

IN DEFENSE OF IMPERFECT COMPLIANCE PROGRAMS

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ABSTRACT

In Organizational Misconduct: Beyond the Principal-Agent Model, Professor Krawiec argues that organizations have perverse incentives to implement ineffective compliance programs and supports this argument with a survey of empirical research. Based on her argument, she urges that organizations be held strictly liable for corporate crimes (in terms of both guilt and punishment), regardless of the implementation of a compliance program by the accused organization. Assuming arguendo that criminal law's current treatment of compliance programs gives organizations an incentive to design inefficient programs, this Comment posits that corporate crime may be better deterred if criminal law embraces, rather than remains agnostic to, compliance programs.

First, Krawiec's policy suggestion overstates the impact of the legal sanction on corporate behavior. The legal sanction is only one of several sanctions imposed for organizational misconduct. The public relations effect of misconduct may harm organizations more than any legal sanction, giving them an incentive to implement compliance programs that assure the public of the organization's compliance with the law. Second, Krawiec does not consider utility that is derived from reducing the public's subjective perception of the likelihood of misconduct. This "placebo effect," which exists regardless of whether a compliance program is objectively effective, may increase utility by offsetting behavioral biases that cause the public to overestimate the probability of organizational misconduct.

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I. INTRODUCTION

Criminal liability can attach to an organization¹ whenever an employee of the organization commits an act within the scope of her em-

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1. An organization is defined in the U.S. Criminal Code as "a person other than an individual." 18 U.S.C. § 18 (2000). This definition includes "corporations, partnerships, associations, joint-stock companies, unions, trusts, pension funds, unincorporated organizations, governments and political subdivisions thereof, and non-profit organizations." U.S. SENTENCING GUIDELINES MANUAL § 8A1.1, cmt. n.1 (2004) [hereinafter SENTENCING GUIDELINES], available at <http://www.ussc.gov/2004guid/gl2004.pdf> (last visited Jan. 10, 2005). This Comment will focus on corporations and corporate misconduct, though the same analysis will usually apply to all organizations.

ployment,² even if the employee acted contrary to company policy and instructions.³ To mitigate organizations' liability for employees' unauthorized criminal acts and to create incentives for organizations to self-police, the U.S. Sentencing Commission amended the Sentencing Guidelines to consider the adoption by an organization of an "effective compliance and ethics program."⁴ Such programs are known simply as compliance programs.

The existence or absence of a compliance program that is deemed effective by the Guidelines has substantial effects on an organization's liability: the existence of an effective compliance program might reduce an organization's sentence,⁵ the absence of an effective program may be a reason for the court to place an organization on probation,⁶ and the implementation of an effective program may be a condition of probation for organizations.⁷ Government responses to the recent series of corporate scandals have increased the emphasis on compliance programs as key elements in mitigating corporate misconduct. Notably, amendments to the Sentencing Guidelines impose stricter criteria for a compliance program to be considered effective and elevate these criteria from commentary into a separate guideline.⁸

2. For a survey of the development of corporate criminal liability, see V.S. Khanna, *Corporate Criminal Liability: What Purpose Does It Serve?*, 109 HARV. L. REV. 1477, 1479-89 (1996).

3. For example, in 1909 the United States Supreme Court stated:

It is now well established that in actions for tort the corporation may be held responsible for damages for the acts of its agent within the scope of his employment.

And this is the rule when the act is done by the agent in the course of his employment, although done wantonly or recklessly or against the express orders of the principal. . . .

. . . .

In this case we are to consider the criminal responsibility of a corporation for an act done while an authorized agent of the company is exercising the authority conferred upon him. . . . Applying the principle governing civil liability, we go only a step farther . . . by imputing [an agent's] act to his employer and imposing penalties upon the corporation for which he is acting in the premises.

N.Y. Cent. & Hudson River R.R. Co. v. United States, 212 U.S. 481, 493-94 (1909) (citations omitted).

4. SENTENCING GUIDELINES, *supra* note 1, § 8B2.1. On the development and goals of the Organizational Sentencing Guidelines, see Diana E. Murphy, *The Federal Sentencing Guidelines for Organizations: A Decade of Promoting Compliance and Ethics*, 87 IOWA L. REV. 697 (2002).

5. SENTENCING GUIDELINES, *supra* note 1, § 8C2.5(f).

6. *Id.* § 8D1.1(a)(3).

7. *Id.* § 8D1.4(c)(1).

8. U.S. SENTENCING COMM'N, AMENDMENTS TO THE SENTENCING GUIDELINES 109-28 (2004) [hereinafter 2004 AMENDMENTS], available at <http://www.ussc.gov/2004guid/RFMay04.pdf> (last visited Jan. 10, 2005); see also News Release, U.S. Sentencing Commission, Commission Tightens Requirements for Corporate Compliance and Ethics Programs (May 3, 2004), available at <http://www.ussc.gov/PRESS/rel0504.htm> (last visited Jan. 10, 2005).

Not all scholars endorse government's increasing emphasis on compliance programs. In *Organizational Misconduct: Beyond the Principal-Agent Model*,⁹ Kimberly Krawiec suggests that liability should be agnostic to the implementation of compliance programs. Krawiec argues that judges are unable to assess the effectiveness of compliance programs and, therefore, cannot identify ineffective programs that are implemented solely to reduce the organization's liability.¹⁰ Indeed, claims Krawiec, empirical research of compliance programs does not indicate that they are, in fact, effective.¹¹ A sentencing policy that is indifferent to an organization's adoption of a compliance program will, therefore, encourage programs that are effective but avoid the pitfall of rewarding those programs that are mere "window dressing."¹²

This Comment challenges Krawiec's critique in two ways. First, it argues that Krawiec's policy suggestion overstates the impact of the legal sanction on corporate behavior. The legal sanction is only one of several sanctions imposed for organizational misconduct. The public relations effect of misconduct may harm organizations more than any legal sanction, giving them an incentive to implement compliance programs that assure the public of the organization's compliance with the law.

Second, in assessing the benefits of compliance programs, Krawiec considers solely the utility derived from objectively reducing misconduct and does not consider utility that is derived from reducing the public's subjective perception of the likelihood of misconduct. This latter effect exists whether a compliance program is objectively effective or not and therefore has been called the "placebo effect" of the compliance program.¹³ As explained below,¹⁴ a reduction in the perceived likelihood of misconduct increases utility by offsetting behavioral biases that cause individuals to overestimate the probability of organizational misconduct.

The rest of this Comment will proceed as follows: Part II explains briefly what compliance programs are and why Krawiec believes that law should be agnostic to their existence in judging the organizations that implement them. A more in-depth (and very good) discussion of compliance programs can be found in Krawiec's article.¹⁵ Parts III

9. Kimberly D. Krawiec, *Organizational Misconduct: Beyond the Principal-Agent Model*, 32 FLA. ST. U. L. REV. 571 (2005).

10. *Id.* at 580-81.

11. *Id.* at 591-97.

12. *Id.* at 574.

13. Amitai Aviram, *The Placebo Effect of Law* (Nov. 24, 2004) (unpublished manuscript, on file with author). The cited paper develops the theory of placebo effects that is discussed in this Comment. Portions of Parts I and IV are based on the cited paper.

14. *See infra* Part IV.

15. Krawiec, *supra* note 9, at 582-97.

and IV raise critiques of and qualifications to Krawiec's endorsement of a strict liability regime. After addressing some critiques previously raised against strict liability regimes and Krawiec's response to them, Part III explains the first of two novel critiques of Krawiec's argument: even if law offers organizations an incentive to design ineffective, "window dressing" compliance programs, organizations still have an incentive to implement effective programs because they are subject to nonlegal sanctions for their misconduct. Part IV explains the second response to Krawiec's argument: even if compliance programs are imperfect in their prevention of organizational misconduct, they may increase social welfare by causing the public to perceive misconduct as less likely. This, in turn, triggers a placebo effect that offsets behavioral biases that cause the public to overestimate the likelihood of misconduct and therefore take excessive precautions against misconduct. Part V provides concluding remarks.

II. CORPORATE COMPLIANCE PROGRAMS AND KRAWIEC'S CRITIQUE OF THEM

Compliance programs are quite commonplace, at least among large businesses. Over ninety percent of *Fortune 500* companies and over seventy-five percent of other large corporations report having an ethics or conduct code.¹⁶ Compliance programs are, generally, voluntary operations.¹⁷ As such, they may take any form that the implementing firm desires. Thus, the firm is free to structure its compliance program in the manner it believes is optimal to mitigate misconduct and assure employees, customers, suppliers, government, or the public that it is mitigating misconduct.

Compliance programs tend to converge, however, around a government standard. As Krawiec describes, criminal law is more lenient toward companies that implement certain compliance programs.¹⁸ Section 8B2.1 of the Guidelines,¹⁹ added recently by the 2004 amendments, sets certain standards that compliance programs must satisfy in order to reduce the culpability score (and hence the sentence) of an offending organization²⁰ or satisfy the probation re-

16. *Id.* at 583 n.30 (citing Andrew Brien, *Regulating Virtue: Formulating, Engendering and Enforcing Corporate Ethical Codes*, 15 BUS. & PROF. ETHICS J. 21, 21 (1996), and Gary R. Weaver et al., *Corporate Ethics Practices in the Mid-1990's: An Empirical Study of the Fortune 1000*, 18 J. BUS. ETHICS 283 (1999)).

17. There are some involuntary compliance programs. For example, an organization may be obligated to develop and implement a compliance program as one of the conditions of probation under the U.S. Sentencing Guidelines. SENTENCING GUIDELINES, *supra* note 1, § 8D1.4(c)(1).

18. See Krawiec, *supra* note 9, at 579, 584-85.

19. SENTENCING GUIDELINES, *supra* note 1, § 8B2.1.

20. *Id.* § 8C2.5(f).

quirements imposed on an offending organization.²¹ Following this standard not only allows firms to receive more lenient treatment under federal criminal law but also increases the likelihood that the public (employees, customers, suppliers, and others) would perceive the compliance program as effective, using the government standard as a benchmark.

Formally, an organization is strictly liable under federal criminal law for most actions that its employees commit within the scope of their employment.²² Under a strict liability standard, the degree of care taken by the organization to prevent the misconduct is irrelevant; if misconduct occurs, the organization is liable.²³ Of course, a higher level of care²⁴ may reduce the likelihood or severity of misconduct and so indirectly reduce liability. Unlike a negligence standard,²⁵ however, a strict liability regime focuses on the output of the activity (that is, whether the result was a crime) rather than on the inputs of the activity (that is, whether the organization did what was reasonable within its means to prevent misconduct). One may consider a strict liability standard to be agnostic to the inputs of an activity (that is, the level of care).

Because the Guidelines may reduce the culpability score (and thus the sentence) of offending organizations that implement compliance programs, they are not completely agnostic to that aspect of care. True, under the Guidelines the implementation of a program would not affect liability, but it would affect the sanction. While the executives of an organization likely have personal moral preferences not to violate the law, the magnitude of the sanction probably also affects the amount of attention and resources that they allocate to preventing misconduct. Thus, the Guidelines are considered a composite regime rather than a strict liability one.²⁶

Krawiec argues that, in practice, large segments of federal law are composite regimes rather than strict liability regimes as they purport to be.²⁷ For example, the U.S. Department of Justice considers whether organizations implement compliance programs in deciding whether to criminally charge organizations for the acts of their em-

21. *Id.* § 8D1.4(c).

22. *See supra* notes 2-3 and accompanying text.

23. *See* RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* § 6.5 (6th ed. 2003) (addressing strict liability in tort law); *id.* § 7.5, at 234; *id.* § 7.7 (addressing strict liability in criminal law).

24. Examples of a higher level of care include setting clear work procedures that comply with the law, educating employees about these procedures and relevant laws, and detecting and punishing violations by employees.

25. *See* POSNER, *supra* note 23, § 6.1 (explaining the Hand formula for negligence in tort law); *id.* § 7.7 (addressing negligence in criminal law).

26. *See* Krawiec, *supra* note 9, at 584.

27. *Id.* at 585-91.

ployees and agents.²⁸ Similarly, the Environmental Protection Agency and the Department of Health and Human Services allow reduced civil penalties and, in some cases, no criminal penalties for organizations with effective internal compliance structures.²⁹ Surveying several additional areas of law, Krawiec demonstrates that many areas of federal criminal law follow a composite regime that considers the implementation of compliance programs in determining liability, sanction, or whether to prosecute the case.³⁰

Compared to a strict liability regime, a composite regime increases the likelihood that organizations will implement compliance programs, while it reduces the average sentence received by organizations with compliance programs. The implementation of a compliance program usually increases social welfare,³¹ while the reduction of the sentence (in itself) may reduce social welfare.³²

Krawiec challenges the efficiency of composite regimes to the extent that they consider the implementation of compliance programs. According to her, judges, juries, and agencies are not able to correctly assess the effectiveness of a compliance program.³³ This Comment does not challenge that argument. Under that assumption, Krawiec anticipates that organizations will form compliance programs that have sufficient content to persuade courts and agencies of their effectiveness, but they will not invest additional resources to make the programs fully effective in mitigating misconduct. At the extreme, compliance programs would be “window dressing” with no effect on misconduct, even though they shield the organizations from liability.

If compliance programs are indeed “window dressing,” argues Krawiec, they do not enhance social welfare. On the other hand, organizations implementing these programs benefit from a reduction in sentences (and sometimes, the privilege of not being prosecuted), which is likely to reduce deterrence of their misconduct and therefore increase misconduct and reduce social welfare. The net effect, argues

28. *Id.* at 585-86.

29. *Id.* at 585.

30. *Id.* at 586-91.

31. Implementing a compliance program increases social welfare in two ways. First, to the extent that the program is objectively effective, it prevents, deters, and stops misconduct. Second, if the program reduces the public’s subjective assessment of the likelihood of misconduct, it may cause placebo effects, which may increase (and less frequently, decrease) social welfare. For more about placebo effects, see *infra* Part IV. For more about the situations in which they do not increase social welfare, see *infra* Part V.

32. Reducing a sentence due to the implementation of a compliance program may reduce social welfare if the compliance program itself has no or very little utility and if, prior to reduction, the sentence was set at the optimal level. If the sentence was previously higher than the optimal level, then the reduction of the sentence may increase social welfare. But if a lower sentence is optimal, it would be so not only for organizations with compliance programs but also for those which do not implement them.

33. Krawiec, *supra* note 9, at 580-81.

Krawiec, is socially harmful; therefore, organizational crime would be more effectively deterred if the law were agnostic to the implementation of compliance programs. In the following two Parts, this Comment will address some critiques of and qualifications to Krawiec's argument.

III. THE IMPACT OF NONLEGAL SANCTIONS ON CORPORATE COMPLIANCE

One may challenge Krawiec's conclusion that organizations will opt for sham compliance programs by noting that effective compliance programs reduce misconduct and, therefore, liability. Would not an organization prefer a compliance program that prevents misconduct and thus removes all liability to one that does not prevent misconduct but only reduces the sanction for the misconduct?

Krawiec raises this argument and responds to it by claiming that organizations benefit from many types of organizational misconduct.³⁴ Again, this Comment does not challenge that claim. If it is correct, then an organization may prefer an impotent compliance program if it could benefit from both the misconduct that it does not prevent and from the degree of leniency that is afforded to firms that implement compliance programs.

But this response has limits. First, even if courts and agencies are incapable of identifying whether a compliance program is optimal, they can identify compliance programs that are completely impotent. The standards set in the Guidelines, as well as judges' and regulators' common sense, will likely suffice to identify sham programs, even if judges and regulators cannot determine precisely how effective the program is. In an effort to persuade courts and agencies of the effectiveness of the program, the organization will have to make the program somewhat effective. Once the program is somewhat effective and prevents some (but not all) misconduct, the benefit from misconduct is reduced. For some organizations, this reduced level of benefit will be lower than the legal and extralegal costs of incurring liability for misconduct, and thus they self-interestedly refrain from any misconduct.

This is particularly true if misconduct that is most profitable to the organization is also most conspicuous to the courts and agencies. In that case, the court or agency would be aware of compliance programs that do not deal with such types of misconduct, and therefore the organization would have to fashion a compliance program that mitigates those forms of misconduct. Unable to allow the most profitable types of misconduct, the firm might find that the benefits to it

34. Krawiec, *supra* note 9, at 601-10.

from less profitable forms of misconduct are outweighed by the costs of incurring liability for the misconduct (even if the sanction is mitigated because of the implementation of the compliance program).

There is another reason to doubt the assumption that organizations benefit from their employees' misconduct so much that they refrain from implementing effective compliance programs. The legal sanctions that are affected by a change in the liability regime are only a portion of the sanctions that the organization suffers for its misconduct. For example, the accounting firm Arthur Andersen lost many of its clients in the wake of the Enron debacle, well before a legal sanction was imposed upon it.

Scholars have documented how "courts of public opinion" deterred violation of norms where law could not reach or did not reach effectively.³⁵ For example, in antebellum South Carolina a woman was murdered by her husband and her sister Eliza (who married one another soon after the murder). The husband was tried and convicted for the murder of his wife and sentenced to death. Eliza was not tried, apparently because the criminal legal system did not view women as legal actors.³⁶ Nonetheless, she was sanctioned severely: Eliza "had been stripped of her adult status and reduced to her cousin's ward. She had no access to her inheritance, except for what she received as an allowance or her guardian agreed to pay towards her expenses, nor was she given custody of her stepchildren . . ."³⁷ All of these sanctions were not ordered by a court but were the response of individuals in her community. The fact that the legal system attached no liability to her actions did not prevent individuals from sanctioning her.

The "court of public opinion" also passes judgment on organizations. Corporations are spending vast amounts of money on programs that are intended to persuade the public that they do not violate norms held by their patrons or employees. Individuals boycott organizations that violate the individuals' norms and support organizations that uphold the same norms. This informal "court" would sanction an organization for misconduct even if the legal system exonerated the organization because it implemented a compliance program.

The greater the portion of nonlegal sanctions for misconduct, the lower the incentive for organizations to create impotent compliance programs, even if those suffice to shield the organization from criminal liability. For example, suppose Acme Corporation benefited \$5

35. See, e.g., Elizabeth Dale, *A Different Sort of Justice: The Informal Courts of Public Opinion in Antebellum South Carolina*, 54 S.C. L. REV. 627 (2003).

36. *Id.* at 635 ("The failure to convict, or even indict, Eliza seems to confirm that formal law, influenced by the gendered assumptions of honor culture, could not conceive of women as legal actors.")

37. *Id.* at 636 (footnotes omitted).

from a certain form of misconduct,³⁸ and it would incur a cost of \$3 to implement a compliance program that would be effective in eliminating the misconduct or a cost of \$1 to implement a sham compliance program that does nothing to prevent misconduct. Also suppose that the law imposes a sanction of \$10 for this form of misconduct but mitigates the sanction to \$5 if an appropriate compliance program was implemented.³⁹ Finally, assume (as Krawiec argues) that the court or agency administering the sanction cannot tell the effective compliance program from the sham program and would impose the mitigated sanction on an organization that implemented either. Acme can also suffer nonlegal sanctions by losing the patronage of customers, the loyalty of employees, and the prospect of attracting potential customers or employees. Some of these individuals would believe in the effectiveness of the sham compliance program and would only sanction Acme if it did not implement any program. But others would sanction Acme unless it implemented the effective program. Thus, Acme would suffer nonlegal sanctions of \$6 (representing a boycott by many individuals) if it implemented no program, or sanctions of \$3 (representing a boycott by a smaller number of individuals) if it implemented the sham program.

The corporation can choose (1) not to implement any compliance program, in which case Acme would benefit \$5 from the misconduct but suffer a \$10 legal sanction and a \$6 nonlegal sanction, resulting in a net loss of \$11; (2) implement a sham compliance program, in which case Acme would still benefit \$5 from the misconduct, incur a \$1 cost for the compliance program, and suffer only \$5 in legal sanctions, but also \$3 in nonlegal sanctions, resulting in a net loss of \$4; or (3) implement an effective compliance program, in which case no misconduct occurs, Acme spends \$3 on the compliance program, and does not suffer any sanction, resulting in a net loss of \$3. If not for the nonlegal sanctions, Acme would have opted to implement a sham program. Nonlegal sanctions, even though they were not as significant in magnitude as the legal sanctions, sufficed to tip the balance of Acme's incentives toward the implementation of an effective program. This may occur even when only a small number of the sanctioning individuals can differentiate between effective compliance programs and their sham counterparts.

38. This assumption conforms with Krawiec's argument that organizations often benefit from their employees' misconduct. Of course, in situations where the organization does not benefit from the misconduct, the organization would have even greater incentive to implement an effective program.

39. For purposes of simplicity, we assume a 100% probability that misconduct will be detected. One can reduce that probability and increase the sanctions accordingly without modifying the outcome of the calculation.

The results above are highly dependent on the numerical assumptions we make and therefore do not prove that nonlegal sanctions *always* suffice to cause organizations to implement effective compliance programs. Rather, they demonstrate that nonlegal sanctions *may* have that effect, even under the unlikely assumptions that the legal system can never recognize “window dressing” compliance programs and that the organization always benefits from the misconduct.

More important, this calculus demonstrates the possible ineffectiveness of the remedy Krawiec advocates—indifference to the implementation of compliance programs. The greater the ratio of nonlegal sanctions to legal sanctions, the less the legal liability standard matters.⁴⁰ If the criminal sanctions are minor compared to the nonlegal sanctions, a shift to a strict liability regime would hardly modify organizations’ incentives: they would focus on avoiding the nonlegal sanction (or, if that sanction is lower than the combined cost of the compliance program and benefit from the misconduct, they would ignore the sanctions altogether).

Even if a shift to a strict liability regime has a limited effect on organizations’ incentives, it certainly has some effect. Why not impose a strict liability regime anyway? A well-known weakness of the strict liability regime is that it creates an incentive for the organization not to police misconduct that it believes can be hidden from the public and prosecutors.⁴¹ For example, if Acme Corporation’s management discovers that despite their efforts to prevent misconduct, an Acme employee had violated the law and due to the strict liability regime Acme would be vicariously responsible, Acme may try to conceal the misconduct in the hope of avoiding its repercussions. Similarly, when constructing its compliance program, Acme would emphasize preventive measures (since those decrease the occurrence of misconduct and thus its liability), but it would not implement detection measures (since once misconduct occurred, it would be best for Acme to keep attention away from it).⁴² Conversely, under a negligence regime (and, to a lesser extent, under a composite regime) Acme would not incur liability if it implemented a program that both policed and prevented misconduct, even if misconduct occurred. On the other hand, Acme would incur liability for misconduct if its com-

40. The effect of the legal standard may extend somewhat beyond the legal sanction, since some individuals may use the legal standard as their benchmark in assessing whether an organization is deserving of a sanction. However, many individuals have standards that are independent of the legal standard.

41. Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687, 708 (1997); Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833, 840 (1994).

42. See Arlen & Kraakman, *supra* note 41, at 701-02.

pliance program made no effort to police misconduct (and was therefore an unreasonably low level of care that amounts to negligence). Therefore, under a negligence regime Acme is more likely to opt for a compliance program that is recognized by the court as sufficient, even if the program uncovers misconduct that would otherwise be hidden. So, while a negligence standard may somewhat reduce deterrence of the organization, it may increase deterrence of the individual perpetrator (by increasing the probability of the misconduct being detected).

Krawiec responds to Arlen and Kraakman's critique by suggesting a modification to the pure strict liability regime: "Firms can still be encouraged to engage in internal policing and cooperation with government authorities through some combination of evidentiary privilege rules and reduced sanctions for cooperation with government investigations."⁴³

But Krawiec's remedies only address the legal sanction. Evidentiary privileges do not assuage the public's suspicion of misconduct; they may agitate it. And reduced sentences for cooperation do not assure the public that future misconduct is less likely, as would a compliance program. Therefore, under a strict liability regime, an organization that exposes misconduct risks nonlegal sanctions even if legal sanctions are mitigated.

One must be cautious in assessing the role of nonlegal sanctions: just as the legal system may be unable to assess correctly the effectiveness of compliance programs, so can private parties err. The existence of nonlegal sanctions has two effects on our analysis. First, as mentioned above, they reduce the impact of a change in the legal standard. Second, they cause organizations to tailor their compliance programs and other activities so as not only to fit legal standards but also to persuade the public of the program's effectiveness. This obviously increases social welfare if the public can recognize what constitutes an effective compliance program (and thus force the organization to implement it). But the next Part explains why social welfare may increase if a compliance program persuades the public of its effectiveness despite not being optimal from an objective perspective.

IV. THE PLACEBO EFFECT OF IMPERFECT COMPLIANCE PROGRAMS

Government endorsement of compliance programs may be beneficial even when government is limited in its ability to assess the effectiveness of the program and, in fact, even when the program is *not* ef-

43. Krawiec, *supra* note 9, at 577. Krawiec goes on to describe specific modifications to the strict liability regime that would induce organizations to police and cooperate with government investigations. *Id.* at 577-79.

fective. Although counterintuitive, this idea posited in this Part is that beyond the benefits derived from the effectiveness of the compliance program, the implementation of such a program may have a placebo effect—generating benefits that result simply from the implementation of a program that is *perceived* to be effective by the people it affects.

The placebo effect is beneficial because it counters a tendency, well-documented in the behavioral literature, of overestimating risks that are salient to us.⁴⁴ Such overestimation causes individuals to reduce activities that may subject them to the risk, well beyond the activity reduction that would be efficient even if the risk were left unchecked.

For example, suppose that there is a 5% probability that any given U.S. company would commit corporate fraud that would eliminate a substantial portion of its shareholders' investment. Knowing this, investors are less likely to purchase shares and are more likely to invest elsewhere (for example, in foreign companies) or consume their wealth rather than invest it. Many investors may not be deterred from investing in a company because of a 5% probability of fraud, especially if their opportunity costs are low (for example, this investment looks much more attractive than the next best alternative). But on the margin, some investors will decide that the risk of fraud makes other uses of their wealth more attractive and will therefore refrain from investing in U.S. companies. Naturally, the number of people who would refrain from investing in U.S. companies will increase as the perceived risk of fraud increases.

If fraud can be prevented by the legal system, investors need not react to this risk because the threat of legal sanction would discipline the companies. However, the legal system is imperfect, and companies may find that 5% of the time they can commit fraud in a way that cannot be detected or proven in court. If a 5% fraud rate is inevitable (in the sense that the most effective law enforcement cannot reduce fraud below 5%), some reduction in investment (presumably in the least promising companies) is the most efficient response to the risk of fraud.⁴⁵

44. See, e.g., Cass R. Sunstein, *The Laws of Fear*, 115 HARV. L. REV. 1119 (2002) (book review); Amos Tversky & Daniel Kahneman, *Judgement Under Uncertainty: Heuristics and Biases*, 185 SCIENCE 1124 (1974).

45. This is analogous to economic analysis of strict liability in tort law. See POSNER, *supra* note 23, § 6.5. In effect, an injured party is "strictly liable" for injuries inflicted on it that cannot or are not prohibited by public and private legal systems, in the sense that the risk of injury would cause them to (1) take the optimal degree of care to avoid injury when feasible to avoid injury and to (2) reduce their activities that run the risk of this type of injury when the optimal level of care is insufficient to avoid injury. *Id.*

Note, however, that the number of people reducing investment depends on the perceived risk of fraud rather than on the actual risk. If something artificially increased the perceived risk of fraud above the actual risk, people would decrease their investment in U.S. companies more than would be warranted by the risk. For example, if the risk of fraud were 5%, but investors perceived it at 50%, a much larger number of investors would reluctantly refrain from investing. From both the individual's perspective and that of society, this is a loss. Correcting this overestimation of risk would enhance welfare.

But why would investors overestimate the risk of corporate fraud? The answer lies in behavioral psychology. There is a rich literature that documents situations in which individuals are biased to overestimate probabilities and, in particular, risks. The availability bias causes people to "assess the frequency of a class or the probability of an event by the ease with which instances or occurrences can be brought to mind."⁴⁶ As a result of this bias, "highly publicized events make people fearful of statistically small risks."⁴⁷ Compounding this bias is the "social amplification" phenomenon, which causes people to perceive as more probable those risks that also concern others with whom they interact.⁴⁸ The combination of these two forces causes the probability of risks that are highly publicized to be significantly overestimated: the availability bias causes each person to individually overestimate the risk, and encountering others who have the same apprehension (because of exposure to information on the same highly publicized risk) exacerbates further the perceived probability of the risk.

Because it grossly overestimates highly publicized risks, the public avoids these risks excessively. To respond to this inefficiency (and alleviate public concerns), governments and private parties alike try to take actions that have a placebo effect; that is, actions that, besides reducing the actual risk, also (and often, first and foremost) reduce the perceived risk by assuring the public that they are effective responses. That an action has placebo effects does not mean that it is a placebo—effective responses are usually more likely than ineffective ones to assure the public of their effectiveness. However, welfare-enhancing effects of actions that have placebo effects extend beyond mitigating the risk that they address. Therefore, given a choice between two courses of action with similar ability to mitigate a threat, society would benefit from picking a course of action that creates a placebo effect.

46. Tversky & Kahneman, *supra* note 44, at 1127.

47. Sunstein, *supra* note 44, at 1127.

48. On social amplification, see Sunstein, *supra* note 44, at 1130-37.

Actions that have placebo effects tend to be swift (since they respond to risks perceived to be highly threatening), decisive (to persuade that they are effective), and highly publicized (to benefit, like the threats they attempt to counter, from the availability bias and social amplification). When undertaken by the government, some actions take the form of executive action (for example, changes in the monetary policy),⁴⁹ others take the form of legislation (for example, the Sarbanes-Oxley Act), and yet others combine both legislative and executive action (for example, FDR's New Deal). Private parties also take actions that have placebo effects, particularly against threats that are perceived by the public to be more effectively dealt with privately, rather than through government.

How do placebo effects impact the debate on corporate compliance programs? In addition to their role in mitigating corporate misconduct, compliance programs also serve to assure the potential victims that they will not be harmed. If potential victims overestimate the risk of misconduct, then the reduction in perceived risk (as long as it does not drive perceived risk below the actual risk) will enhance social welfare.

To have a significant placebo effect, the risk of corporate misconduct must be overestimated by many individuals and the compliance program should be perceived by the same people as reducing the risk of misconduct. In addition, for compliance programs to be efficient, they must not preclude a significantly more efficient response to corporate misconduct.⁵⁰

The risk of corporate misconduct is particularly susceptible to being overestimated. Popular culture frequently portrays big business and the capitalists that control it as evil, calculating, and heartless.⁵¹ For example, several popular movies portray managers callously defrauding or manipulating shareholders.⁵² Though the audience is

49. The effect of a monetary policy is, in fact, primarily a placebo effect. For example, an expansive monetary policy (reducing the interest rate) increases economic development because people believe that it does. Its objective effect, increasing the supply of money, has little effect in itself because without the subjective belief in its effect, it would cause inflation that would devalue money to its former value.

50. This latter requirement seems to be satisfied as far as the Guidelines' treatment of compliance programs is concerned: compliance programs do not hinder any government action to curb corporate misconduct and do not eliminate incentives for the company to police itself effectively, since the company still suffers significant noncriminal sanctions for its misconduct.

51. See, e.g., Carol B. Swanson, *The Turn in Takeovers: A Study in Public Appeasement and Unstoppable Capitalism*, 30 GA. L. REV. 943, 957-58, 969-70 (1996); Larry E. Ribstein, *Film and Firms* (July 7, 2004) (unpublished manuscript), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=563181 (last visited Jan. 10, 2005).

52. E.g., *THE HUDSUCKER PROXY* (Warner Bros. 1994) (managers conspire to appoint an incompetent CEO to drive share prices down so that they can acquire control of the company); *THE SOLID GOLD CADILLAC* (Columbia TriStar 1956) (managers overcompensate themselves, manipulate shareholder meetings, and patronize small shareholders).

aware that the movies portray fictitious events, the movie makes corporate fraud more vivid and creates a sense of familiarity with corporate fraud. This may trigger an availability bias and cause individuals to perceive corporate fraud as more likely.

Another cause for a difference between perceived and actual risk of corporate misconduct is the business cycle. Allegations of corporate misconduct seem to be more common when the alleged perpetrator is not meeting investor expectations. There are at least two explanations for this pattern. First, it is easier for perpetrators to cover up their misdeeds when the company is expanding and its profits increasing. Conversely, misconduct is harder to conceal when the company fails to meet expectations. Second, investors may be more trusting when the economy is doing well and less forgiving when their investment does not fulfill their expectations.⁵³ Business cycles cause many businesses' prospects to improve and worsen at the same time, and therefore many companies decline at the same time, each becoming more susceptible to allegations of misconduct. Awareness of many simultaneous allegations of wrongdoing biases individuals, causing them to overestimate the probability of wrongdoing. Significant media coverage of these allegations contributes to the social amplification of the risk⁵⁴ and portrays corporate misconduct as an epidemic.⁵⁵

The other element required to make a placebo effect significant—gaining the public's confidence in compliance programs' effectiveness—presents a greater hurdle. Private parties may be perceived as benefiting from the misconduct⁵⁶ and thus as lacking the incentive to self-police appropriately. On the other hand, popular culture seems to acknowledge and even emphasize a role for socially responsible companies.⁵⁷ Individuals must decide whether to place a given company in the "good" or "bad" rubric and assess the perceived effective-

53. See Larry E. Ribstein, *Bubble Laws*, 40 Hous. L. Rev. 77 (2003).

54. This is not to say that media coverage of corporate misconduct is welfare-reducing, only that it contributes to overestimating the threat and making corporate misconduct seem ubiquitous. On the other hand, media coverage may deter some executives from wrongdoing by increasing both the probability of detection and the magnitude of punishment. "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman." LOUIS D. BRANDEIS, OTHER PEOPLE'S MONEY AND HOW BANKERS USE IT 92 (1914).

55. Due to the availability bias, media coverage of several similar events within a short time period may cause the public to grossly overestimate a risk. See Cass R. Sunstein, *Hazardous Heuristics*, 70 U. Chi. L. Rev. 751, 758-59 & n.31 (2003) ("Many perceived 'epidemics' are in reality no such thing, but instead a product of media coverage of gripping, unrepresentative incidents.").

56. See Krawiec, *supra* note 9, at 601-609.

57. See Ribstein, *supra* note 51 (manuscript at 26-27).

ness of their compliance programs accordingly.⁵⁸

This is where government endorsement plays a significant role: Criminal enforcement that is agnostic to the implementation of compliance programs—as proposed by Krawiec—sends a message to the public that compliance programs are ineffective. If companies are held strictly liable for all consequences of their misconduct, they may still implement the programs most effective in mitigating misconduct and reduce business activity that cannot be effectively self-policed. However, the public will not perceive the risk mitigated and thus will itself reduce activity that is affected by corporate misconduct. To prevent this loss of social welfare, the placebo effects of compliance programs must be embraced by signaling government's belief that an effective compliance program will reduce the risk of misconduct. Doing so through the Guidelines may be a sensible path.

V. KRAWIEC'S ARTICLE—SOME OF ITS CONTRIBUTIONS, QUALIFICATIONS, AND COUNTER-QUALIFICATIONS

Professor Krawiec's article contributes to understanding how criminal law should address compliance programs. First, she points out that even in areas of criminal law, in which an organization is nominally strictly liable for its employees' behavior, the actual liability may be more akin to a negligence standard. This is so because the implementation of a compliance program might significantly reduce the sanction and even the probability of being prosecuted. While this insight does not prove the superiority of either a negligence regime or a strict liability one, it does reveal that the actual incentives that the legal system provides may differ from those it formally claims to give. This Comment argues, however, that the incentives given by the legal system may be less powerful than nonlegal sanctions. Nonlegal actors may hold an organization strictly liable for its misconduct regardless of the legal standard. For example, a firm may implement a compliance program that shields itself from legal suits of racial discrimination yet be unable to attract qualified employees who believe that the firm is discriminating and is not legally liable merely due to a "technicality." The risk of losing those employees (and perhaps the patronage of customers) may cause the firm to police its misconduct even when the legal system does not punish the firm for the misconduct; this is true even when the firm benefits from the misconduct. Thus, a change in the legal standard of liability may not cause a significant change in organizations' incentives to police misconduct.

58. The fact that companies engage in "PR activities" (well-publicized contributions to public causes) indicates that the public perceives some firms as "good" despite business' generally negative stereotype.

Another important insight offered by Krawiec is that empirical evidence does not demonstrate the effectiveness of compliance programs. This is not in opposition with the point made in this Comment about nonlegal sanctions, because a firm can avoid nonlegal sanctions not only by effectively preventing misconduct but also (and more successfully) by being perceived as effectively preventing misconduct. Thus, firms may implement a compliance program that seems to be effective but is not instead of one that is effective, if the former is less costly.

This Comment demonstrates, however, that a compliance program may enhance social welfare if it reduces the public's perceived risk of misconduct, even when the actual risk of misconduct is not affected. In this situation, social welfare is enhanced by offsetting excessive avoidance of the risk due to behavioral biases that cause many individuals to overestimate the actual risk. For example, availability bias may cause an individual who is exposed to extensive media coverage of corporate scandals to overestimate the likelihood of corporate misconduct and excessively refrain from investing in companies. If the same individual believed that a corporation's compliance program was effective in reducing the likelihood of misconduct, her assessment of that risk may be closer to the objective probability, and correspondingly her willingness to invest would be closer to the efficient level.

Placebo effects do not make all compliance programs efficient. First, to create a placebo effect an individual must believe that the compliance program reduces the likelihood of corporate misconduct, rather than being ineffective window dressing. Government endorsement of such programs is an important criterion in fostering such belief. By eliminating preferential treatment of companies that implement compliance programs, as Professor Krawiec advocates, a signal would be sent that government does not view compliance programs as effective. This may reduce, or even eliminate, the placebo effect of compliance programs, including those programs that are effective in reducing misconduct.

Second, excessive placebo effects can decrease utility. Placebo effects are beneficial as long as they guide individuals closer to an objective assessment of the risk of misconduct. If placebo effects cause individuals to be overly optimistic about the likelihood of misconduct,⁵⁹ they may engage in excessive activity that is vulnerable to misconduct. For example, suppose that minority shareholders antici-

59. Placebo effects of a compliance program may be excessive (for example, reduce social welfare) when the behavioral biases that should cause individuals to overestimate the likelihood of misconduct are not significant, and therefore individuals perceive correctly the risk of misconduct.

pate a 10% probability of being oppressed by the majority stockholders and that this is precisely the objective likelihood of such misconduct. Now suppose that new laws are enacted to protect minority stockholders. And suppose further that these laws reduce oppression by 1% (to 9%), but they are perceived by the public to reduce oppression by half (to 5%).⁶⁰ The result would be that investors overinvest and expose themselves to a greater risk than they were willing to take.

This scenario, however, is not very likely. Legislation, compliance programs, and other actions of assurance rarely address a risk that does not excessively concern the public and that is not subject to availability bias and social amplification. Unless a risk concerns many people (thus causing social amplification) and is covered by many media venues (thus causing an availability bias), battling this risk may not be a worthwhile task for the politician (interested in votes of grateful constituents) or the corporate executive (interested in favorable public relations).

The third situation in which placebo effects of compliance programs are inefficient is when they preclude better responses to the same risk. If the implementation of persuasive (though not necessarily effective) compliance programs were to preclude the employment of a more effective program, then the utility of the placebo effects may not compensate for the lost utility from better addressing the objective risk. As explained above, this does not seem to be the case with corporate compliance programs. If a firm has an incentive to implement an effective compliance program instead of a current “window dressing” program, it can do so. If it is efficient for government or third parties to take action to mitigate misconduct, compliance programs do not prevent them from doing so.⁶¹

Professor Krawiec’s article lays the foundation for a debate on the appropriate accommodations that law should afford to compliance programs and demonstrates some perverse incentives criminal law offers to creators of sham programs. The present Comment does not object to that argument but explains why establishing the validity of that argument does not necessarily condemn law’s endorsement of compliance programs.

60. The same effect would occur if, instead of legislation, compliance programs were implemented with similar results (for example, reduction of oppression by 1% and reduction of the expectation of misconduct by 5%).

61. Under the Guidelines, the implementation of a compliance program may reduce a convicted firm’s fine. See SENTENCING GUIDELINES, *supra* note 1, § 8C2.5(f). But this benefit is relative to the fines paid by offenders that have not implemented compliance programs. If the reduced fines for compliance programs do not deter firms, government can raise the maximum sentence for the crime, increasing the deterrence of firms that have compliance programs while also maintaining the incentive for firms to have such programs.