

CORPORATE CULTURE AND CORPORATE COMPLIANCE PROGRAMS: TOWARDS AN UNDERSTANDING OF AN ORGANIZATION'S ETHICAL INFRASTRUCTURE

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I. Introduction

Approximately every two years the Ethics Resource Center conducts large scale survey of US employees on ethical behavior at work. Since 2000, between 41% and 55% of employees indicate that they have observed misconduct within their organizations within the last twelve month, and between 8% and 14% have felt pressure from within the organization to compromise the company's standards.² This misconduct is not just the actions of a few rogue employees scattered about various companies. In 53% of the cases of observed misconduct, the respondent indicated that the misconduct was committed by multiple people or was a company-wide problem.³ In addition, the respondents are not just seeing one-off instances of poor conduct. In 26% of the cases, the misconduct was identified as an "ongoing pattern," and in an additional 41% of cases the misconduct was identified as happening over multiple incidents.⁴ Despite this widespread misconduct, over the past 13 years of the survey, between 37% and 47% of employees do not report the misconduct that they have observed.⁵

To reduce this misconduct—whether it is financial fraud, bribery, sexual harassment, antitrust violations, or any other type of wrongdoing—the government incentivizes corporations to adopt effective compliance programs. Starting in 1991, the Organizational Sentencing Guidelines provides for mitigated sentences for corporations that had effective compliance programs in place at the time of the wrongdoing. When deciding whether or not to bring criminal charges against a corporation, the Department of Justice (DOJ) considers a corporations compliance program and ethical culture. In some situations, the government requires a corporation to adopt an improved compliance program. For example, settlement agreements between a corporation and the government (such as Deferred Prosecution Agreements with the DOJ or Corporate Integrity Agreements with the U.S. Department of Health and Human Services) often require the corporation to make structural changes to its compliance program.

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² ETHICS RESOURCE CENTER, NATIONAL BUSINESS ETHICS SURVEY OF THE U.S. WORKFORCE 14 (2014), available online at <http://www.ethics.org/downloads/2013NBESFinalWeb.pdf>. Although the percentage of employees observing misconduct typically increases as the economy improves, between the surveys of 2011 and 2013, the economy improved but the level of observed misconduct declined. *Id.* at 15. The survey asked employees about 26 specific categories of misconduct, such as discrimination, violations of health or safety standards, stealing, falsifying expense reports, and breaching customer privacy. *Id.* at 41-42.

³ *Id.* at 21. 41% of respondents indicated that the behavior was committed by multiple people, and 12% indicated that it was company-wide. *Id.*

⁴ *Id.* at 20-21. In addition, 43% of the misconduct was committed by senior leaders (24%) or middle managers (19%). *Id.* at 20.

⁵ *Id.* at 26. Of those that do report misconduct, since 2001, over 20% report experiencing some type of retaliation for reporting the misconduct. *Id.* For those that do report misconduct, 82% reported it to their supervisor. *Id.* at 30. Only 16% used a hotline and only 15% reported to an ethics officer. *Id.*

The government's consideration of compliance programs has not been without controversy. In the late 1990s and early 2000s, many legal commentators complained that the US Department of Justice (DOJ) gave corporations too much credit for their compliance programs when determining whether or not to bring criminal charges against the corporation. Some commentators complained that corporations were essentially being required to adopt compliance programs that were expensive but not effective.⁶ Others believed that the DOJ's consideration of compliance programs (including a requirement that a compliance program was only effective if it included cooperation with the government in identifying the wrongdoers) created perverse incentives that could actually increase the likelihood of corporate crime due to the scapegoating of employees.⁷ That is, the government's consideration of compliance program created a moral hazard problem where compliance programs (even if ineffective and created solely to appease external stakeholders), provided the corporation insurance against criminal prosecution.

More recently, many legal commentators have taken the opposite view and argued that corporations do not receive sufficient credit from the DOJ for their investments in their compliance programs. These commentators argue that an adequate compliance program should be a defense to a corporate crime charge.⁸ In response to the critics that claim that corporations intentionally adopt ineffective compliance programs (so called "paper programs" or "cosmetic compliance"), commentators state that the "sheer size of the compliance industry" shows that corporations cannot be involved in a "bad faith attempt at intentional window dressing."⁹

While these commentators debate the appropriate place of compliance programs in government enforcement actions, others have shifted their focus to corporate culture and its positive or negative influence on corporate wrongdoing. Consider the banking industry, for example. In 2015, the Wall Street Journal reported that "'Culture' is the buzzword of the moment at banks—and a puzzle that regulators and Wall Street firms are wrestling to solve."¹⁰ An independent investigation of Barclays after its interest rate manipulation scandal placed significant blame for that scandal (and other the company's other legal problems) on the company's culture of wanting to win "at all costs," which was "hostile" to the compliance department.¹¹ JP Morgan Chase issued a report in which the company acknowledged its mistakes

⁶ Kimberly D. Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L.Q. 487 (2003).

⁷ William S. Laufer, *Corporate Liability, Risk Shifting, and the Paradox of Compliance*, 54 VAND. L. REV. 1343 (1999).

⁸ Although some scholars want the government to give corporations credit for their compliance programs and provide guidance for what a corporation must do to have an effective compliance program, they do not want the government to dictate the structure of corporations' compliance programs, such as through deferred prosecution agreements.

⁹ Miriam Hechler Baer, *Governing Corporate Compliance*, 50 B.C. L. REV. 949, 952 (2009).

¹⁰ Emily Glazer & Christina Rexrode, *As Regulators Focus on Culture, Wall Street Struggles to Define It*, Wall St J, Feb. 1, 2015,

¹¹ SALZ REVIEW: AN INDEPENDENT REVIEW OF BARCLAYS' BUSINESS PRACTICE 82, 88 (2013), available online at: <http://www.euromoney.com/downloads/2013/Barclays-Salz-review.pdf>. The Salz Report found that Barclays was a company without a common set of values. Id. at 81. Instead, each subunit developed their own values, which were typically based on what was important to that unit's leader. Id. at 81-82. The values focused on "winning and commercial drive" taken to the extreme of winning "at all costs." Id. at 82. In the Retail and Business Banking division, the Salz Report noted a "material shift from client focus to one that valued scale and financial performance." Id. at 88. Employees felt powerless to question any new financial targets due to a "culture of fear." Id. In addition, employees believed that "senior management did not want to hear bad news and that employees should be capable of solving problems." Id. at 8. Citing an internal employee survey, the Salz Report notes that "A significant proportion of employees in the investment bank . . . said that they were 'reluctant to report problems to

that resulted in legal problems, and outlined how it planned to strengthen its corporate culture.¹² The US Department of Treasury Financial Crimes Enforcement Network (FinCEN) issued an advisory stating that recent anti-money laundering enforcement actions demonstrated that “the culture of an organization is critical to its compliance.”¹³ In the United Kingdom, the Financial Reporting Council (FRC) stated that one of the five areas its governance team will focus on in 2015 is company culture and “how best to assess culture and practices and embed good corporate behaviour throughout companies.”¹⁴ The chairman of the FRC wrote an opinion article titled “Why it’s time boards faced up to the corporate culture challenge.”¹⁵

This increased focus on corporate culture is a positive development and long overdue. In 2004, the government amended the Organizational Sentencing Guidelines to state that an effective “compliance and ethics program” requires a corporation to “(1) exercise due diligence to prevent and detect criminal conduct; and (2) otherwise promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law.”¹⁶ This language was added due to concerns that corporations were adopting “paper programs.” A “paper program” is a compliance program that exists on paper but is not supported by the corporate culture and therefore does not meaningfully influence employee behavior. For example, in a corporate culture that does not respect the law, employees will find ways to “workaround” internal controls.¹⁷

Despite this increased attention to corporate culture and creating a “culture of compliance” within corporations, it seems that compliance programs and culture are often treated separately; there are the technical aspects of a compliance program and then there are the “soft” issues of corporate culture. This view has been fostered by discussions within the academic literature on implementing either a surveillance and sanction focused “command-and-control” program, or a values focused “integrity” program. Lost is the recognition that compliance

management,’ and that they did not feel able to ‘report unethical behaviour without fear of reprisal.’” Id. at 157-58. This prevented management and the board from having the information they needed to react to developing problems at the bank.

¹² JP MORGAN CHASE & CO., HOW WE DO BUSINESS – THE REPORT 5 (2014) available online at: http://files.shareholder.com/downloads/ONE/4090721795x0x799950/14aa6d4f-f90d-4a23-96a6-53e5cc199f43/How_We_Do_Business.pdf

¹³ US DEPARTMENT OF TREASURY FINANCIAL CRIMES ENFORCEMENT NETWORK (FINCEN, ADVISORY: ADVISORY TO U.S. FINANCIAL INSTITUTIONS ON PROMOTING A CULTURE OF COMPLIANCE, FIN-2014-A007, Aug. 11, 2014, available online at: http://www.fincen.gov/statutes_regs/guidance/pdf/FIN-2014-A007.pdf

¹⁴ FINANCIAL REPORTING COUNCIL, DEVELOPMENTS IN CORPORATE GOVERNANCE AND STEWARDSHIP IN 2014 23 (2015), available one at: <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/Developments-in-Corporate-Governance-and-Stewardsh.pdf>

¹⁵ Sir Winfried Bischoff, *Why it’s time boards faced up to the corporate culture challenge*, CITY AM, Jan. 12, 2015, available online at: <http://www.cityam.com/206870/why-it-s-time-boards-faced-corporate-culture-challenge>. Bischoff asked the question of “Where does the responsibility lie for ensuring ethical corporate behaviour, and who is accountable when culture is found to be at fault?” He answered that question by pointing to the FRC’s UK Corporate Governance Code (which was revised in 2014) which places those responsibilities with the board of directors. Id. The Corporate Governance Code states, “One of the key roles for the board includes establishing the culture, values and ethics of the company.” FINANCIAL REPORTING COUNCIL, UK CORPORATE GOVERNANCE CODE 2 (2014), available online at: <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-2014.pdf>

¹⁶ U.S. SENTENCING COMM’N, U.S. SENTENCING GUIDELINES MANUAL §8B2.1 (2010).

¹⁷ One consulting firm working with banks found “there was a 75% greater chance of employees going around internal controls when the word “workaround” was used in their [internal] communications.” Glazer & Rexrode, *supra* note 10.

programs and corporate culture cannot be separated; each impacts the other. A strong compliance program may be necessary to make up for a weak ethical culture.¹⁸ A weak compliance program can push a corporation towards a weak ethical culture. Conversely, a strong compliance program can help create a strong ethical culture.

The goal of this article is help push us over this hurdle and provide a model for seeing how compliance programs and corporate culture are related. This article uses the model of an organization's ethical infrastructure developed by Tenbrunsel and colleagues, and then recent developments in the management and behavioral ethics literature to show how a corporation must align its compliance program and corporate culture to create an ethical infrastructure that has legitimacy in the eyes of employees. Without legitimacy, the program will be ineffective, and potentially create more unethical behavior than before the program was rolled-out. A so-called paper program is not necessarily a "bad faith attempt at intentional window dressing,"¹⁹ but a program that is misaligned with the company's culture and has lost legitimacy. This model shows that a corporation—even one acting in good faith—that adopts the technical aspects of a compliance program but does not attend to the organization's informal systems and ethical climate will not be successful in encouraging ethical behavior.

This article proceeds by briefly outlining the functions of a compliance program. Next, the article shows the limits of discussing the implementation of compliance programs as either using a so-called compliance focus (relying on detection and punishment) or an integrity approach (relying on values activation). The next part presents Tenbrunsel and colleague's ethical infrastructure model as a better way to understand how compliance programs are implemented in organizations and are influenced by (and also influence) the informal systems of the organization and the organization's climate. The next section reviews recent literature in behavioral and organizational ethics to highlight some of the empirically-supported insights from the ethical infrastructure model.

II. Compliance and Ethics Programs

A. What are the functions of a compliance program?

The view of compliance programs in economic theory, and often from a legal perspective, is that these programs function to inform employees of the rules of correct conduct and create systems to monitor employees' compliance with those rules. That was the perspective that the drafters of the 2004 Amendments to the Organizational Sentencing Guidelines were trying to move away from. The 2004 Amendments sought to move towards the view of a compliance program the business ethics and management perspectives. For example, Kaptein argues that compliance programs should serve seven different functions.²⁰ First, the program's policies and training clarify what is unethical behavior. Second, the program allows management to show the importance they attach to ethical behavior. Third, the program should ensure that

¹⁸ Kristin Smith-Crowe et al., *The Ethics "Fix": When Formal Systems Make a Difference*, J. BUS. ETHICS (forthcoming), at *2.

¹⁹ Baer, *supra* note 9, at 952.

²⁰ Muel Kaptein, *The Effectiveness of Ethics Programs: The Role of Scope, Composition, and Sequence*, J. BUS. ETHICS (forthcoming), at *3-*4. In an empirical study, after controlling for the basic structural elements of a compliance program, Kaptein found support for these factors in reducing unethical behavior. Muel Kaptein, *Understanding Unethical Behavior by Unraveling Ethical Culture*, 64 HUMAN RELATIONS 843, 848-51 (2011).

employees have the resources they need to act ethically.²¹ Fourth, the program should foster commitment to ethical behavior among employees by increasing their attachment and loyalty to the company through such means as fair treatment.²² Fifth, the program should help create transparency around the ethical and unethical behavior that occurs in the organization. Sixth, the program should encourage open discussion of ethical issues. Seventh, the program should reinforce ethical behavior through the appropriate use of rewards and punishment.

As indicated above, to be considered to have an effective compliance and ethics program under the Organizational Sentencing Guidelines, a corporation must exercise due diligence and “promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law.” However, subsection (b) under Chapter 8, Part B.2 of the Guidelines states that “Due diligence and the promotion of an organizational culture that encourages ethical conduct and a commitment to compliance with the law . . . minimally require the following[.]” Those requirements, in brief, are:

- (1) “[S]tandards and procedures to prevent and detect criminal conduct.”
- (2) The governing authority should have knowledge of the program and “exercise reasonable oversight with respect to the implementation and effectiveness” Overall responsibility for the program should be assigned to “high-level personnel” and the person with day-to-day responsibility for the program should “be given adequate resources, appropriate authority, and direct access to the governing authority or an appropriate subgroup of the governing authority.”
- (3) No person should be placed “within the substantial authority personnel of the organization” if they have engaged in illegal activities or other conduct inconsistent with the program.
- (4) Conduct effective training programs for individuals at all levels of the organization, including agents.
- (5) The company should conduct monitoring and auditing for conduct in violation of company standards, test the effectiveness of the program, and ensure that employees are aware of an anonymous hotline to report misconduct.
- (6) The company should use incentives to ensure compliance with the program, and “appropriate disciplinary measures for engaging in criminal conduct”
- (7) In response to any criminal conduct that is detected, the company should modify the program as necessary to prevent similar conduct in the future.

Using Kaptein’s functions of a compliance and ethics program as a definition of an ethical corporate culture, it is easy to see that the requirements of the Guidelines could be implemented to support an ethical corporate culture. However, it is also easy to see how those requirements could be implemented in a manner more consistent with the standard economic model and not meet a definition of an ethical corporate culture from a management perspective. Thus, although the 2004 Amendments require corporations to consider their ethical cultures, the Guidelines do not provide corporations with much guidance. Thus, a significant amount of attention is still placed on viewing compliance programs as implemented under the economic model or the management model. As discussed in the following section, this distinction in

²¹ “When employees lack resources, such as time, budgets, equipment, information, and authority, the risk of unethical behavior increases.” Kaptein (forthcoming), *supra* note 20, at 3.

²² “An organization that is characterized by low morale, mistrust, and dissatisfaction can be a breeding ground for unethical behavior.” *Id.* at *3.

implementation approaches has its roots in a well-known article by Lynn Sharp Paine, but this distinction has developed in a way that is often beyond the point of her article. The ethical infrastructure model discussed further below helps break us from this either/or approach and gives us a clearer understanding of the connection between an ethical culture and a compliance program.

B. Views on Implementing a Compliance and Ethics Program: Compliance versus Integrity

It is common for commentators to distinguish between compliance programs focused on monitoring and deterrence, and those compliance programs focused on motivating employees to do the right thing because it is the right thing to do. Lynn Sharp Paine started this categorization of compliance programs into one of two categories with an article²³ published just a three years after the organizational sentencing guidelines were promulgated and compliance programs were rapidly adopting compliance programs. After noting the importance of compliance programs and the need to educate managers and employees on their legal requirements,²⁴ Paine argued that many compliance programs placed too much emphasis on “threat of detection and punishment.”²⁵ She argued that programs that focus only on penalties for compliance, and have “unrealistic” standards that ignore the “root causes of misconduct” in organization, will be viewed as “nothing more than liability insurance for senior management.”²⁶ An integrity strategy (as opposed to simply a “compliance” strategy), on the other hand, seeks “to create an environment that supports ethically sound behavior, and to instill a sense of shared accountability among employees.”²⁷ Rather than viewing legal requirements an “constraint imposed by external authorities,” managers must work to make ethical behavior and legal compliance a “positive aspect of organizational life.”²⁸ According to Paine, an integrity strategy has the same basic structural features as a compliance strategy (e.g., codes of conduct, training, mechanisms to investigate potential wrongdoing, hotlines, audits, and internal controls), but it goes deeper into the organization’s operating patterns and requires the involvement of all managers.²⁹ Ultimately, she argued, it must be a management driven process, not a lawyer driven process.³⁰ In short, a compliance program based on an integrity strategy focuses on a “commitment to ethical values,” as opposed to the more basic goal of “prevent criminal misconduct.”³¹

The interpretation of this article along with additional work in behavioral ethics (especially that focused on extrinsic motivation crowding out intrinsic motivation), often led commentators to believe that integrity-based compliance program should attempt to minimize

²³ Lynn Sharp Paine, *Managing for Organizational Integrity*, HARV. BUS. REV., Mar.-Apr. 1994, at 106, 110–11.

²⁴ Paine, *supra* note 23, at 109 (noting that “employees can be frustrated and frightened by the complexity of today’s legal environment” and “even managers who claim to use the law as a guide to ethical behavior often lack more than a rudimentary understanding” of the law).

²⁵ *Id.* at 110.

²⁶ *Id.* at 111.

²⁷ *Id.* at 111.

²⁸ *Id.*

²⁹ *Id.*

³⁰ *Id.* at 113.

³¹ *Id.* at 113 & 117. Paine further states that “In the end, creating a climate that encourages exemplary conduct may be the best way to discourage damaging misconduct. Only in such an environment do rogues really act alone.” *Id.* at 117.

the use of formal monitoring of employees' behavior.³² The concern was that too much monitoring would cause employees to feel untrustworthy (and thus start to act untrustworthy), or that acting for extrinsic reasons would "crowd out" intrinsic reasons for following the company's standards. What is often missing from those discussions, however, is a better understanding of how the company monitors the employees (and frames the perception of that monitoring), how the company carries out punishment for violating company standards, and the other cultural factors present in the organization. The following sections present a model and considers recent empirical evidence that takes those factors into account.

III. A Corporation's Ethical Infrastructure

Tenbrunsel and colleagues developed the concept of an organization's ethical infrastructure.³³ This model is relatively straightforward, which makes it easy to see the relationships between the three systems in the model. In addition, it moves away from the use of the term "culture," which has led to some confusion among those in the compliance field, and it moves us away from the either/or approach of compliance-based versus integrity-based programs.

An organizations ethical infrastructure consists of three systems: a formal system, which is embedded within an informal system, which is embedded within the organization's climate.³⁴ The formal and the informal systems both consistent of communication, surveillance, and sanctioning systems, as briefly described below:³⁵

- *Formal System:*
 - *Communication:* The explicit guidelines for how employees should perform their jobs in an ethical manner, including codes of conduct, training programs, and written performance standards.³⁶
 - *Surveillance:* The organization's official policies and procedures on how it will monitor employees and how employees can report wrongdoing.³⁷
 - *Sanctioning:* The formal rewards and punishments of the organization, including performance evaluations and promotions, as well as the sanctions for wrongdoing.³⁸

- *Informal System:*
 - *Communication:* The "water cooler" conversations and other interactions that convey the organization's ethical norms.³⁹ Informal communications

³² See, e.g., Donald C. Langevoort, *Monitoring: The Behavioral Economics of Corporate Compliance with Law*, 2002 COLUM. BUS. L. REV. 71, 105 (2002) (noting that employees may only accept a "threshold" level of monitoring and that "ethics-or integrity-based systems will often deliberately be designed in such a way that they look particularly leaky.")

³³ Ann E. Tenbrunsel et al., *Building Houses on Rocks: The Role of the Ethical Infrastructure in Organizations*, 16 SOCIAL JUSTICE RESEARCH 285 (2003).

³⁴ Id. at 286-87.

³⁵ Id. at 286.

³⁶ Id. at 287 & 289.

³⁷ Id. at 287 & 290-91.

³⁸ Id. at 287 & 290-91.

³⁹ Id. at 291.

also includes the “tone at the top,” as set by leadership’s actual behavior (not leadership’s official policies).

- *Surveillance*: This is the observation of an employee’s behavior by his or her peers or supervisors, with any violations of ethical norms handled outside of the organization’s official policies and procedures.⁴⁰
- *Sanctioning*: Examples of informal sanctions include include harsh words, ostracism, and group pressure.⁴¹

The third system of the ethical infrastructure is the organizational climate. An organization’s climate is the employees’ shared perceptions of the organization as it relates to any particular aspect of the organization.⁴² As opposed the formal and informal systems which are based on tangible events (e.g., company policies, actual treatment by other employees), the climate is based on how employees perceive the totality of all those various objects and events.⁴³

Although those in the compliance field more commonly refer to an organization’s culture, the management literature distinguishes between an ethical climate and an ethical culture. The organization’s ethical climate relates to employees’ perceptions of what is or is not unethical behavior in that organization.⁴⁴ That is, what is or is not the “right” way to act in that organization.⁴⁵ Ethical culture, on the other hand, relates to those factors in the organization that “impede unethical behavior and encourage ethical behavior.”⁴⁶ Thus, ethical climate relates to the organization’s values, and the ethical culture relates to behavioral control.⁴⁷

Researchers have identified five different types of ethical climates.⁴⁸ When faced with an ethical dilemma, the climate of the organization tells an employee what is appropriate to consider as follows:

- *Instrumental climate*: employees only consider their own self-interest or the interest of the organization
- *Caring climate*: employees consider the needs of others
- *Independence climate*: employees should use their own values as a guide
- *Rules climate*: the rules of the organization determine how to handle the dilemma
- *Laws and Codes Climate*: society’s standards dictate the appropriate behavior.

Research has supported the influence of ethical climates on ethical behavior. In 2010, Kish-Gephart and colleagues conducted what is called a meta-analysis of thirty years of research on unethical behavior in organizations.⁴⁹ The results showed that a self-interested climate

⁴⁰ Id. at 292.

⁴¹ Id. at 292.

⁴² Id. at 294.

⁴³ Id. at 296.

⁴⁴ Kaptein (2011,) *supra* note 20, at 845.

⁴⁵ Jennifer J. Kish-Gephart et al., *Bad Apples, Bad Cases, and Bad Barrels: Meta-Analytic Evidence About Sources of Unethical Decisions at Work*, 95 J. APPLIED PSYCH. 1, 6 (2010).

⁴⁶ Kaptein (2011,) *supra* note 20, at 845.

⁴⁷ Kish-Gephart et al., *supra* note 45, at 7.

⁴⁸ Linda Klebe Trevino et al., *(Un)ethical Behavior in Organizations*, 65 ANNUAL REV. PSYCH. 635, 640 (2014).

⁴⁹ Jennifer J. Kish-Gephart et al., *Bad Apples, Bad Cases, and Bad Barrels: Meta-Analytic Evidence About Sources of Unethical Decisions at Work*, 95 J. APPLIED PSYCH. 1 (2010). The authors’ research included 136 different studies. Id. at 10. In addition to examining the organizational environment, the authors also examined individual differences (including demographics (e.g., age and gender) and psychological differences (e.g., philosophical orientation, locus of control)) and the characteristics of the moral issue at hand (e.g., proximity to the harm, magnitude of consequences). Id at 2-5.

increased unethical behavior, while caring, rules, and laws and codes climates reduced unethical behavior.⁵⁰

For the ethical infrastructure model, Tenbrunsel and colleagues consider the organizational climate towards three issues: ethics, respect, and procedural justice.⁵¹ With respect to organizational climate for ethics, the authors' concept matches the above ethical climates. The climate for respect refers to the extent to which employs are "shown consideration, and treated with dignity."⁵² The climate for procedural justice is the employees' perceptions "of the fairness of the procedures used to make decisions" in the organization.⁵³ Respect and procedural justice are important because fair treatment by the organization encourages employees to reciprocate in their behavior towards the organization and its rules.⁵⁴ In addition, respectful treatment from the organization encourages thoughtful consideration of the welfare of others, as opposed to focusing only on self-interest.⁵⁵

Understanding that the formal system is embedded in the informal system, which is all embedded in the organizational climate, is important for understanding how the ethical infrastructure actually impacts employees' ethical behavior. With respect to influencing behavior, the more deeply embedded system is the more influential system. Thus, the formal system is weaker than the informal system, which is weaker than the organizational climate.⁵⁶ The informal system is stronger than the formal system because the informal system better reflects the reality of what the employee is facing.⁵⁷ For example, a formal code of conduct or the lessons from a training session can be easily trumped by a conflicting message from the employee's informal environment (e.g., group pressures). The organizational climate is stronger than the informal system because it is the employees' perceptions of what type of behavior is appropriate and expected in that environment. Because the systems are embedded, the overall strength of the ethical infrastructure depends on how consistent the three systems are with each

⁵⁰ Kish-Gephart et al., *supra* note 45, at 21. The authors referred to self-interested climates as egoistic, a caring climate as benevolent, and the rules and law climates as principled. *Id.* at 6. The authors excluded the independence climate as it focused on individuals following their own beliefs. *Id.* See also Aditya Simha & John B. Cullen, *Ethical Climates and Their Effects on Organizational Outcomes: Implications From the Past and Prophecies for the Future*, 26 ACAD. MGMT. PERSPECTIVES 20, 27 (2012) (stating that "The essential theme emerging from this stream of research is that benevolent and principled climates (i.e., caring, independence, rules, and law and code) are the climates associated with positive outcomes, and egoistic climates (i.e., instrumental) are associated with a whole host of negative outcomes.")

⁵¹ Tenbrunsel et al., *supra* note 33, at 294.

⁵² *Id.* at 294.

⁵³ *Id.* at 294.

⁵⁴ *Id.* at 295. The authors acknowledge the strong "conceptual overlap" between the climates for respect and procedural justice, but keep them as separate concepts in their model because "respect for the individual is a construct that has been overlooked in the organizational ethics literature and, thus, deserves its own special treatment." *Id.* at 296.

⁵⁵ *Id.* at 295.

⁵⁶ *Id.* at 299-300. The authors state: "More specifically, we argue that formal systems are weaker than informal systems because the principles that are conveyed through formal systems are less entrenched in an employee's organizational experience and hence the furthest removed from that individual; similarly, informal systems are weaker than organizational climate because the principles conveyed through informal systems are less rooted in the organizational experience and hence further removed from the individual than those conveyed through the relevant climates." *Id.* at 300.

⁵⁷ *Id.* at 300.

other.⁵⁸ Thus, a strong formal program that is inconsistent with the informal system and organizational climate, will not be an effective compliance program.⁵⁹

The authors also argue that the relationship between the ethical infrastructure of the organization and ethical behavior is not linear, but curvilinear.⁶⁰ That is, consider a graph where the Y-axis (vertical axis) is unethical behavior and the X-axis (horizontal axis) starts at no ethical infrastructure and moves to a weak infrastructure and then to a stronger infrastructure. As we move from no infrastructure to a weak infrastructure, the amount of unethical behavior will increase. As the infrastructure gets stronger, then the amount of unethical behavior will decrease. This inverted U-shape results because a weak ethical infrastructure is expected to lead to more unethical behavior than an organization having no infrastructure. The reason for this, according to the authors, is because the organization's infrastructure encourages individuals to "no longer rely on their values; rather they look to the organization to decide what is ethical."⁶¹ If the infrastructure is weak, then the individuals receive the message that "the ethical principles or values in question are relatively unimportant."⁶² As discussed in the next Part, recent empirical work provides support for this conclusion, as well as for other aspects of the ethical infrastructure model that are instructive for helping us to better understand compliance programs.

IV. Insights from the Empirical Evidence

A. Lost Legitimacy: Understanding the Double-Edged Sword of "Mandated" Compliance Programs

Corporations adopt or modify their compliance programs due to government pressure. Due to the incentives of the Organizational Sentencing Guidelines, the consideration of compliance programs under the DOJ's prosecution manual, and inclusion in settlement agreements to end an enforcement action, compliance programs are essentially "mandated" by the government. The ethical infrastructure model shows how these "mandated" programs can lead to not just ineffective programs (and a waste of resources), but also be counter-productive programs.

Under a institutional theory in organization studies, corporations' adoption of "check-the-box" or "paper" or "cosmetic" compliance programs are referred to as being "decoupled" from the organization. Decoupling occurs when an organization faces pressure to adopt certain

⁵⁸ Id. at 302.

⁵⁹ Id. at 303 (stating "If they are to be effective, formal ethical systems must reside in informal reinforcements and organizational climates that are solid. If not, the formal systems acts more like a Band-Aid than an antibiotic, addressing the symptoms, but not the underlying causes.")

⁶⁰ Id. at 297.

⁶¹ Id. at 297. The authors further explain: "When there is no infrastructure in place, individuals are more likely to perceive the ethical dimensions of the decision and hence are more likely to behave ethically. When a strong ethical infrastructure is in place, individuals behave ethically because the organization is telling them that they have to do so. However, when a weak infrastructure is in place, individuals do not perceive the ethical dimensions of the situation nor do they sense any deep ethical conviction from the organization. Consequently, ethical behavior is least likely when an ethical infrastructure is weak." Id at 299.

⁶² Id. The authors also state, "Perhaps one of the worst things that can happen is for an organization to put in figureheads and systems that are only weakly supported. Perhaps even worse is to initiate an ethics program only to abandon it, or decrease its importance, at a later point in time because attention shifts elsewhere. Such weak, or weakened, efforts may send a signal that ethical considerations are actually unimportant, thus increasing, rather than decreasing unethical behavior." Id. at 304.

practices to gain or to maintain legitimacy with external audiences, but those practices conflict with other goals of the organization.⁶³ In response, the organization adopts the practices, but does not fully implement those practices.⁶⁴ It is important to remember that this does not mean that the entire organization fails to implement the compliance program, but it may be that only certain departments fail to implement the practices.⁶⁵

An in-depth case study by MacLean and Behnam showed the dangers of decoupling.⁶⁶ Their study was an in-depth case study of a large mutual life insurance company that engaged in certain deceptive sales practices that were banned in every state.⁶⁷ Although the company made strong statements against the practice and developed a compliance program to prevent the practice, the compliance program contained a loophole that allowed employees to easily work around the controls that prevented the practice.⁶⁸ With respect to the formal communication, surveillance, and sanctioning systems, the sales personnel only received compliance training once a year (which was the minimum required under federal regulations),⁶⁹ the monitoring of sales practices was very limited compared to the monitoring of sales results,⁷⁰ and if the company did find wrongful sales practices, the typical punishment was a warning letter (and not the progressive disciplinary actions stated in formal policy).⁷¹ Informally, managers made fun of violations rather than punishing the behavior.⁷² Due to this implementation, employees viewed the compliance program as a “self-protection mechanism for senior executives.”⁷³ Those in the compliance department viewed their meetings as “empty rituals.”⁷⁴ Those outside the department viewed compliance as a “hassle” and “a system to beat.”⁷⁵

The program had lost legitimacy with the employees. The ineffective compliance program was not simply a waste of the company’s resources, but helped lead to the “institutionalization of organizational misconduct.”⁷⁶ Looking at the situation through the lens of the ethical infrastructure model, the continued existence of a compliance program that was widely known to be ineffective had an impact on the informal system and the organization’s ethical climate. The widely ignored compliance program sent a message to employees on what was expected behavior and this message was reinforced through informal interactions among the organizational members.

⁶³ Tammy L. MacLean & Michael Behnam, *The Dangers of Decoupling: The Relationship Between Compliance Programs, Legitimacy Perceptions, and Institutionalized Misconduct*, 53 ACAD. MGMT. J. 1499, 1500 (2010).

⁶⁴ Id. at 1500-1501.

⁶⁵ See id. (stating “decoupled compliance structures may either manifest themselves as public of programs that do not exist in practice, or as programs that exist in practice but are disconnected from important, on-going, line-related organizational functions”).

⁶⁶ Id.

⁶⁷ Id. at 1502.

⁶⁸ Id. at 1507. In short, the compliance program used a 90-day window from the sale of a policy to monitor activity that would indicate use of this deceptive sales practice (“churning”). Id. Employees, however, quickly learned that they could wait 91 days from a sale to engage in the wrongful practice and the system would not catch their activity. Id.

⁶⁹ Id. at 1507.

⁷⁰ Id. at 1509. In addition, it would not be uncommon for the audit or compliance department to be told to “slow down” an investigation into wrongful practices. Id. at 1509-10.

⁷¹ Id. at 1509-10.

⁷² Id. at 1509.

⁷³ Id. at 1510.

⁷⁴ Id. at 1511.

⁷⁵ Id.

⁷⁶ Id. at 1516.

Larger scale empirical studies have reached similar conclusions. An important early study on compliance programs found that if employees developed a cynical perception of the company's compliance program and believed that it served only to protect top management from blame for any wrongdoing, then the organization suffered from more unethical behavior and employees were less likely to report any observed wrongdoing.⁷⁷ Recent reviews of the empirical business ethics literature found that after controlling for other factors related to an organization's ethical climate and culture, the mere existence of an ethics code has a positive effect on unethical behavior.⁷⁸ Although this may simply mean that employees in the study are more aware of what should be considered unethical behavior in the organization,⁷⁹ it also suggests that without a supportive ethical culture "employees can view the mere existence of a code as a negative sign that the code represents window dressing only, thus producing a cynical response that leads to more unethical behavior."⁸⁰ In a more recent study, MacLean and colleagues conclude from their survey-based study that "When organizational members perceive ethics programs as merely window dressing they may also perceive the organization as lacking integrity, demonstrating inconsistency between its words and deeds . . . thus leading to negative perceptions."⁸¹

Importantly, a compliance programs loss of legitimacy is not necessarily due to an organization's intentional, bad faith act to adopt a paper program. Instead, hurdles and misunderstandings within the organization, can prevent compliance programs from being implemented appropriately. For example, recent research shows that despite the increased attention placed on compliance programs in the last few years, many Chief Ethics and Compliance Officers (CECO) still face challenges in gaining support from other members of the organization. Organizational members resist the CECO's efforts for a variety of reasons, such as believing that ethics is something each individual has learned before entering the workforce (and that it is "very, very odd" to have someone the business teaching it), without a crisis facing the organization the issues of ethics and compliance are a very low priority, senior managers typically view themselves as an expert in ethics, the program is viewed as a "check the box" activity, or the program is viewed as conflicting with other business goals.⁸² To the extent that the program is not appropriately implemented for any of these reasons, the legitimacy of the program is slowly chipped away, which can have negative consequences for the organization.

B. When Sanctions Work

⁷⁷ Linda Klebe Treviño et al., *Managing Ethics and Legal Compliance: What Works And What Hurts*, 41 Calif. Mgmt. Rev. 131, 136-40 (1999). The authors' conclude that having a program that is perceived as protecting top management "may be worse than having no program at all." Id. at 140.

⁷⁸ Linda Klebe Trevino et al., *(Un)ethical Behavior in Organizations*, 65 ANNUAL REV. PSYCH. 635, 639 (2014); Kish-Gephart et al., *supra* note 45, at 21.

⁷⁹ In survey-based research, the researchers typically measure unethical behavior in an organization by whether or not the employee has observed unethical behavior in the last twelve months. Thus, a code of conduct helps an employee understand and identify unethical behavior, and therefore the employee may become more aware of unethical behavior happening in the organization.

⁸⁰ Klebe Trevino et al. 2014, *supra* note 78, at 639.

⁸¹ Tammy MacLean et al., *When Organizations Don't Walk Their Talk: A Cross-Level Examination of How Decoupling Formal Ethics Programs Affects Organizational Members*, 128 J. BUS. ETHICS 351, 354 (2015) (citations omitted from the quote).

⁸² Linda Klebe Trevino et al., *Legitimizing the Legitimate: A Grounded Theory Study of Legitimacy Work Among Ethics and Compliance Officers*, 123 ORG. BEHAVIOR & HUMAN DECISION PROCESSES 186, 191-94 (2014).

Viewing compliance programs as the formal system within the organization's ethical infrastructure helps us understand when surveillance and sanctions help promote ethical behavior. As discussed above, the distinction between a compliance-based program and an integrity-based program has created confusion on the use of sanctions—suggesting that they may crowd out intrinsic motivations. Recent research suggests that the relationship between extrinsic motivation and ethical behavior is more complicated. Mulder, for example, argues that in certain situations sanctions can increase an individuals' moral concerns related to that issue, as opposed to “crowd out” those concerns.⁸³ Under her model, a sanctioning system will increase “moral concerns” (intrinsic motivation) if the employee perceives the sanction as retribution, as opposed to compensation for the damage caused.⁸⁴ Mulder identifies various factors that influence when an employee is more likely to view a sanction as retribution rather than simply compensation. First, a severe (as opposed to a mild) sanction “will more easily trigger retributive concerns” because it is more likely to communicate that authority views the behavior as morally wrong.⁸⁵ Second, a non-financial penalty (a loss of privileges, for example) is more likely to be viewed as retributive.⁸⁶ Third, if the sanctioned behavior is relatively rare in the local group, then it is more likely to be retribution.⁸⁷ Thus, if it is common for members in the group to engage in the behavior and receive a small financial penalty as a result, then the employee is likely to view the penalty as compensatory and moral concerns will not be engaged. Finally, if the authority makes the immoral aspects of the behavior salient to the employee (and how the action is disapproved by others for those reasons), then the employee will view the sanction as retribution.⁸⁸

That sanctioning system operates within the organization's ethical infrastructure. To receive the retributive message based on the above factors, the employee must accept the moral authority of the person giving the sanction.⁸⁹ Influenced by the work of Tyler, Mulder argues that an employee will accept the moral message of the sanction if the employee trusts the authority and the sanction is administered through a procedurally fair system.⁹⁰ Trust and procedural justice increase the legitimacy of the retributive sanction and raises moral concerns.⁹¹

⁸³ Laetitia B. Mulder, *The Two-Fold Influence of Sanctions on Moral Concerns*, in PSYCHOLOGICAL PERSPECTIVES ON ETHICAL BEHAVIOR AND DECISION MAKING 169, 170 (David DeCremer, ed., 2009).

⁸⁴ *Id.* at 171-72.

⁸⁵ *Id.* at 172-73. The sanction must still be fair, as too severe of a penalty may be viewed as unfair and illegitimate, and the employee may not accept the retributive message. *Id.* at 176.

⁸⁶ *Id.* at 173.

⁸⁷ *Id.* at 174.

⁸⁸ *Id.* at 174-75.

⁸⁹ *Id.* at 175.

⁹⁰ *Id.* at 175. See also, Laetitia B. Mulder et al., *Sanctions and Moral Judgments: The Moderating Effect of Sanction Severity and Trust in Authorities*, 39 EURO. J. SOC. PSYCH. 255, 265 (2009) (presenting the results of three empirical studies showing the importance of trust in the sanctioning authority, as lack of trust may cause the person sanctioned to question the motivation of the authority (e.g., imposing a sanction due to self-interest) or question the ability of the authority to judge the morality of the action).

⁹¹ Mulder, *supra* note , at 176. Mulder summarizes the implications of her findings as:

[M]erely installing a sanctioning system may often not be enough: It may be necessary to make clear to individuals *why* the sanctioned behavior is immoral (for example, because it harms others or the collective) and, preferably, the feeling should be created that most other people do not show the behavior and disapprove of it. Also, it should be made clear that the sanction is not a payment that softens the consequences of one's behavior. . . . [T]he sanction should be severe enough that so that it shows disapproval, but not so severe that it is perceived as unreasonable and illegitimate.

Id. at 176-77.

Subsequent research confirms these conclusions.⁹² Thus, only in the presence of a climate for procedural justice will appropriately structured formal sanctions increase moral concerns. As discussed further in the next subsection, the organization's climate for procedural justice (in which both the formal and informal systems are embedded) is important for understanding the effectiveness of a compliance program.

C. The Climate for Procedural Justice

The work of Tom Tyler shows the importance of an organization's climate for procedural justice (or, procedural fairness) and how it influences the organization's formal and informal systems. With respect to employee compliance in organizational settings, research has shown that procedural justice is more important than outcome fairness.⁹³ Procedural justice in an organization involves two aspects. First, that the decision-making process is fair (e.g., the employee has some voice in the process, rules and policies are followed consistently for all organization members, decisions are made transparently).⁹⁴ Second, that there is fairness in interpersonal treatment.⁹⁵ This aspect is similar to the climate of respect under the ethical infrastructure model.

Their research shows that when the organization operates in a procedurally fair manner, then employees will believe in the legitimacy of management's authority and believe that their values match the values of the organization.⁹⁶ This, in turn, causes voluntary compliance with the organization's rules, and is significantly more effective in eliciting rule compliance than an approach based on risk of punishment.⁹⁷

⁹² See Peter Verboon & Marius van Dijke, *When Do Severe Sanctions Enhance Compliance? The Role of Procedural Fairness*, 32 J. ECON. PSYCH. 120, 127 (2011) (stating "Severe sanctions increased compliance with the authority more than mild sanctions, but this effect was found only when authorities acted in a fair manner. . . . [T]his effect results because followers morally evaluate the enacting authority higher.")

⁹³ Tom Tyler et al., *The Ethical Commitment to Compliance: Building Value-Based Cultures*, 50 CAL. MGMT. REV. 31, 33 (2008).

⁹⁴ Id. Legitimacy is the "belief that authorities, institutions, and social arrangements are appropriate, proper, and just" and "when it is possessed, leads people to defer voluntarily to decisions, rules, and social arrangement." Tom R. Tyler, *Psychological Perspectives on Legitimacy and Legitimation*, 57 ANNUAL REV. PSYCH. 375, 376 (2006). Tyler states that the research on organizations shows that "those authorities who exercise their authority fairly are more likely to be viewed as legitimate." Id. at 380. See also Id. at 392 (stating "The findings reviewed consistently suggest that the legitimacy of authorities and institutions is linked to the fairness of the procedures by which they exercise their authority") and 394 (stating "legitimacy derives from judgments about how those others exercise authority, judgments not based upon the favorability or even the fairness of the decisions the authorities make, but upon beliefs about what are fair or ethical procedures for exercising authority.")

⁹⁵ Tyler et al, *supra* note 93, at 33 & 37 (describing this factor as "the manner in which people are treated while decisions are being made include whether processes are dignified and the people in them are treated politely, whether people's rights are respected, and whether the authorities involved are sincerely trying to do what is right for all of the people in the situation")

⁹⁶ Id. at 34 & 36.

⁹⁷ Id. at 34-35. These findings are consistent with Tyler's work on why people follow the law more generally. See Tom R. Tyler, *Legitimacy and Criminal Justice: The Benefits of Criminal Justice*, 7 OHIO ST. J. CRIM. L. 307, 315 (2009) (stating "people are more likely to obey the law if they think it is legitimate and/or consistent with their values").

Additional research confirms the importance of the organization's climates for procedural justice and respect for encouraging ethical behavior.⁹⁸ For example, Trevino and Weaver found that employees observed less unethical conduct in their organizations and were more likely to report observed wrongdoing if they had a general perception that their organization treated employees fairly.⁹⁹ Consistent with Tyler, fair treatment included employees' perceptions that the organization follows through on its ethics program (e.g., following up on reports of unethical behavior and disciplining those that violate the company's policies).¹⁰⁰

D. Embedment in the Informal System: The Importance of Local Managers

Much of the discussion about compliance programs has focused on the "tone at the top." That is, the ethical tone for the organization set by top management. The academic literature is showing that the tone set by local managers is also very important. The work by Tyler and colleagues that relate to an organization's climates for procedural justice and respect show that the perception is determined by treatment at the workgroup level as well as from the tone at the top.¹⁰¹ Other research also shows the importance of the formal system and the informal system in shaping perceptions of justice. For example, Blader and Tyler show the procedural justice is determined by the formal rules of the organizations on how decisions are to be made and how employees are to be treated, as well as by how the individuals interacting with employees actually make decisions and actually treat the employees.¹⁰²

In addition to influencing perceptions of justice, research shows that interactions in the informal system influence ethical decision making. For example, Kaptein explored a variety of factors that could influence the effectiveness of a company's code of conduct.¹⁰³ The strongest influence on reducing unethical behavior was how well both senior management and local management lived up to the code of conduct.¹⁰⁴ Kaptein measured managements' influence by asking employees if their managers were viewed as "positive role models as regards the [code of ethics], set reasonable performance targets . . . that promote compliance with the [code], do not authorize violations of the [code] to meet business goals, are approachable if employees have questions about or report violates of the [code], are aware of the extent to which employees violate and comply with the [code], and respond appropriately when they become aware of any violations of the [code]."¹⁰⁵

⁹⁸ A review of the behavioral ethics literature published in 2006 stated that "individual's expectations for fairness . . . produce expectations in observers that those who violate ethical expectations will be disciplined Failure to satisfy the "fairness heuristic" . . . is likely to lead to self-protection and possibly unethical behavior" (citations omitted). Linda K. Trevino et al., *Behavioral Ethics in Organizations: A Review*, 32 J. OF MGMT. 951, 966 (2006).

⁹⁹ Linda Klebe Trevino & Gary R. Weaver, *Organizational Justice and Ethics Program "Follow-Through": Influences on Employees' Harmful and Helpful Behavior*, 11 BUS. ETHICS Q. 651, 663-65 (2001).

¹⁰⁰ Id. The authors believe these results show that "ethics/compliance management should be more tightly coupled with the management of the broader organizational culture to improve employees' perceptions of fairness in the organization in general and in the ethics/compliance program." Id. at 667.

¹⁰¹ Tyler et al, *supra* note 93, at 35.

¹⁰² See also Steven L Bader & Tom R. Tyler, *A Four-Component Model of Procedural Justice: Defining the Meaning of a "Fair" Process*, 29 PERSONALITY & SOC. PSYCH. BULLETIN. 747, 749 & 755-56 (2003).

¹⁰³ Muel Kaptein, *Toward Effective Codes: Testing the Relationship with Unethical Behavior*, 99 J. BUS. ETHICS 233, 234-38 (2011).

¹⁰⁴ Id. at 245.

¹⁰⁵ Id. at 241.

Other research shows the importance of the informal environment surrounding the employee at the peer or local manager level. For example, people are more likely to behave ethically when they have the opportunity to discuss the ethical aspects of the questionable behavior, as opposed to being surrounded by discussions only related to self-interest.¹⁰⁶ Employees are more likely to internally report observed wrongdoing if they are surrounded by ethical co-workers in addition to ethical leadership.¹⁰⁷ Overall, the ethical infrastructure model shows the need to consider these informal interpersonal interactions at the group level for determining ethical behavior.

V. Conclusion

The government and corporations continue to place faith in the ability of corporate compliance programs to reduce illegal and unethical behavior by managers and employees. Despite these efforts, the levels of observed unethical behavior by corporate employees has continued at a steady level over the past decade. And, of course, corporate scandals continue to fill the business sections of newspapers. Although many (including the US Sentencing Commission through their amendments to the Organizational Sentencing Guidelines) have recognized the importance of a corporation's culture for controlling unethical behavior, there continues to be a wide-spread lack of understanding of the relationship between the compliance program and the corporation's culture. To help correct the problem, this article presents the ethical infrastructure model as a way to better understand the relationship between a corporation's formal system (e.g., compliance program), informal system (e.g., group pressures and ethical norms), and the climate of the organization. Based on the most recent empirical research on behavioral and organizational ethics, this article presents the support for this model and highlights several key insights. The insights include understanding when a formal compliance program that loses legitimacy with its employees may lead to more unethical behavior, when sanctions for unethical behavior can increase moral concerns, the importance of an organizational climate that demonstrates procedural justice and fair treatment of employees, and the importance of the ethical behavior of an employee's local work group in addition to the "tone at the top."

¹⁰⁶ Trevino et al. 2014, *supra* note 78, at 643.

¹⁰⁷ David M. Mayer et al., *Encouraging Employees to Report Unethical Conduct Internally: It Takes a Village*, 121 *ORG. BEHAVIOR & HUMAN DECISION PROCESSES* 89, 100 (2013)