-Client Waiver and the Federal Sentencing Guidelines, November 15, 2005, at 6 (available online at: http://www.uscc.gov/AGENDAS/agd11_05.htm). For a discussion of ways in which white collar criminal law and its enforcement, including the OSG and Sarbanes Oxley, create ethical dilemmas for management, see generally John Hasnas, Ethics and the Problem of White Collar Crime, 54 **Am. U.L. Rev.** 579 (2005).

219. U.S. Sentencing Comm’n, supra note 54, at 116 n.384 (citing the case of Stender v. Lucky Stores Inc., 803 F. Supp. 259 (N.D. Cal. 1992), where notes from a training session that involved a frank discussion on employee perceptions of discrimination in the organization were later used in a discrimination lawsuit against the organization); see also Id. at 123–125 (highlighting the comments of a compliance consultant that he believed an attorney would be committing malpractice if the attorney did not advise a company against using focus groups, surveys, and other mechanisms to understand the ethical climate of the firm).

220. See generally Michael Goldsmith & Chad W. King, Policing Corporate Crime: The Dilemma of Internal Compliance Programs, 50 **Vand. L. Rev.** 1 (1997) (developing proposed legislation for immunity for compliance program materials); but see Sturm, supra note at 560–61 (arguing against a self-evaluative privilege in the discrimination context because it creates “perverse incentives”).

221. Christopher A. Wray & Robert K. Hur, Corporate Criminal Prosecution in a Post-Enron World: The Thompson Memo in Theory and Practice, 43 **Am. Crim. L. Rev.** 1095, 1179–81 (2006) (discussing proposals for more centralized control over waiver requests by prosecutors and allowing corporations to limit waiver to only the government).

wide variety of employees at all levels of the firm participated in or were at least aware of the fraudulent activities that permeated their corporations.²²² The regulatory challenge is to find ways that the law can encourage those employees to report misconduct of superiors and co-workers, and more importantly, to refuse to engage in fraudulent practices in the first place. Great strides will be taken towards this goal if firms adopt integrity-based compliance programs. Empirical evidence provides strong support that such programs have a positive impact on employee attitudes, improve subjective norms, increase perceived behavior control, and strengthen moral obligations. Through hardware mechanisms required by Sarbanes Oxley, SEC implementing rules, and the OSG, we are moving in the direction of improving corporate compliance programs and encouraging the managerial commitment necessary for firms to develop ethical corporate cultures. To complement these hardware mechanisms, the government should find new ways of encouraging mediating groups to develop and share best practices, as well as place pressure on firms to adopt those practices.

222. **Bethany McLean & Peter Elkind, *The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron*** 296–97 (2003) (discussing the various movie and song parodies the members of Enron’s broadband finance group developed to celebrate their “earnings achievements” done through “smoke and mirrors,” which the general counsel reportedly ordered destroyed after the party); **Scott Green, *Manager’s Guide to the Sarbanes-Oxley Act: Improving Internal Controls to Prevent Fraud*** 13 (2004) (noting how employees and managers in 22 different businesses were involved in CUC International’s successful efforts to hide over \$500 million in fake profits from an acquiring company).