COSMETIC COMPLIANCE AND THE FAILURE OF NEGOTIATED GOVERNANCE

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ABSTRACT

Across a range of legal regimes—including environmental, tort, employment discrimination, corporate, securities, and health care law—United States law reduces or eliminates enterprise liability for those organizations that can demonstrate the existence of "effective" internal compliance structures. Presumably, this legal standard rests on an assumption that internal compliance structures reduce the incidence of prohibited conduct within organizations. This Article demonstrates, however, that little evidence exists to support that assumption. In fact, a growing body of evidence indicates that internal compliance structures do not deter prohibited conduct within firms and may largely serve a window-dressing function that provides both market legitimacy and reduced legal liability. This leads to two potential problems: (1) an under-deterrence of corporate misconduct, and (2) a proliferation of costly—but arguably ineffective—internal compliance structures.

The United States legal regime's enthusiastic embrace of internal compliance structures as a liability determinant is consistent with the increasing influence of what are referred to in this Article as "negotiated governance" models that seek to improve government regulation and/or the litigation process through more cooperative governance methods that provide a governance role to the regulated group and other interested parties. Drawing on the incomplete contracts literature, this Article argues that, although the negotiated governance model provides valuable descriptive insights into the mechanisms by which legal rules develop, the model's proponents minimize the dangers of opportunistic behavior during the renegotiation phases of governance (that is, the implementation and enforcement phases) by those with the greatest stake in the meaning of

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incomplete law—in this case, business organizations and legal compliance professionals, including lawyers.

I. INTRODUCTION

The recent epidemic of corporate misbehavior, including scandals at major companies such as Enron, WorldCom, and Tyco, has been accompanied by an almost predictable backlash against corporate greed and immorality by industry experts, politicians, and the public at large.[1] Even President George W. Bush has joined the crusade, lamenting the "abuses" and "excesses" of American business and declaring that "America's greatest economic need is higher ethical standards."[2]

Not all of the renewed interest in ethical corporate conduct is mere rhetoric. Business schools are scrambling to include more coverage of ethics in their curriculum;[3] the New York Stock Exchange recently approved new listing standards that require all listed companies to have an internal audit function and adopt and publish a code of business conduct and ethics;[4] the Sarbanes-Oxley Act of 2002 (passed in the wake of the Enron scandal) mandates that all reporting companies file "internal control report[s]"[5] and disclose information about their ethics codes;[6] and the ethics and compliance consulting business—already a multi-billion dollar industry—has seen a surge in demand.[7] Indeed, given the present consensus that more corporate

1. For example, a recent CBS News poll revealed that only 25% of Americans believe that most corporate executives are honest. Jenna Russell and D.C. Denison, *Corporate Scandals Fail to Taint MBA Students' Optimism*, CHI. TRIB., Aug. 2, 2002, at C5 [hereinafter Russell & Denison].

2. *Bush Talks Tough on Business*, BBC NEWS (July 9, 2002), *at* http://news.bbc.co.uk/1/hi/business/2118162.stm. Similarly, in a July 16, 2002 speech, Federal Reserve Chairman Alan Greenspan blamed "infectious greed" for the corporate governance breakdowns that had led to recent corporate debacles. Greg Ip, *Greenspan Issues Hopeful Outlook as Stocks Sink*, WALL ST. J., Jul. 17, 2002, at A1.

3. Russell & Denison, *supra* note 1.

4. Press Release, New York Stock Exchange, *NYSE Approves Measures to Strengthen Corporate Accountability* (Aug. 1, 2002), *at* http://www.nyse.com/press/NT00545421.html.

5. 15 U.S.C.A. § 7262 (West 2002). The internal control report must be contained in each annual report required by section 13(a) or 15(d) of the Securities Exchange Act (the "Exchange Act") and "state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting; and . . . contain an assessment, as of the end of the most recent fiscal year of the issuer, of the effectiveness of the internal control structure and procedures of the issuer for financial reporting." *Id.*

6. 15 U.S.C.A. § 7264 (West 2002). In each periodic report required under section 13(a) or 15(d) of the Exchange Act, reporting issuers must "disclose whether or not, and if not, the reason therefor, such issuer has adopted a code of ethics for senior financial officers, applicable to its principal financial officer and comptroller or principal accounting officer, or persons performing similar functions." *Id*.

7. Jan Norman, *Righting Corporate Wrongs*, ORANGE CO. REG., Jul. 19, 2002, at C1.

conduct codes and internal compliance programs (referred to collectively in this Article as "internal compliance structures") are the remedy for America's recent lapse in corporate morality, the legal compliance profession (which includes lawyers, ethics and compliance consultants, and internal compliance and human resources personnel) appears headed for another banner decade.

Few, however, have paused to consider the reasons for—and the accuracy of—the belief that pouring more resources into internal compliance structures will cure what ails corporate America. In fact, the response of the legal compliance profession (including legal academia) to the ever-growing importance of internal compliance structures as a liability determinant has been overwhelmingly positive.[8] Relatively few commentators have made more than a passing reference to the potential inefficiency of such a system.

This enthusiastic embrace of internal compliance structures as a liability determinant is consistent with the increasing influence of what I refer to in this article as "negotiated governance" models.[9] Although these models vary

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8. *See, e.g.*, Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687, 745-52 (1997) (arguing in favor of the OSG liability mitigation provisions, which reduce an organizational defendant's criminal liability based on internal compliance structures); Charles M. Foster, Jr. et al., *Compliance Programs: An Alternative to Punitive Damages for Corporate Defendants*, 49 S.C. L. REV. 247, 263-66 (1998) (analogizing to the OSGs and urging courts to impose mandatory internal compliance structures, instead of punitive damages, on corporate defendants); Harvey L. Pitt & Karl A. Groskaufmanis, *Minimizing Corporate Civil and Criminal Liability: A Second Look at Corporate Codes Of Conduct*, 78 GEO. L.J. 1559, 1647 (1990) (arguing that "corporate self-regulation provides a superior alternative to tort or criminal liability as a means of effecting society's expectations of business") [hereinafter Pitt & Groskaufmanis]; Charles J. Walsh & Alissa Pyrich, *Corporate Compliance Programs as a Defense to Criminal Liability: Can a Corporation Save its Soul?*, 47 RUTGERS L. REV. 605, 607-08 (1995) (arguing that corporate compliance programs should insulate organizations from criminal liability); Note, *Growing the Carrot: Encouraging Effective Corporate Compliance*, 109 HARV. L. REV. 1783, 1794-95 (1996) (arguing that the OSG's do not go far enough in rewarding corporations for compliance efforts and advocating "a program that would allow corporations to apply for amnesty status, with approval contingent upon the existence of a satisfactory compliance program") [hereinafter Note]. *See also infra* notes 103-13 and accompanying text (discussing scholarship advocating negotiated governance).

9. A variety of terms are used to describe these governance models, including: "contractarian," "collaborative," "experimentalist," "problem solving," "empowered participatory," "enforced self-governance," "responsive regulation," "set of negotiated relationships," and "government-stakeholder network structures." *See, e.g.*, IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION 4-6 (1992) (employing the phrases "responsive regulation" and "enforced self-governance") [hereinafter Ayres & Braithwaite]; David A. Dana, *The New "Contractarian" Paradigm in Environmental Regulation*, 2000 U. ILL. L. REV. 35, 36 (2000) (referring to a "contractarian" governance model); Michael C. Dorf, *Legal Indeterminacy and Institutional Design*, 78 N.Y.U. L. REV. 875, 886 (2003) (referring to "experimentalist" or "problem solving" legal institutions) [hereinafter Dorf]; Jody Freeman, *Collaborative Governance in the Administrative State*, 45 UCLA L. REV. 1, 22 (1997) (adopting the phrase "collaborative" governance) [hereinafter Freeman, *Collaborative Governance*]; Jody Freeman, *The Private Role in Public Governance*, 75 N.Y.U. L. REV. 543, 571 (2000) (referring to governance as a "set of negotiated relationships") [hereinafter Freeman, *Private Role*]; Richard B. Stewart, *Administrative Law in the Twenty-First Century*, 78 N.Y.U. L. REV. 437, 448 (2003)

in their particulars, each purports to increase the effectiveness of government regulation and/or the litigation process through more cooperative governance methods that permit a voice to the regulated group and other interested private parties.[10]

Although this Article does not adopt public choice theory's radically negative view of private influence on the governance process, neither does it accept the benign view of private influence embodied in most variations of the negotiated governance model. Instead, this Article argues that, although negotiated governance may well have the capacity to enhance regulatory efficiency under some circumstances, it does not currently achieve that goal in broad and important areas of the law that govern organizational conduct.[11] This failure is particularly clear when one carefully examines the role of one form of negotiated governance—the use of internal compliance structures as a liability determinant—in the United States legal regime.

As discussed in Part III of this Article, in many instances, United States

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(discussing "government-stakeholder network structures"); Archon Fung & Erik Olin Wright, *Thinking About Empowered Participatory Governance* 3, *in* DEEPENING DEMOCRACY (Archon Fung & Eirk Olin Wright eds., 2003); Susan Sturm, *Second Generation Employment Discrimination: A Structural Approach*, 101 COLUM. L. REV. 458, 475 (2001) (referring to "problem solving" regulation) [hereinafter Sturm]. I adopt the phrase "negotiated governance" model to collectively refer to these theories in order to further the contractual metaphor used throughout this Article—and in Part VI, in particular—to analyze the governance process. "Negotiated governance," however, should be distinguished from "negotiated rulemaking," a form of administrative rulemaking established by the Negotiated Rulemaking Act of 1990, 5 U.S.C. §§ 561-570 (1994). Although negotiated rulemaking is one form of negotiated governance, the phrase "negotiated governance" encompasses much more than negotiated administrative rulemaking, as discussed *infra* in notes 103-13 and accompanying text.

10. Because this Article addresses only the application of negotiated governance models to the control of business organizations, the phrase "regulated group" as used in this Article refers to business organizations. Many commentators, however, envision negotiated governance as much broader, providing guidance for the regulation of other parties, such as criminal defendants. *See, e.g.*, Michael C. Dorf & Charles F. Sabel, *Drug Treatment Courts and Emergent Experimentalist Government*, 53 VAND. L. REV. 831 (2000) (discussing criminal defendants with known drug problems); Dorf, *supra* note 9, at 965-80 (discussing the Supreme Court's treatment of coercive interrogations). Although not addressed in this Article, it is possible that the conclusions here regarding the failures of negotiated governance with respect to the regulation of business organizations would not apply to the regulation of groups with less economic and political power, such as criminal defendants. However, these conclusions may well hold true for regulation and litigation affecting other powerful interests, such as doctors, lawyers, and other professionals—groups that are not only well organized but have access to capital and political influence as well.

11. It is worth emphasizing that the claim of this Article is not that negotiated governance in all instances is doomed to failure. Instead, my argument is that internal compliance-based organizational liability regimes are one (quickly growing) example of negotiated governance, and that the existing empirical evidence regarding the effectiveness of internal compliance structures as deterrence mechanisms should cast doubt on the widespread adoption by the legal system (and enthusiasm by legal scholars) of such liability regimes. Although other forms of negotiated governance may prove more effective, the poor empirical showing of internal compliance structures as a means of deterring organizational misconduct should cause more skepticism than evidenced in the legal and management literature.

law reduces or eliminates enterprise liability for those organizations that can demonstrate the existence of "effective" internal compliance structures.[12] Presumably, this legal standard stems from an assumption that internal compliance structures reduce the incidence of prohibited conduct within organizations. This Article demonstrates, however, that little evidence exists to support that assumption. In fact, a growing body of evidence indicates that internal compliance structures do not deter prohibited conduct within firms, and may largely serve a window-dressing function that provides both market legitimacy and reduced legal liability.

This is not to imply that internal compliance structures are inherently bad or that all American corporations are centers for uncontrolled illegality. Most corporate managers no doubt have a genuine commitment to monitoring, detecting, and preventing legal violations within their firms, and may use their internal compliance structures to further that goal. Furthermore, this Article does not suggest that a focus on corporate ethics is misplaced, or that the legal system should not attempt to encourage ethical corporate conduct whenever possible.

Instead, this Article argues that the present legal regime, which places an overwhelming and steadily increasing importance on internal compliance structures as a liability determinant, raises potential dangers of underenforcement and social waste that have been largely unaddressed in the legal literature. The inherent danger posed by a legal system that is overly reliant on internal compliance structures as a liability determinant stems from the extraordinarily favorable legal treatment received by organizations that adopt such systems, and the correspondingly harsh legal treatment of organizations without them. This leads to two potential problems: (1) an under-deterrence of corporate misconduct and (2) a proliferation of costly—but arguably ineffective—internal compliance structures.

First, the current legal regime's extremely favorable treatment of companies with internal compliance structures may result in an under-deterrence of prohibited corporate misconduct and a frustration of the normative goals of legal rules.[13] This is because the indicia of an effective

12. Under the Organizational Sentencing Guidelines, effective internal compliance structures are those that are "reasonably designed, implemented, and enforced so that [they] generally will be effective in preventing and detecting criminal conduct. Failure to prevent or detect the instant offense, by itself, does not mean that the program was not effective." U.S. ORGANIZATIONAL SENTENCING MANUAL § 8A1.2(k) (2001). The Manual goes on to list the minimum steps that the organization must have taken in order to qualify for consideration of a reduced sentence. *Id. See infra* notes 18-25 and accompanying text (discussing the OSG minimum steps for effective internal compliance).

13. This assumes, first, that the purpose of the legal rule in question is substantive, rather than cosmetic. For example, if Congress thought that recent market downturns were due solely to an

compliance system are easily mimicked and true effectiveness is difficult for courts and regulators to determine, particularly *ex post*. As a result, firms engaged in legally prohibited, but potentially profitable, conduct can reduce or eliminate firm-level liability (and give the appearance of legitimacy to corporate stakeholders and the marketplace at large, thus reducing market sanctions for failures to comply with expected behavioral norms) by mimicking an effective compliance system, without reducing the incidence of prohibited conduct within the firm.[14]

Second, the harsh treatment under current law of companies without internal compliance structures (or with less extensive structures than the industry standard) has caused a proliferation of costly—but potentially ineffective—internal compliance structures.[15] This is because even organizations with a genuine commitment to legal compliance, as evidenced

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irrational loss of investor confidence, then the ethics code and internal control provisions of the Sarbanes-Oxley Act may have been viewed as cost-effective mechanisms for luring investors back into the stock market while at the same time disrupting normal business practices as little as possible. This, however, assumes a degree of investor naïveté that is inconsistent with most theories of market conduct. Second, some laws may be so ill-advised that under-enforcement, or non-enforcement, would benefit society. Nonetheless, an insistence on internal compliance structures as a liability determinant remains a particularly costly means of non-enforcement.

14. *See* Kimberly D. Elsbach, *The Architecture of Legitimacy* 391, *in* THE PSYCHOLOGY OF LEGITIMACY (John T. Jost & Brenda Major eds., 2001) (arguing that firms may use legitimacy as a tool to attract and retain important stakeholders, such as employees, customers, industry analysts, media representatives, and investors). Firms might choose to implement ineffective compliance systems for two basic reasons. First, legal violations may be profitable if the legal system under-enforces, either because penalties are set too low or because detection is imperfect. *See* Donald C. Langevoort, *Monitoring: The Behavioral Economics of Corporate Compliance with Law*, 2002 COLUM. BUS. L. REV. 71, 80 (2002) [hereinafter Langevoort, *Monitoring*]; Kimberly D. Krawiec, *Accounting for Greed: Unraveling the Rogue Trader Mystery*, 79 OR. L. REV. 301 (2000) [hereinafter Krawiec]. Second, ineffective compliance may represent a principal-agent problem in which the management agents derive the benefits of misconduct, but suffer few of the losses. Langevoort, *Monitoring*, *supra*, at 80.

15. Organizations currently invest substantial resources in various types of internal compliance structures. *See, e.g.*, Richard S. Allen & Kendyl A. Montgomery, *Applying an Organizational Development Approach to Creating Diversity*, 30 (2) ORG. DYNAMICS 149, 151 (2001) (stating that "U.S. companies spend an estimated $200 to $300 million a year on diversity training programs" that "meet with mixed results or even failure"); P.E. Murphy, *Corporate Ethics Statements: Current Status and Future Prospects*, 14 J. BUS. ETHICS 727 (1995) (stating that since the 1970s, "corporations have invested a substantial amount of energy in revising their ethics statements"); Harvey L. Pitt & Karl A. Groskaufmanis, *Minimizing Corporate Civil and Criminal Liability: A Second Look at Corporate Codes of Conduct*, 78 GEO. L.J. 1559, 1634 (1990) (stating that "adopting corporate codes (and the compliance programs that inevitably accompany them) is costly").

As might be expected, numerous legal compliance professionals have arisen to fill this demand. *See, e.g.*, HELEN HEMPHILL & RAY HAINES, DISCRIMINATION, HARASSMENT, AND THE FAILURE OF DIVERSITY TRAINING: WHAT TO DO NOW 4 (1997) [hereinafter HEMPHILL & HAINES] (stating that more than 5000 diversity trainers and consultants were in existence in 1995, and discussing interviews with human resource managers who reported receiving up to thirty brochures a week from diversity specialists).

by top management's dedication to ethical corporate behavior, a corporate culture that reflects that commitment, and an incentive structure that is compatible with and reinforces the goal of legal compliance, are forced to adopt costly additional internal compliance structures in order to avoid the risk of harsh penalties when violations occur—as they inevitably will for any large organization, management's good intentions notwithstanding.[16]

Because internal compliance structures are a liability determinant in so many legal regimes, this realization has important implications for a wide variety of fields, including environmental, tort, employment discrimination, corporate, securities, and health care law. This Article, however, will focus primarily on the impact of compliance-based liability determinants in three legal fields: organizational sentencing under the Organizational Sentencing Guidelines (the "OSGs"); enterprise and director liability under corporate and securities law, including the recent modifications made by the Sarbanes-Oxley Act; and employer liability under equal employment opportunity ("EEO") law.[17]

This Article pays special attention to the development of internal compliance-based liability standards under EEO law because compliance-

16. Each of these factors—management's commitment to corporate ethics, organizational culture, and institutional incentive structure—have been determined to significantly influence the level of organizational misconduct. *See, e.g.*, MARSHALL CLINARD, CORPORATE ETHICS AND CRIME: THE ROLE OF MIDDLE MANAGEMENT 132-36 (1983) (finding that, in interviews with 64 retired managers of Fortune 500 corporations, behavior and philosophy of top management was most commonly asserted as the primary reason for illegal employee behavior); Jeff Allen & Duane Davis, *Assessing Some Determinant Effects of Ethical Consulting Behavior: The Case of Personal and Professional Values*, 12(6) J. BUS. ETHICS 449 (1998) (finding that corporate culture and reward systems—rather than ethics codes—impact employee behavior); Anita Jose & Mary S. Thibodeux, *Institutionalization of Ethics: The Perspectives of Managers*, 22 J. BUS. ETHICS 133, 139 (1999) (finding that 98.8% of managers surveyed ranked top management support and that 93% ranked corporate culture above factors such as conduct codes and training programs as important in encouraging ethical corporate conduct); Gary R. Weaver et al., *Integrated and Decoupled Corporate Social Performance: Managerial Commitments, External Pressures, Corporate Ethical Practices*, 42(5) ACADEMY OF MGMT. J. 539, 547 (1999) (finding that top management support for ethics programs is more important in deterring misconduct than are external forces such as the OSGs, which tend to promote only formal window dressing changes, including ethics codes, that are not integrated into organizational activities). Other statistically significant factors include: financial pressure, organizational size, complexity, and decentralization, and industry concentration. *See, e.g.*, Marie McKendall et al., *Ethical Compliance Programs and Corporate Illegality: Testing the Assumptions of the Corporate Sentencing Guidelines*, 37 J. BUS. ETHICS 367, 376 (2002) (finding that lower firm profitability is positively associated with firm OSHA violations) and at 368 (discussing earlier studies that find illegal activity is more likely in firms facing financial pressure) [hereinafter McKendall et al.]; Marie A. McKendall & John A. Wagner, III, *Motive, Opportunity, Choice, and Corporate Illegality*, 8(6) ORG. SCI. 624, 644 (1997) (finding that organizational size, structure, complexity, and industry concentration are significant factors in predicting corporate illegality).

17. EEO law includes Title VII, as well as other relevant anti-discrimination statutes such as the Americans with Disabilities Act and the Age Discrimination in Employment Act. *See infra* note 52.

based liability has developed more quickly in the EEO field, has been litigated more often, and has been subject to more empirical testing by academic researchers in a variety of fields, including law, economics, sociology, and psychology. As a result, these EEO legal developments and the academic commentary assessing them hold great importance for other legal regimes that regulate organizational conduct.

This Article also seeks to explain the means by which a governance mechanism so consistent with the precepts of the negotiated governance model could produce a result so inconsistent with that model's predictions of more effective governance. As will be explained, consistent with the negotiated governance model, the governance process may be usefully analyzed as a series of repeated interactions in which a variety of groups with a stake in the governance process—including courts, legislatures, regulatory agencies (collectively, "policy makers"), the regulated group (in this case, business organizations), private interest groups, and legal compliance professionals—negotiate the meaning of ambiguous or incomplete law. To borrow the contractual metaphor employed by other legal scholars, analyzing the governance process as a set of related contracts is a useful analytical tool that highlights the roles played by the aforementioned groups in collectively constructing law.

Because any law—like any contract—is necessarily incomplete, however, these actors are left to fill in legal gaps during the implementation and enforcement phases of governance, creating an opening for opportunistic behavior that may appropriate any social gains created by new legal standards and frustrate the normative goals of law. In particular, this gap-filling process proves to be an important mechanism by which various actors outside of the regulated organization (for example, lawyers and consultants) and within it (for example, senior management, division managers, internal compliance and human resources personnel, and in-house legal departments) advance their own interests. As a result, large segments of the internal compliance-based liability regime can be attributed to the gap-filling of incomplete law with terms favorable to those parties most influential in this gap-filling process: organizational defendants and legal compliance professionals.

The remainder of this Article proceeds as follows. Part II.A discusses the internal compliance structures commonly employed by business organizations, which tend to mirror the recommendations of the OSGs. Part II.B then presents a brief history of the rise of compliance as an industry, beginning with the defense contracting scandal of the 1980s and its impact on the OSGs, which were developed shortly thereafter. Part III discusses the role of internal compliance structures in other parts of the U.S. legal regime,

concentrating specifically on corporate and securities law in Part III.A, and on employment discrimination law in Part III.B.

Part IV demonstrates that, despite the legal regime's heavy reliance on internal compliance structures as a liability determinant, little evidence exists concerning their effectiveness as deterrence mechanisms. Part IV then analyzes the empirical evidence relating to three types of internal compliance structures—ethics codes, the OSG-recommended internal compliance structures, and diversity training—and concludes that insufficient evidence exists as to their effectiveness to support the legal regime's embrace of such structures as liability mitigators.

Part V locates the rise of internal compliance structures as an important feature of the U.S. legal regime within the broader negotiated governance literature, arguing that the negotiated governance model provides important descriptive insights into the development of much legal policy. Part VI demonstrates, however, that to the extent governance is properly understood as a set of related contracts or negotiated relationships, such contracts and relationships are highly incomplete. Insights from the literature on incomplete contracts thus implies that these incomplete contractual relationships present the danger of rent-seeking behavior by private parties during renegotiation—that is, during the implementation and enforcement phases of governance.

Part VII ties together the Incomplete Contracts Governance Theory developed in Part VI and the analysis of internal compliance structures as a liability determinant developed in Parts III and IV through a specific illustration: the rise of grievance procedures as a liability mitigator under EEO law. Part VIII concludes.

II. COMPLIANCE AS AN INDUSTRY

A. Internal Compliance Structures Defined

The internal compliance structures adopted by most business organizations share several common features, which are derived from the OSGs' minimum requirements for an effective compliance program.[18] First, an effective internal compliance structure contains a written ethics code or similar code of conduct that sets forth the ostensible limits of acceptable

18. McKendall et al., *supra* note 16, at 372 (stating that "[t]he kinds of ethical compliance programs detailed in the Sentencing Guidelines mirror the type of advice that has been offered to organizations about how to promote the type of ethical climate that will positively affect employee behavior.").

behavior within the firm.[19] Many corporate codes of conduct also describe mechanisms of code enforcement, such as internal reporting and information gathering, policies regarding the investigation of reported violations, whistleblowing procedures and policies for protecting whistleblowers against retaliation, and internal procedures and sanctions for conduct or ethics code violations.[20] In addition, many organizations also have an EEO code that sets forth the organization's commitment to equal hiring practices.

Second, the organization must take steps to ensure that the code is communicated to employees and other agents, for example, through training programs designed to familiarize personnel with the code, and/or through dissemination and publication of the code.[21] Common mechanisms for dissemination include company newsletters, employee manuals, and organization websites.[22] In the EEO context, this commonly takes the form of diversity or "sensitivity" training.

Third, an effective internal compliance structure will contain monitoring and auditing systems reasonably designed to detect prohibited conduct by employees and other agents.[23] Fourth, effective internal compliance requires the presence of a reporting system that enables employees to report violations of the conduct code or of laws and regulations by others within the organization without fear of reprisal.[24] In the EEO context, this may take the form of internal grievance procedures, adopted by many organizations as a forum through which employees can voice their concerns about discriminatory conduct. Finally, specific, high-level personnel within the organization must have responsibility for oversight of compliance with the conduct code.[25]

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19. U.S. SENTENCING GUIDELINES MANUAL § 8A1.2(k)(1) (2001).

20. Andrew Brien, *Regulating Virtue: Formulating, Engendering and Enforcing Corporate Ethical Codes*, 15(1) BUS. & PROFESSIONAL ETHICS J. 21 (1996) [hereinafter Brien]; Richard S. Gruner, *Developing Judicial Standards for Evaluating Compliance Programs: Insights from EEO Litigations*, 1317 PLI/CORP. 162, 169 (2002) [hereinafter Gruner].

21. U.S. SENTENCING GUIDELINES MANUAL § 8A1.2(k)(4) (2001).

22. Gruner, *supra* note 20, at 177.

23. U.S. SENTENCING GUIDELINES MANUAL § 8A1.2(k)(5) (2001).

24. *Id.*

25. U.S. SENTENCING GUIDELINES MANUAL § 8A1.2(k)(2) (2001). Other necessary minimum steps listed in the U.S. Sentencing Guidelines Manual include: the organization must have used due care not to delegate authority to employees with a propensity to engage in illegal activities; once a violation has been detected, the organization must take all reasonable steps to respond appropriately to the offense and to prevent further similar offenses; and the code of conduct must have been consistently enforced. U.S. SENTENCING GUIDELINES MANUAL § 8A1.2(k) (2001).

B. A Short History—The Organizational Sentencing Guidelines

Although one could argue that the "compliance industry" began, not with business, but with government in the wake of the Watergate scandal,[26] the real rise of compliance as big business is usually traced to the defense contracting scandal of the mid-1980s.[27] With the disclosures by a defense department whistle-blower of fraud, overbilling, and kickbacks by government defense contractors, fifty-five contractors agreed to adopt ethics codes and internal ethics officers, in a largely successful effort to fend off federal regulators.[28]

The agreement, termed the Defense Industry Initiative (or, "DII") required each of the signatories to:

> [A]dopt a written code of conduct, to conduct employees orientation and training with respect to the code, to provide employees with a mechanism (such as a hotline or helpline) to surface concerns about corporate compliance with procurement laws and regulations, to adopt procedures for voluntary disclosure of violations of federal procurement laws, to participate in best practices forums, and to make public information which shows the commitment to do all of these things.[29]

Shortly after implementation of the DII, the U.S. Sentencing Commission began debate on the OSGs, and representatives of the DII testified before the

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26. PETER W. MORGAN & GLENN H. REYNOLDS, THE APPEARANCE OF IMPROPRIETY 73-98 (1997) [hereinafter MORGAN & REYNOLDS].

27. Lisa Girion, *Interest in Corporate Ethics is Still Weak*, L.A. TIMES, July 8, 2002, at C1 [hereinafter Girion]. *See also* The Defense Industry Initiative on Business Ethics and Conduct, *Origins and Development of the Defense Industry Initiative*, *at* http://www.dii.org/annual/2000/origins.html. Harvey Pitt and Karl Groskaufmanis, however, attribute the rise of internal compliance structures to the price-fixing scandals in the heavy electrical equipment industry in the 1960s and to Judge J. Cullen Ganey's sentencing of General Electric, in particular. *See* Pitt & Groskaufmanis, *supra* note 8, at 1580-82.

28. Girion, *supra* note 27; Andy Pasztor & Lucette Lagnado, *Health Care: Ethics Czar Aims to Heal Columbia*, WALL ST. J., Nov. 26, 1997, at B1 [hereinafter Pasztor & Lagnado].

29. DEFENSE INDUSTRY INITIATIVE ON BUSINESS ETHICS AND CONDUCT, 2000 ANNUAL REPORT 1 (2000). The impetus for the DII arguably came from the February 28, 1986 Interim Report of the Packard Commission, which stated, "defense contractors must promulgate and vigilantly enforce codes of ethics that address the unique problems and procedures incident to defense procurement. They must also develop and implement internal controls to monitor these codes of ethics and sensitive aspects of contract compliance." *Id.* at 1-2.

The DII was later copied by other troubled industries, including the health care industry, which has been plagued repeatedly by Medicare fraud and drug company kickback scandals. Pasztor & Lagnado, *supra* note 28. Interestingly, Alan Yuspeh, a primary engineer of the defense industry initiative, was also the drafter of some of the medical industry voluntary-compliance efforts. *Id.*

Commission as to the content and impact of the DII model.[30] A few years later, in 1991, the compliance industry received its most important boost when the U.S. Sentencing Commission passed the OSGs (referred to by some industry insiders as "The Ethics Consultants Full Employment Act of 1991").[31]

For all practical purposes, the OSGs require companies to adopt internal compliance structures, by substantially reducing the penalties imposed on companies with such programs that are convicted of a federal crime, and substantially increasing the penalties on companies without them.[32] The Commission was clearly influenced by the DII experience, as the OSGs bear a striking resemblance to the DII terms.

Interestingly, early drafts of the OSGs contained no provision for penalty reduction based on internal compliance structures. Instead, during the comment period from 1987 to 1991, the Commission initially explored two competing proposals: (1) a "just punishment" regime, based on the Commission's guidelines for individual defendants, that considered indicia of organizational culpability, such as top management involvement in the crime and organizational attempts to discipline culpable employees prior to indictment; and (2) a law and economics-based "optimal deterrence" approach that would equate the organization's financial penalty to the social harm caused by the conduct, reduced by the probability of detection.[33] Both proposals were eventually determined to be unworkable,[34] and ultimately were rejected in favor of a regime that provides substantial incentives for organizations to adopt internal compliance structures—incentives for which the business community, including the Business Roundtable, lobbied hard.[35]

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30. DEFENSE INDUSTRY INITIATIVE ON BUSINESS ETHICS AND CONDUCT, 2000 ANNUAL REPORT 27-28 (2000).

31. MORGAN & REYNOLDS, *supra* note 26, at 101 (quoting from an Aug. 14, 1996 interview with Frank Nauron, Ethics Resource Center, Washington, D.C.).

32. Paula Desio (Deputy General Counsel to the United States Sentencing Commission), *An Overview of the Organizational Guidelines*, United States Sentencing Commission, *available at* http://www.ussc.gov/TRAINING/corpover.PDF; Michele Galen, *Keeping the Long Arm of the Law at Arm's Length*, BUS. WK., Apr. 22, 1991, at 104 (quoting Professor John C. Coffee as stating that, in light of the OSGs, a failure by general counsel to implement an internal compliance program constitutes professional malpractice).

33. John R. Steer, *Changing Organizational Behavior—The Federal Sentencing Guidelines Experiment Begins to Bear Fruit* (unpublished paper presented at the Twenty-Ninth Annual Conference on Value Inquiry, Tulsa, OK (Apr. 26, 2001)), *available at* 1317 PLI/CORP. 113 (2002) [hereinafter Steer]. John R. Steer is the Vice-Chair of the United States Sentencing Commission.

34. The optimal deterrence proposal, in particular, proved difficult to implement, given the inability to accurately quantify all social harm, and the lack of reliable empirical data on the probability of detection for various offenses. *Id.*

35. Jeffrey M. Kaplan, *The Sentencing Guidelines: The First Ten Years* (2001), *available at* http://www.singerpubs.com/ethikos/kaplan%20_Guidelines%2010%20years.htm (reprinted from the

The OSGs set financial penalties for organizations convicted of a crime by establishing a base fine, which is then multiplied by a culpability score.[36] As organizational culpability increases or decreases, the base fine is multiplied by a multiplier ranging from .05 to 4.[37] As a result, the fine may be reduced to one-twentieth or increased by 400% of the original amount.

The convicted organization's internal compliance structures are extraordinarily important in reducing the culpability multiplier, because courts are instructed to reduce or increase the multiplier based on mitigating or aggravating factors, including whether the organization possessed an "effective program to detect and prevent violations of the law."[38] Assuming the absence of any aggravating factors (such as the involvement of high-level personnel in the violation or a prior history of similar misconduct), the implementation of effective internal compliance structures will reduce the organization's culpability score by three points, resulting in a significant reduction of the multiplier and a corresponding reduction of the fine by up to sixty percent.[39]

Nov./Dec. 2001 issue of ETHIKOS); McKendall et al., *supra* note 16, at 370 (discussing pressure from the business community to adopt guidelines that accounted for organizations' internal compliance structures). *See generally* William S. Lofquist, *Legislating Organizational Probation: State Capacity, Business Power, and Corporate Crime Control*, 27 L. & SOC'Y REV. 741 (1993) (discussing the lobbying activity of the Business Roundtable, National Association of Manufacturers, Chamber of Commerce, numerous corporations, and other interested public and private groups in connection with the OSGs).

36. The base fine is set at the greatest of: (1) the amount determined from the OSG "Offense Level Fine Table," which sets forth base fines ranging from $5000 to $72,500, (2) the pecuniary gain to the corporation resulting from the illegal conduct, or (3) the pecuniary loss caused by the offense, to the extent that the offense was committed intentionally, recklessly, or knowingly. U.S. SENTENCING GUIDELINES MANUAL § 8C2.4(a)(d) (2001).

37. U.S. SENTENCING GUIDELINES MANUAL § 8C2.6 (2001).

38. U.S. SENTENCING GUIDELINES MANUAL § 8C2.5 (2001). Other culpability factors include: (1) tolerance of or participation in the offense by high-level personnel, (2) the organization's prior history of similar misconduct, (3) the level of organizational cooperation in the investigation, (4) voluntary self-reporting of the violation, and (5) whether the organization accepted responsibility for the illegal conduct. *Id.*

39. *Id.* As previously discussed, the official comments to the OSGs define the minimum factors necessary for an organization's internal compliance structures to be considered "effective," and thus qualify for a reduced sentence. *See supra* notes 18-25 and accompanying text (discussing the minimum factors).

From 1994-2001, only two organizations received sentencing mitigation based on the existence of an effective internal compliance program. *See* Organizations Sentenced Under Chapter Eight: Culpability Factors, Tables 47-54, *available at* http://www.usc.gov/corp/orgizsp.htm. This should not, however, be construed either as evidence that the OSGs have been unsuccessful in inducing organizations to adopt internal compliance structures or as evidence that the OSG-recommended internal compliance structures have been so successful in reducing misconduct that few organizations that adopt such structures violate the law. In fact, survey data indicates that the OSGs have been a major influence in corporate decisions to implement internal compliance structures and the empirical evidence shows no correlation between the OSG-recommended internal compliance structures and

III. THE LEGAL LANDSCAPE

The OSGs' internal compliance-based approach to deterring organizational misconduct was quickly emulated in other legal fields. As a result, although the OSGs were the first, and in that sense, most important, legal incentive for the widespread adoption of internal compliance structures, today a wide array of civil, criminal, and regulatory provisions encourage the implementation of such structures.

For example, both the Environmental Protection Agency (the "EPA") and the Department of Health and Human Services (the "HHS") borrow heavily from the OSGs' internal compliance-based liability regime in recent policies and guidelines. Specifically, each allows for reduced civil penalties and, in some cases, recommends no criminal penalties, for companies with effective internal compliance structures.[40] Furthermore, the HHS guidelines for determining the effectiveness of compliance efforts are modeled after the OSGs' minimum steps for an effective internal compliance program.[41] More informally, the Justice Department considers firms' internal compliance

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reduced organizational misconduct. *See* 2000 Ethics Officers Association Member Survey (Public Version), *available at* http://www.eoa.org/Research/survey_2k.html (indicating that 53% of survey respondents listed "In response to Federal Sentencing Guidelines for Organizations" as a factor that had "a lot of influence" on the organization's commitment to ethics) [hereinafter 2000 Ethics Officers Association Member Survey]. *See infra* notes 85-88 and accompanying text (reviewing the empirical data concerning the effectiveness of the OSGs in deterring legal violations).

Instead, the most likely explanation for this result is that the overwhelming majority of organizations that are criminally convicted and sentenced under the OSGs are small corporations that often do not have the resources to invest in internal compliance and are ineligible for mitigation in any event because of senior management involvement in the misconduct. Large organizations, by contrast, typically have invested substantial resources in internal compliance structures and are generally able to negotiate a civil settlement or plea agreement. An examination of these agreements demonstrates that the organization's internal compliance structures play an important role in this process. *See* 2000 Ethics Officers Association Member Survey, *supra*; Steer, *supra* note 33, at 131.

40. *See* Policy Statement on Incentives for Self-Policing: Discovery, Disclosure, Correction, and Prevention of Violations, 65 Fed. Reg. 19,618 (Apr. 11, 2000). The HHS Guidelines, which are contained in separate industry-specific documents, may be accessed at http://oig.hhs.gov/faud/complianceguidance.html (providing links to compliance program guidance for, among others, pharmaceutical manufacturers, ambulance suppliers, nursing facilities, hospitals, and "Medicare + choice" organizations) [hereinafter HHS Guidelines].

41. *See id.* The Office of the Inspector General of HHS has also required substantial adoptions of internal compliance structures by organizations settling health care fraud charges. As stated by two recent commentators:

> These Agencies [the Department of Justice and HHS] have recently required all organizations settling health care fraud charges to adopt government-supervised corporate integrity programs as part of the defendants' settlement agreements. These government-imposed compliance programs usually require corporations to commit substantial assets to compliance and involve significant government and private oversight.

Thomas E. Bartrum & L. Edward Bryant, Jr., *The Brave New World of Health Care Compliance Programs* 6 ANNALS OF HEALTH L. 51, 55 (1997).

efforts both before and after the violation in determining whether to criminally charge organizations for the acts of their employees and agents, and state Attorneys General take corporate internal compliance structures into account in enforcement decisions.[42]

The Judiciary has jumped aboard the compliance bandwagon as well, providing companies with more incentives to engage in internal compliance. For example, internal compliance structures may be relevant in determining whether the employee's conduct was undertaken with an intent to benefit the corporation and thus in deciding enterprise-level civil punitive or criminal liability. The defense may be established through evidence that the corporate defendant had in place ethics codes prohibiting the conduct in question and compliance programs ostensibly designed to detect violations.[43] Business organizations are also often required to implement internal compliance structures as part of civil or criminal settlements.[44]

Finally, internal compliance structures may be a useful device for demonstrating the organization's attempts to comply with legal rules, thus painting the firm as the victim—as opposed to the perpetrator—of

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42. Memorandum written by Deputy Attorney General Eric Holder, *Bringing Criminal Charges Against Corporations* (June 16, 1999), *at* http://www.usdoj.gov/criminal/fraud/policy/Chargingcorps.html; Woo, *Self Policing Can Pay Off for Companies*, WALL ST. J., Sept. 8, 1993, at B5.

43. *See, e.g.*, U.S. v. Beusch, 596 F.2d. 871, 878 (4th Cir. 1979) (stating, "a corporation may be liable for acts of its employees done contrary to express instructions and policies, but that the existence of such instructions and policies may be considered in determining whether the employee in fact acted to benefit the corporation"); Lowry's Reports, Inc. v. Legg Mason, Inc., 2003 WL 21635302, at *6 (D.Md. 2003) (holding, "[t]he fact that Legg Mason's employees infringed Lowry's copyrights in contravention of policy or order bears not on Legg Mason's liability, but rather on the amount of statutory and punitive damages and the award of attorneys' fees"); In re Exxon Valdez, 1995 WL 527990, at *11 (D.Al. 1995) (upholding jury instructions that "you must consider whether the actions of employees were in violation of direct . . . policies of the defendant corporation" in assessing the corporation's liability for punitive damages); JEFFREY M. KAPLAN ET AL., COMPLIANCE PROGRAMS AND THE CORPORATE SENTENCING GUIDELINES § 20:9 (2002) (stating, "[c]ompliance programs have also found their way into jury instructions on the issue of whether an errant employee's actions were intended to benefit the corporation, a necessary element of vicarious liability for the corporations [sic]."). *But see* U.S. v. Twentieth Century Fox Film Corp., 882 F.2d 656, 660 (2d Cir. 1989) (holding that although internal compliance structures are one factor that may mitigate corporate criminal liability for the acts of employee agents, "Fox's compliance program, however extensive, does not immunize the corporation from liability when its employees, acting within the scope of their authority, fail to comply with the law and the consent decree.").

44. *See, e.g.*, John Hechinger, *Merrill to Pay New Hampshire a $500,000 Fine*, WALL ST. J., Jul. 19, 2002, at C7 (disclosing the terms of a Merill Lynch settlement for the acts of an employee broker under which Merill must pay a $500,000 fine and hire a consulting firm to review its compliance programs); John R. Wilke & Don Clark, *Despite Settlement, Microsoft Faces More Legal Challenges*, WALL ST. J., Nov. 4, 2002, at A1 (reporting on the terms of an antitrust settlement that, among other things, requires Microsoft to establish a compliance committee consisting of at least three members of its outside board and to appoint an internal compliance officer). *See also infra* note 53 and accompanying text (discussing compliance-based remedies as settlements in discrimination suits).

misconduct. This scapegoating defense has been especially common, though not always successful, in connection with various "rogue trading" scandals.[45]

A. Corporate and Securities Law

Corporate and securities laws also provide some incentive for the implementation of internal compliance structures. Section 15(b)(4)(E) of the Securities Exchange Act, for example, authorizes the SEC to suspend or revoke the registration of any broker/dealer that "has failed reasonably to supervise, with a view to preventing violations of the provisions of [the securities or commodities laws], another person who commits such a violation, if such other person is subject to his supervision."[46] This supervisory requirement is deemed to be met, however, so long as procedures reasonably designed to detect and prevent violations have been implemented.[47] Similar provisions are contained in the Commodity Exchange Act and in the self-regulatory organization ("SRO") rules.[48]

The Sarbanes-Oxley Act of 2002 significantly expands the importance of internal compliance structures in securities law. The Act and SEC rules implementing it, for example, require the disclosure of information relating to internal controls over financial reporting, the company's conduct and

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45. Krawiec, *supra* note 14, at 306-07 (arguing that management of financial firms may purposely foster an institutional culture that promotes rogue trading, because that same culture results in more profitable traders); Randall Smith & Susan Pulliam, *IPO 'Rogue' Battles to Clear His Name*, WALL ST. J., Sept. 17, 2002, at C1 (reporting on an imprisoned broker, who—although his employer, CSFB, alleges that he is a "rogue" who violated firm policies—claims that he is the company's scapegoat); Michael Lim Choo San & Nicky Tan Ng Kuang, The Report of the Inspectors Appointed By The Minister For Finance on Baring Futures (Singapore) Pte Ltd. at B.iv (Sept. 7, 1995) (finding, "[Baring's] claim that it was unaware that account 88888 existed, and also that the sum of S$1.7 billion which the Baring Group had remitted to BFS, was to meet the margins required for trades transacted through this account, if true, gives rise to a strong inference that key individuals of the Baring Group's management were grossly negligent, or wilfully [sic] blind and reckless to the truth.").

46. 15 U.S.C. § 78o(b)(4)(E) (2000).

47. *Id.* Section 15(b)(4)(E) of the Securities Exchange Act provides:

> No person shall be deemed to have failed reasonably to supervise any other person, if—
>
> (i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and
>
> (ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.

Id.

48. *See, e.g.*, NASD Rules of Fair Practice, art. III, § 27 (requiring NASD members to establish and maintain a system to supervise employees); N.Y. Stock Exchange Rule 342.21 (requiring that trades be subjected to review procedures); Chicago Board of Options Exchange Rules 4.2 and 9.8; 17 C.F.R. § 166.3 (2000).

ethics codes, and whether the company has an audit committee meeting certain criteria.[49]

In addition, under the Delaware Chancery Court's 1996 *Caremark* decision, corporate directors may face civil liability for failures to implement internal compliance structures.[50] Although this liability risk may by slight, it has been argued that corporate boards—at the urging of legal professionals—may have overestimated the risk of personal liability.[51]

B. Employment Discrimination

Despite the importance of the OSGs, the legal arena that perhaps has had the greatest impact on the implementation of internal compliance structures is the employment discrimination area, especially the law of workplace harassment.[52] Because compliance-based liability standards are developing more quickly in the employment discrimination field than elsewhere, there has been greater judicial and academic assessment of the success of a

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49. 15 U.S.C.A. §§ 7262, 7264, 7265 (West 2002). *See also* 17 C.F.R. § 229.308 (2003); 17 C.F.R. § 229.406 (2003) and § 229.401 (2003).

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

51. Chancellor Allen painted the liability risk as relatively inconsequential, holding that "only a sustained or systematic failure of the board to exercise oversight" such as "an utter failure to attempt to assure that a reasonable information and reporting system exists" would lead to director liability. *Caremark*, 698 A.2d at 970. *See also* Cindy Alexander et al., *Regulating Corporate Criminal Sanctions: Federal Guidelines and the Sentencing of Public Firms*, 12 FED. SENT. REPT'R, No. 1, at 20 (1999); Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L.J. 797, 819-20 (2001) (arguing that boards of directors have overestimated the threat of personal liability under Caremark) [hereinafter Langevoort].

52. Employment discrimination is governed by a variety of statutes, rules, and regulations. The most important of these is Title VII of the Civil Rights Act of 1964, which prohibits employment discrimination on the basis of "race, color, religion, sex, or national origin." 42 U.S.C. § 2000e-2(a)(1) (1994 & Supp. 2003). In addition to Title VII's prohibitions against workplace discrimination, the Age Discrimination and Employment Act and the Americans with Disabilities Act prohibit employment discrimination on the basis of age and disability, respectively. Age Discrimination in Employment Act of 1967, 29 U.S.C. §§ 621-634 (1988 & Supp. V 1993); Americans with Disabilities Act, 42 U.S.C. §§ 12,101-12,213 (Supp. V 1993). Other relevant anti-discrimination laws include the Family and Medical Leave Act of 1993, 29 U.S.C. § 2601 (2000); several post-reconstruction civil rights laws, 42 U.S.C. §§ 1981, 1981(a), 1983, 1988; executive orders under Presidents Kennedy and Johnson; the rules, regulations, and interpretations of the Equal Employment Opportunity Commission; and various state statutes. *See* Elizabeth Chambliss & Lauren B. Edelman, *Sociological Perspectives on Equal Employment Law*, *in* LAW'S DISCIPLINARY ENCOUNTERS: READINGS IN LAW AND SOCIAL SCIENCE (Victoria Saker Woeste, Bryant G. Garth, & Robert L. Nelson eds., forthcoming U. of Chicago Press, 2003).

compliance-based liability system in deterring employment discrimination than in other fields of law. As a result, the role of internal compliance structures in the employment discrimination context is extremely important because it provides insights for employers implementing other types of compliance structures and for courts evaluating those structures. In addition, if, as seems likely, the standard for enterprise liability in other legal areas becomes more dependant on the presence of internal compliance structures, these discrimination cases and academic commentary will assume greater importance to other fields.

A firm's internal compliance structures are relevant in the employment discrimination context in at least three ways.[53] First, internal compliance structures may operate as a defense against punitive damages when an employee claims that she has been the victim of intentional discrimination. Second, internal compliance structures may serve as an affirmative defense against enterprise liability when an employee alleges that she has been the victim of hostile work environment harassment. Third, and less obviously, the existence and efficacy of the employer's internal compliance structures may be examined—along with other circumstantial evidence—to determine whether the employer harbored discriminatory intent.

1. Punitive Damages

In the Civil Rights Act of 1991, Congress provided plaintiffs alleging violations of Title VII with additional remedies, including the possibility of punitive damages in cases successfully alleging intentional discrimination.[54] In *United States v. Kolstad*, the Supreme Court referred to the Restatement (Second) of Agency to establish four instances in which employers may be liable for punitive damages for the acts of their agents:

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53. Courts may also require employers found guilty of discrimination to implement codes of conduct and training procedures as a remedy. *See, e.g.*, Stair v. Lehigh Valley Carpenters Local Union No. 600, 855 F. Supp. 90 (E.D.Pa. 1994) (requiring a union found guilty of sexual harassment to institute mandatory yearly training programs for local members); Matt O'Connor, *Pizza Hut to Fight Bias in Chain*, CHI. TRIB., Aug. 21, 1999, at C1 (reporting agreement by Pizza Hut to provide "racial-sensitivity" training to each of its more than 100,000 employees who may come into contact with customers as part of a legal settlement with African American customers alleging discrimination at one Illinois restaurant).

54. 42 U.S.C. § 1981a(a)(1) (2000). In order to collect punitive damages, the complaining party must show that the defendant "engaged in a discriminatory practice or discriminatory practices with malice or with reckless indifference to the federally protected rights of an aggrieved individual." 42 U.S.C. § 1981a(b)(1) (2000).

> (a) [T]he principal authorized the doing and the manner of the act, or (b) the agent was unfit and the principal was reckless in employing him, or (c) the agent was employed in a managerial capacity and was acting in the scope of employment, or (d) the principal or a managerial agent of the principal ratified or approved the act.[55]

Arguing that the Restatement's "scope of employment" rule created "perverse incentives," however, the Court established a defense to punitive damages based on the actions of managerial agents under instance (c). Employers who are able to demonstrate good faith efforts to comply with the provisions of Title VII may thus avoid punitive damages stemming from the actions of their agents acting within the scope of their employment.[56]

Since *Kolstad*, numerous defendants have attempted to qualify for this defense by pointing to their internal compliance structures (and to their equal employment policies and diversity education programs, in particular) as evidence of good faith. Although in many cases courts have found that such procedures are inadequate to demonstrate good faith convincingly, some defendants have successfully used their internal compliance structures as a shield from punitive damages.[57] As a result, there has been an increasing emphasis during discovery on the employer's internal compliance structures, with plaintiff's lawyers and the EEOC seeking to determine how much money the employer has spent on diversity training, the content of the training sessions, and the expertise of the trainers.[58]

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55. Kolstad v. American Dental Ass'n, 527 U.S. 526, 542-43 (1999) (quoting RESTATEMENT (SECOND) OF AGENCY § 217(c)).

56. *Id*. at 545.

57. *See, e.g.*, Harris v. L & L Wings, Inc., 132 F.3d 978, 983-84 (4th Cir. 1997) (cited favorably in *Kolstad* and stating that "in some cases, the existence of a written policy instituted in good faith has operated as a total bar to employer liability for punitive damages" and further stating that "the institution of a written sexual harassment policy goes a long way towards dispelling any claim about the employer's 'reckless' or 'malicious' state of mind."); Bryant v. Aiken Regional Medical Centers, Inc., 333 F.3d 536 (4th Cir. 2003) (holding that a hospital could not be liable to African-American employees for punitive damages because the "hospital undertook wide-spread good-faith anti-discrimination efforts, including its implementation of an organization-wide antidiscrimination policy, its creation of a grievance policy, and its diversity training program, and thus it could not be vicariously liable for it managerial employees' discriminatory decisions that were contrary to its good faith efforts."); EEOC v. Wal-Mart Stores, Inc., 187 F.3d 1241, 1249 (10th Cir. 1999) (stating, "the extent to which an employer has adopted antidiscrimination policies and educated its employees about the requirements of the ADA is important in deciding whether it is insulated from vicarious punitive liability."); Jaudon v. Elder Health, Inc., 125 F. Supp.2d 153, 172 (D.Md. 2000) (finding that the defendant employer had demonstrated a good faith effort to comply with Title VII because it had "published, maintained, and distributed sexual harassment, open door, and equal opportunity policies.").

58. Ellen McLaughlin & Carol Merchasin, *Training Becomes Important Step to Avoid Liability*, 23 NAT. L.J., Jan. 29, 2001, at B10.

2. Workplace Harassment

The United States Supreme Court has recognized two forms of workplace harassment (tangible employment actions and hostile environment harassment) as forms of discrimination, and thus viable claims under Title VII.[59] The Court could hardly be clearer in its insistence that employers will be rewarded in harassment actions for the adoption of internal compliance structures, stating that, "Title VII is designed to encourage the creation of antiharassment policies and effective grievance mechanisms. Were employer liability to depend in part on an employer's effort to create such procedures, it would effect Congress' intention to promote conciliation rather than litigation in the Title VII context."[60]

Employers face liability for hostile environment harassment by their employees under three different standards:[61] (1) for co-worker hostile environment harassment, the employer is judged under a negligence standard and is liable for all harassment of which it knew (or should have known) and negligently failed to correct; (2) for supervisor hostile environment harassment of which the employer was aware, the employer is held to a negligence standard and is liable only for its own negligence in failing to properly respond to the harassment; and (3) for supervisor hostile

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59. Tangible employment actions (or, "quid pro quo" harassment) involve "a significant change in employment status, such as hiring, firing, failing to promote, reassignment with significantly different responsibilities, or a decision causing a significant change in benefits" made on the basis of any of Title VII's protected classes. "Hostile environment" harassment occurs when the employer's behavior is so severe or pervasive that, although there is no tangible harm, such as job loss or decreased pay, the behavior nonetheless alters the terms or conditions of employment in violation of Title VII. Burlington Industries, Inc. v. Ellerth, 524 U.S. 742, 761-62 (1998).

Because the employer faces strict vicarious liability for all tangible employment actions, the employer's internal procedures are not relevant in a tangible employment action, except perhaps to the extent that they can be invoked to dispute the existence of the harassment or employed as a defense to punitive damages. *Burlington Industries*, 524 U.S. at 762-63 (holding that "a tangible employment action taken by the supervisor becomes for Title VII purposes the act of the employer. . . . In that instance, it would be implausible to interpret agency principles to allow an employer to escape liability."). However, the employer's internal procedures are likely to be relevant in one form or another in all hostile environment claims.

60. *Burlington Industries*, 524 U.S. at 764.

61. B. Glenn George, *If You're Not Part of the Solution, You're Part of the Problem: Employer Liability for Sexual Harassment*, 13 YALE J.L. & FEMINISM 133, 142 (2001) [hereinafter George]. Although the Supreme Court distinguished between (and adopted differing standards for) supervisor hostile environment harassment of which the employer was aware and such harassment of which the employer remained unaware, apparently a majority of circuits have failed to appreciate this distinction and have applied the two-pronged affirmative defense to all supervisor hostile environment claims. *Id.* at 143. According to Professor B. Glenn George, the Third, Fifth, Sixth, Seventh, Eighth, and Ninth Circuits have all erroneously applied the two-pronged defense for vicarious liability to cases in which the employer was aware of the harassing conduct and thus should have been judged under a negligence standard. *Id*. at 145.

environment harassment of which the employer is unaware, the employer is vicariously liable, unless it can establish a two part affirmative defense: (a) "that the employer exercised reasonable care to prevent and correct promptly any sexually harassing behavior, and (b) that the plaintiff employee unreasonably failed to take advantage of any preventive or corrective opportunities provided by the employer or to avoid harm otherwise."[62]

In each of these hostile environment harassment claims, the employer's anti-harassment policies and internal complaint procedures will be relevant to proving knowledge, negligence, or an affirmative defense. For example, an anti-harassment policy, employee training designed to prevent harassment, and formal harassment complaint procedures may all constitute evidence that the employer was not negligent in failing to discover the harassment.[63] Similarly, these same procedures may be used to show that, despite the plaintiff's complaints of harassment, knowledge cannot be imputed to the employer.[64]

The cases in which the employer's harassment policies and procedures will be most directly relevant, however, are cases of supervisor hostile work environment harassment unknown to the employer, in which the employer may escape liability by utilizing its internal compliance structures to show that it exercised reasonable care to prevent the harassment. In adopting the two-pronged affirmative defense, the Supreme Court declined to require anti-harassment policies and compliance structures as a matter of law and never stated that such policies and structures, standing alone, are sufficient to

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62. Faragher v. City of Boca Raton, 524 U.S. 775, 807 (1998). *See also Burlington Industries*, 524 U.S. at 764 (1998) (adopting the same standard).

63. *See, e.g.*, Newton v. Shell Oil Co., 52 F. Supp.2d 366, 372 (D.Conn. 1999) (stating that an employer must provide some avenue for complaints in order to avoid liability for a negligent failure to know of existing harassment); Velez v. City of Jersey City, 817 A.2d 409, 414 (N.J.Super.A.D. 2003) (holding, "an employer may be held liable for sexual harassment under a theory of negligence based upon 'its failure to have in place well-publicized and enforced anti-harassment policies, effective formal and informal complaint structures, training, and/or monitoring mechanisms.'") (quoting Lehman v. Toys R Us, Inc., 132 N.J. 587, 621, 626 A.2d 445, 462 (1993). *See also* George, *supra* note 61, at 151 (stating that "[I]f knowledge is lacking, the court's focus is limited under Faragher/Burlington Industries to past efforts to prevent harassment, usually in the form of a well-publicized anti-harassment policy.").

64. For example, in Madray v. Publix Supermarkets, Inc., 208 F.3d 1290 (11th Cir. 2000), *cert. denied*, 531 U.S. 926 (2000), the court held that, because the employer's well-publicized anti-harassment policy specified the proper channels for harassment complaints and the plaintiff did not follow those channels, knowledge of the plaintiff's harassment could not be imputed to the employer, despite the plaintiff's informal complaints to three different management-level employees. *Id.* at 1293. *See also* Giuliani v. Stuart Corp., 512 N.W.2d 589 (Minn. App. 1994) (stating, "[w]hen companies institute written policies established to deal intelligently with allegations of sexual harassment, it is more likely that management will be informed of any impropriety occurring within the company. Companies that fail to institute such policies will naturally find themselves vulnerable to the likelihood that knowledge will be imputed to them."); George, *supra* note 61, at 151-52 (discussing *Madray*).

insulate employers from liability for supervisor hostile environment harassment. The Court, however, did highlight the importance of anti-harassment policies and internal complaint procedures in establishing the first prong of the defense, stating that "[w]hile proof that an employer had promulgated an anti-harassment policy with complaint procedure is not necessary in every instance as a matter of law, the need for a stated policy suitable to the employment circumstances may appropriately be addressed in any case when litigating the first element of the defense."[65]

Many lower courts, however, seem to have gone much further, and have treated internal compliance structures designed to eliminate harassment as both necessary and sufficient conditions for liability avoidance. For example, some lower courts have treated anti-harassment policies and internal complaint procedures as in and of themselves legally sufficient to establish the reasonableness of the employer's attempts to prevent or correct harassment.[66] As a result, some employers have been able to use internal compliance procedures as a means to escape liability for proven instances of even repeated and severe harassment. Similarly, many lower courts have seemed to treat internal compliance structures as a necessary condition for liability avoidance, ruling that defendants without such structures cannot establish the affirmative defense.[67]

Although the true extent to which anti-harassment internal compliance structures reduce employer liability is an empirical question that is only partially answered here,[68] as discussed in Part VI.B.1, legal compliance

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65. *Burlington Industries*, 524 U.S. at 745. *See also Faragher*, 524 U.S. at 807.

66. *See, e.g.*, Smith v. First Union National Bank, 202 F.3d 234, 244 (4th Cir. 2000) (stating that "[a]n employer's adoption of an effective anti-harassment policy is an important factor in determining whether it exercised reasonable care to prevent any sexually harassing behavior."); Brown v. Perry, 184 F.3d 388, 396 (4th Cir. 1999) (stating that if "there is no evidence that an employer adopted or administered an anti-harassment policy in bad faith or that the policy was otherwise defective or dysfunctional, the existence of such a policy militates strongly in favor of a conclusion that the employer 'exercised reasonable care to prevent' and promptly correct sexual harassment."); Idusuyi v. State of Tennessee Dept. of Children's Services, 2002 WL 220640, at *4 (6th Cir. 2002) (holding that the employer was entitled to judgment as a matter of law on its affirmative defense because it had a policy prohibiting sexual harassment, a complaint procedure that the plaintiff failed to use, and a two-hour training session on sexual harassment); Citroner v. Progressive Cas. Ins. Co., 208 F. Supp.2d 328, 341 (E.D.N.Y. 2002) (holding that the employer exercised reasonable care to prevent racial harassment because it had adopted an anti-harassment policy and a complaint procedure, "the Code of Conduct and Open Door Policy.").

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

68. *See infra* notes 167-87 and accompanying text (discussing the impact of the defendant employer's grievance procedures on the avoidance of enterprise-level liability for workplace harassment).

professionals have cleverly, but predictably, repackaged these lower court decisions into absolute necessities for organizations hoping to avoid huge liabilities.[69] The result is a proliferation of anti-harassment compliance structures, with very little inquiry by courts, commentators, or the legal profession into the evidence of their effectiveness as a means of harassment prevention.

3. Discriminatory Intent

Increasingly, plaintiffs alleging intentional discrimination are unable to point to direct evidence of overt animus.[70] Whether through changed social mores or increased sophistication regarding litigation, employers are unlikely today to leave a smoking gun that plaintiffs can use to demonstrate discrimination.[71] As a result, victims of discrimination are likely to rely on circumstantial evidence to prove their case.[72]

Most disparate treatment claims thus proceed under the three-part framework established by the Supreme Court in *McDonnell Douglas v. Green*,[73] under which both the plaintiff and defendant may invoke the employer's internal compliance structures (or lack thereof) in seeking to provide circumstantial evidence that the employer did or did not intentionally

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69. *See, e.g.*, Ellen McLaughlin & Carol Merchasin, *Training Becomes Important Step To Avoid Liability*, NAT'L. L.J., JAN. 29, 2001, at B10 (stating, "engaging in quality training in conjunction with a well-written policy will likely translate into successfully meeting the good-faith defense of Kolstad."); Gruner, *supra* note 20, at 163 (stating that "the liability standards in the EEO field . . . make compliance program quality the key to reducing certain forms of employer liability."). *See also infra* Part VII (discussing the role of legal professionals in constructing vague EEO law).

70. As stated by one commentator, "the sign on the door that 'Irish need not apply' or the rejection explained by the comment that 'this is no job for a woman'—are largely things of the past." Sturm, *supra* note 9 at 459-60.

71. Rosen v. Thornburgh, 928 F.2d 528, 533 (2d Cir. 1991) (stating that "an employer who discriminates is unlikely to leave a 'smoking gun,' such as a notation in an employee's personnel file, attesting to a discriminatory intent.").

72. *Id.* (stating that "[a] victim of discrimination is therefore seldom able to prove his or her claim by direct evidence and is usually constrained to rely on the cumulative weight of circumstantial evidence.").

73. McDonnell Douglas v. Green, 411 U.S. 792 (1973). Under the *McDonnell Douglas* framework, the plaintiff initially bears the burden of establishing a prima facie case of discrimination by demonstrating that she is a member of a protected class, that she was qualified for the job that is the subject of the dispute, and that she suffered an adverse employment action under circumstances giving rise to an inference of discrimination. *Id*. at 802. Once the plaintiff establishes this prima facie case, the burden then shifts to the defendant to provide a legitimate, non-discriminatory reason for the adverse employment decision. St. Mary's Honor Center v. Hicks, 509 U.S. 502, 506 (1993). If the defendant provides evidence of a legitimate non-discriminatory purpose, then the burden shifts back to the plaintiff to prove "by a preponderance of the evidence that the legitimate reasons offered by the defendant were not its true reasons, but were a pretext for discrimination." Texas Dept. of Community Affairs v. Burdine, 450 U.S. 248, 253 (1981).

discriminate against the plaintiff based on her status as a member of a protected class.[74] Although whether the presence of such internal compliance structures results in systematic differences in the likelihood and amount of employer liability for intentional discrimination is an empirical question that has not yet been answered, the important point for the purposes of this Article, as discussed in Part VI.B, is that corporate management—at the urging of a variety of legal compliance professionals—believes that such structures are important to liability determinations.

IV. EVIDENCE OF EFFECTIVENESS

As discussed in the previous section, the U.S. legal system places a heavy emphasis on internal compliance structures as a liability determinant in a wide variety of legal contexts. Presumably, this emphasis stems from an assumption that internal compliance structures are an effective means of reducing the incidence of socially undesirable conduct within organizations. This section will demonstrate, however, that this assumption—which underlies an important and ever-growing segment of the legal regime relating to organizational liability—has not withstood empirical testing.

In fact, little evidence exists at all concerning the effectiveness of internal compliance structures as a means to reduce socially harmful conduct, a fact that, in and of itself, is troubling given the legal system's enthusiastic embrace of such structures as a liability determinant. Even more disturbing, perhaps, is the fact that the evidence that does exist is decidedly mixed, with many of the most methodologically sound studies indicating the lack of effectiveness of such structures.

This section analyzes the empirical evidence regarding three types of internal compliance structures: (1) ethics or conduct codes; (2) the OSG-recommended internal compliance structures; and (3) diversity training. As will be shown, there is insufficient empirical evidence to conclude that any of these mechanisms—so enthusiastically embraced by the legal system—are effective deterrence mechanisms.

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74. Vicki Schultz, *Telling Stories About Women and Work: Judicial Interpretations of Sex Segregation in the Workplace in Title VII Cases Raising the Lack of Interest Argument*, 103 HARV. L. REV. 1749, 1789-92 (1990) (discussing the use at trial of evidence of internal compliance structures, especially affirmative action policies, to establish the lack of interest defense in sex discrimination cases). Similarly, employers' internal compliance structures may be relevant to decisions in disparate impact cases. Sturm, *supra* note 9, at 488-89.

A. Ethics Codes

Ethics codes are one of the most common internal compliance structures employed by business organizations, with over 90% of *Fortune 500* corporations reporting that they have some sort of ethics code.[75] In addition, legal compliance professionals seem to agree on the importance of establishing ethics codes that communicate the firm's commitment to lawful activity.[76]

Despite the pervasiveness of ethics codes in corporate America and the insistence by many legal compliance professionals on their importance as a deterrence tool, little evidence exists to support the theory that ethics codes modify employee behavior. Although some studies do find a significant relationship between ethics codes and employee conduct, they are often plagued by methodological problems, such as a failure to query respondents on or identify modified behavior due to the codes (as opposed to simply asking survey respondents whether they believe ethics codes are important factors affecting behavior), a reliance on hypothetical dilemmas in lab settings (as opposed to analyzing actual conduct in an employment setting), and a sole reliance on self-reporting (as opposed to documenting observable instances of employee code infractions).[77] Furthermore, these findings are contradicted by a large number of studies that find no significant relationship between ethics codes and employee conduct.[78]

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75. Brien, *supra* note 20, at 21. In addition, in a recent survey of 254 large firms, 78% responded that they had an ethics code. G. Weaver, L. Trevino, & P. Cochran, *Corporate Ethics Practices in the Mid-1990s: An Empirical Study of the Fortune 1000*, 18 J. BUS. ETHICS 283 (1999).

76. McKendall et al., *supra* note 16, at 372.

77. *See, e.g.*, Alan Kitson, *Taking the Pulse: Ethics and the British Cooperative Bank*, 15(9) J. BUS. ETHICS 1021 (1996) (interviews with 17 bank managers); Donald L. McCabe et al., *The Influence of Collegiate and Corporate Codes of Conduct on Ethics-Related Behavior in the Workplace*, 6(4) BUS. ETHICS Q. 461 (1996) (questionnaire to 328 college graduates); Margaret Anne Pierce & John W. Henry, *Computer Ethics: The Role of Personal, Informal, and Formal Codes*, 15(4) J. BUS. ETHICS 425 (1996) (questionnaire responses from 356 data processing management professionals).

78. *See, e.g.*, Jeff Allen & Duane Davis, *Assessing Some Determinant Effects of Ethical Consulting Behavior: The Case of Personal and Professional Values*, 12(6) J. BUS. ETHICS 449 (1993) (questionnaire survey of 207 national business consultants); Joseph L. Badaracco, Jr. & Allen P. Webb, *Business Ethics: A View of From the Trenches*, 37(2) CA. MGMT. R. 8 (1995) (interviews with 30 middle managers); Arthur P. Brief et al., *What's Wrong with the Treadway Commission Report? Experimental Analyses of the Effects of Personal Values and Codes of Conduct on Fraudulent Financial Reporting*, 15(2) J. BUS. ETHICS 183 (1996) (questionnaires and experiment with nearly 400 executives and controllers); Victor J. Callan, *Predicting Ethical Values and Training Needs in Ethics*, 11(10) J. BUS. ETHICS 761 (1992) (questionnaires from 226 state government employees); Margaret Anne Clark & Sherry Lynn Leonard, *Can Corporate Codes of Ethics Influence Behavior?*, 17(6) J. BUS. ETHICS 619 (1998) (questionnaires from 150 graduate and undergraduate business students). However, many of these studies suffer from the same methodological problems that beset those studies

One of the most recent and comprehensive of these studies attempts to address some of the methodological flaws associated with prior studies, by seeking to document a correlation between ethics codes and behavioral modification by employees in a corporate setting.[79] The study consisted of in-depth interviews with fifty-seven employees at four large Canadian companies.[80] The study author concluded that, although ethics codes may have the potential to alter employee behavior, "this appears to take place on very rare occasions."[81] The author found that respondents were unable to provide specific instances of behavior modification due to ethics codes and, in fact, overwhelmingly indicated that their employers' ethics codes had not altered their behavior.[82] In addition, some respondents indicated that they had never referred to their employers' corporate code.[83]

These findings, while not dispositive, call into question the legal regime's mitigation of damages based on the presence of ethics and conduct codes. Of course, ethics codes are only one type of compliance structure, and a superficial one at that. Perhaps researchers have been unable to document a link between ethics codes and ethical conduct because supporting compliance structures, such as those required by the OSGs, are necessary to deter misconduct. As discussed in the following subsection, however, this hypothesis also has not withstood empirical testing.

B. The OSGs

As previously discussed, due to advice from legal compliance professionals, organizational compliance structures tend to mirror the recommendations of the OSGs. There has been very little research, however, that seeks to determine whether these structures deter illegal conduct. Instead, most research on internal compliance structures has focused on the percentage of companies using various structures, analysis of the substantive content of ethics and conduct codes, employee surveys of their perceptions of their company's conduct codes, and self-reporting of conduct code

finding a significant relationship between ethics codes and employee conduct.

79. Mark S. Schwartz, *The Nature of the Relationship Between Corporate Codes of Ethics and Behavior*, 32 J. BUS. ETHICS 247 (2001) [hereinafter Schwartz]. Like previous studies, however, Schwartz relied on self-reporting, rather than observed conduct modifications.

80. *Id.* at 247. The subjects had spent an average of 13.4 years at their respective companies. All participants were interviewed individually. Fifty-one of the fifty-seven interviews were taped and transcribed. The average interview length was sixty-five minutes. *Id*. at 252.

81. *Id*. at 253

82. *Id*.

83. *Id*.

violations.[84] In fact, I was able to identify only three large-scale studies that seek systematically to test the assumptions of the OSG recommendations.[85]

None of the studies supported the hypothesis that the internal compliance structures recommended by the OSGs have a deterrent effect on organizational illegality. The most recent of these studies, a longitudinal comparison of the presence of OSG-recommended compliance structures and the incidence of OSHA violations, by Marie McKendall, Beverly DeMarr, and Catherine Jones-Rikkers, studied internal compliance structures that nearly mirror the OSG recommendations and found that they had no impact on corporate illegality.[86]

Indeed, the authors found empirical support for the proposition that internal compliance structures such as those recommended by the OSGs are largely window-dressing.[87] The study's one robust finding—a positive correlation between internal compliance structures recommended by the OSGs and the incidence of willful and repeat OSHA violations—led the study authors to speculate that, because willful and repeat violations are the type most likely to entail management involvement or knowledge, organizations may be using the type of internal compliance structures

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84. McKendall et al., *supra* note 16, at 373.

85. The three studies are: M. Cash Mathews, *Codes of Ethics: Organizational Behavior and Misbehavior*, *in* RESEARCH IN CORPORATE SOCIAL PERFORMANCE 107, 125 (W. Frederick ed., 1987) (examining the incidence of administrative and civil actions taken by four federal regulatory agencies against 485 corporations from 1973 through 1980 and concluding that "there is little relationship between codes of conduct [and enforcement mechanisms] and corporate violations.") [hereinafter Mathews]; Marie McKendall & John A. Wegner, III, *Motive, Opportunity, Choice, and Corporate Illegality*, 8(16) ORG. SCI. 624 (1997); McKendall et al., *supra* note 16.

86. McKendall and her co-authors included independent variables for all aspects of the OSG recommendations for an effective compliance program except one: the appointment of a specific individual with responsibility for the compliance program. McKendall et al., *supra* note 16, at 376-79.

87. *Id.* at 380. Similarly, M. Cash Mathews found an unanticipated positive correlation between certain aspects of conduct code content (such as codes that require compliance affidavits by employees or that mention "maintaining the reputation of the corporation") and the number of violations. Among several potential explanations for this finding offered by Cash is that "perhaps executives at law-abiding corporations do not feel the need to convince others of their 'good reputation.'" Mathews, *supra* note 85, at 125. *See also* Richard A. Barker, *An Evaluation of the Ethics Program at General Dynamics*, 12 J. BUS. ETHICS 165, 175-77 (1993) (finding that the ethics program at General Dynamics is intended primarily to differentiate the firm from its competitors, rather than to deter misconduct); Dove Izraeli & Mark Schwartz, *What Can We Learn From the U.S. Federal Sentencing Guidelines for Organizational Ethics?*, 17 J. BUS. ETHICS 1045 (1998) (stating that the primary purpose of internal compliance structures is to mitigate damages rather than to deter misconduct); McKendall et al., *supra* note 16, at 379 (stating that, "a growing number of researchers have charged that the purpose of corporate ethical practices is not foremost and genuinely to promote ethical behavior"); Gary R. Weaver et al., *Corporate Ethics Practices in the Mid-1990's: An Empirical Study of the Fortune 1000*, 18(3) J. BUS. ETHICS 283, 283 (1999) (finding that "the vast majority of firms have committed to the lower cost, possibly more symbolic side of ethics activity") [hereinafter Weaver et al.].

recommended by the OSGs as a mechanism to hide management involvement in or reduce enterprise liability for purposeful illegal activity.[88]

C. Diversity Training

Diversity training is becoming an increasingly common type of internal compliance structure in American businesses. A 1998 study by the Society for Human Resource Management, for example, found that seventy-five percent of firms in the Fortune 500 and thirty-six percent of other firms have a diversity training program of some sort.[89] Nonetheless, systematic study of the impact of these programs has generally not been undertaken.[90] Most diversity training programs are never subjected to orderly evaluation. Even when they are, such evaluation normally consists of qualitative feedback from participants.[91] Few attempts have been made to evaluate the impact of diversity training on employee behavior.

In a recent working paper, Katerina Bezrukova and Karen Jehn of the Wharton School reviewed twenty empirical studies published in major management, psychological, and sociological journals, and concluded that, "[h]aving reviewed the available empirical studies on the effects of diversity training programs in corporations and on campuses it is obvious that it is too soon to draw any comprehensive conclusions."[92]

Specifically, Bezrukova and Jehn found that researchers have investigated the impact of diversity training on three dependent variables: awareness of diversity issues; behavior and attitude change; and response to the diversity program.[93] Much of the empirical research revealed improvements in participants' awareness of diversity issues due to diversity training.[94]

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88. Weaver et al., *supra* note 79, at 380.

89. Richard S. Allen & Kendyl A. Montgomery, *Applying an Organizational Development Approach to Creating Diversity*, 30(2) ORG. DYNAMICS 149, 149 (2002).

90. Loriann Roberson et al., *Designing Effective Diversity Training: Influence of Group Composition and Trainee Experience*, 22 J. ORG. BEHAVIOR 871, 871 (2001) [hereinafter Roberson et al.]; Katerina Bezrukova & Karen A. Jehn, *The Effects of Diversity Training Programs* (July 2001) (working paper at 9, on file with author) [hereinafter Bezrukova & Jehn].

91. Roberson et al., *supra* note 90, at 872.

92. Bezrukova & Jehn, *supra* note 90, at 16.

93. *Id*. at 9.

94. *See* Bezrukova & Jehn, *supra* note 90, at 10-11. *See also* Heidi Tarr Henson, *Gauging the Outcomes of Organizational Diversity Implementations: The Intersection of Attitudes, Awareness, and Behavior*, 60(7-A) DISSERTATION ABSTRACTS INT'L 2,325 (2000) (finding that diversity training achieved an awareness of diversity issues, but did not result in attitudinal changes) [hereinafter Henson]; Dick Wallace Kracht, *Diversity Training Among Manufacturing Companies: Reaction and Learning in a For-Profit and Not-for-Profit Work Environment*, 59(7-A) DISSERTATION ABSTRACTS INT'L 2,345 (1999) (finding an increase in perceived learning among 141 employees after diversity training); J. Mausehund et al., *Diversity Training: Effects of an Intervention Treatment on Nonverbal*

However, the studies provided little empirical support for the proposition that diversity training contributes to attitudinal or behavioral changes.[95]

Finally, anecdotal evidence as well as some formal studies document a backlash against diversity training that undermines the goal of increasing tolerance toward racial, gender, and cultural diversity.[96] At the same time, some other studies document generally positive reactions to diversity training by program participants.[97]

Awareness, 58(1) BUSINESS COMMUNICATION Q. 27 (1995) (finding a positive link between diversity training and awareness of nonverbal factors in interpersonal communications between people from different cultures); Dana Yavette Law, *An Evaluation of a Cultural Diversity Training Program*, 59 (5-B) DISSERTATION ABSTRACTS INT'L 2,468 (1998) (finding improved awareness of diversity issues in training group relative to control group); David L. Tan et al., *Changes in Attitude After Diversity Training*, 50(9) TRAINING & DEVELOPMENT 54 (1996) (finding a significant increase in diversity awareness in 739 managers after diversity training workshops).

95. *Compare* Taylor Cox, Jr., *The Multicultural Organization*, 5(2) ACADEMY OF MGMT R. 34 (1991) (finding that "Race Relations Competence Workshops" resulted in more positive attitudes toward African-Americans and better inter-race relations among workshop participants) *with* Sara Rynes & Benson Rosen, *What Makes Diversity Programs Work?* 39(10) H.R. MAGAZINE 67 (1994) (surveying 785 members of the Society for Human Resource Management and finding positive short term impact of diversity training on attitudes, but less positive long-term benefits); Diane Marie Govern, *The Effect of Diversity Awareness Training on Oral Presentation Ratings*, 58(10-B) DISSERTATION ABSTRACTS INT'L 5,681 (1998) (finding no correlation between diversity training and ratings of oral presentations by black and white police sergeant candidates); Henson, *supra* note 94 (finding no attitudinal change in respondents from diversity training). Bezrukova and Jehn, *supra* note 90, also reviewed five studies that tested the impact of diversity training programs on college campuses. Although four studies found a small positive correlation between diversity training and attitudes toward ethnic minorities, the authors attributed this variation to self-selection bias, rather than to a real change in attitudes. The other study found no correlation between diversity training and racial attitudes. *Id.* at 12-13.

96. *See, e.g*., HEMPHILL & HAINES, *supra* note 15. Hemphill and Haines questioned over 500 executives, managers, and directors, and over 100 diversity consultants at sixty-five companies. *Id*. at 1 & 5. They document a considerable backlash against diversity training and a belief by many senior managers that such training fails to reduce harassment and discrimination. An example of comments that they describe as typical is, "every white man in my workforce went ballistic over the diversity training program I brought in last month." *Id*. at 1. *See also* Michael Mobley & Tamara Payne, *Backlash: The Challenge of Diversity Training*, 46(12) TRAINING AND DEVEL. 46 (1992) (stating that "in our own diversity training work we have found backlash subtly sabotaging efforts to provide team-oriented, flexible organizations."); Stephen Paskoff, *Ending the Workplace Diversity Wars*, TRAINING, Aug. 1996, at 43 (stating that "[m]any of today's programs are a waste of valuable time" and further asserting that "thousands of managers have similar attitudes").

97. *See* Bezrukova & Jehn, *supra* note 90, at 13-14 (discussing the available studies). Further compromising the effectiveness of diversity training is the fact that frank discussions of stereotypes and prejudices during diversity training can lead to angry disagreements and, in some cases, lawsuits. Some of the statements made by managers and employees during these sessions have been admitted as evidence of discriminatory intent in EEO cases. *See, e.g.*, Stender v. Lucky Stores Inc., 803 F. Supp. 259, 292-93 (N.D. Cal. 1992) (admitting into evidence management statements regarding gender stereotypes made in response to a request by a consultant for an example of a stereotype during a meeting on the company's non-discriminatory promotion and hiring practices); HEMPHILL & HAINES, supra note 15, at 1 (quoting a business executive as stating that a diversity training session in which participants were encouraged to discuss stereotypes produced angry employees and evidence in several discrimination lawsuits). As a result, legal compliance professionals now encourage a more

V. INTERNAL COMPLIANCE AS NEGOTIATED GOVERNANCE

Given the lack of empirical support for internal compliance structures as effective deterrence mechanisms, the question must be answered: what explains their enthusiastic embrace by the legal system? In other words, a close analysis of the growth of internal compliance structures as a liability determinant has far-reaching implications beyond the criticism of existing legal policy—it also provides an illustrative case study of the mechanisms by which flawed legal policy develops.

This Part V argues that the United States legal regime's current focus on internal compliance structures as a liability determinant is part of a larger trend toward "negotiated governance" that seeks to improve regulation by providing a greater governance role to the regulated group and other interested parties. Although these negotiated governance models vary in their particulars, they share two common themes. First, all assert that regulation should be more co-operative and collaborative, and less authoritative. Second, each rests on an assumption that greater involvement in the governance process by a variety of interested groups—including the regulated group—will produce a more effective regulatory regime.

This Article accepts much of the negotiated governance models' descriptive claims regarding the mechanisms by which legal policy is often made in the United States. As noted by Professor Jody Freeman, both critics and advocates of negotiated governance, focused on normative arguments regarding the desirability of private actors in the governance process, often ignore the extent to which modern regulation already resembles the negotiated governance model.[98]

This Article, however, rejects the negotiated governance models' benign view of the impact of private actors on the governance process. As discussed in this Part V, the various negotiated governance models largely fail to address an important point: to the extent that governance is properly analyzed as a set of negotiated relationships or related contracts,[99] the inability (and,

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"sterilized" version of diversity training, in which management is discouraged from openly expressing any views that might be usable in litigation and all training materials are prepared with an eye toward litigation. *See, e.g.*, Ellen McLaughlin & Carol Merchasin, *Training Becomes Important Step to Avoid Liability*, NAT'L L.J., Jan. 29, 2001, at B10 (advising management to create "jury worthy" training sessions, refrain from discussing prejudices or stereotypes, and to draft all training materials "with an eye toward possible discovery in litigation.").

98. Freeman, *Private Role*, *supra* note 9, at 547 (noting that the "longstanding tradition of private participation in governance" in the United States has been "barely noticed by the public, acknowledged by politicians, or scrutinized by scholars") and at 555 (arguing that "administrative law scholarship mostly ignores the private role in administration.").

99. Like Jody Freeman, who also explicitly adopts the contractual metaphor in analyzing the

sometimes, unwillingness) of policymakers to perfectly specify all contract terms means that these contracts or relationships are highly incomplete.[100] As a result, the regulated group (with the assistance of legal compliance professionals) is left to fill in these contractual gaps, through the formal or informal development of standard norms and practices. Accordingly, much—though not all—of the internal compliance-based liability regime results from court or regulatory agency approved industry responses to vague or incomplete law, a phenomenon referred to here as an "Incomplete Contracts Governance Theory."

This is not to imply that advocates of negotiated governance fail to appreciate the connection between incomplete law and negotiated governance. To the contrary, some of the model's most prominent advocates explicitly note that much negotiated governance results from legal incompleteness.[101] Far from seeing this as a potentially dangerous opportunity for strategic renegotiation as implied by the incomplete contracts literature, however, advocates of negotiated governance applaud legal incompleteness as a mechanism that encourages more creative solutions to governance problems.[102]

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governance relationship, I adopt the contractual analogy without implying that formal contracts exist or that contractual terms are explicitly negotiated or renegotiated. *Id.* at 571. Instead, "the point is simply that every aspect of policymaking, implementation, and enforcement depends on the combined efforts of public and private actors." *Id.*

100. One notable exception is J. GREGORY SIDAK & DANIEL F. SPULBER, REGULATORY TAKINGS AND THE DEREGULATORY CONTRACT (1998). Professors Sidak and Spulber refer to state public utility regulation as a "contract between the state and the regulated company," and acknowledge that this contract is highly incomplete. *Id*. at 101, 104-05. However, Professors Sidak and Spulber focus solely on the possibility of opportunistic behavior by the government regulator during the renegotiation process, and do not address the possibility of opportunistic behavior by the regulated group or other interested parties. *Id.* at 105-08. I do not mean to imply in this Article that policymakers never behave opportunistically during the renegotiation of incomplete regulatory contracts. Instead, my thesis is that the regulated group and others with an interest in filling out the incomplete contract terms, such as legal compliance professionals, will often behave opportunistically as well.

101. *See, e.g.*, Dorf, *supra* note 9, at 886 (stating that "[w]hen experimentalist courts must resolve the most contentious questions the legal system poses, they give deliberately incomplete answers. Thus, in prospect at least, experimentalist appellate courts that declare rights based on irreducibly ambiguous authority deliberately include ambiguity in their own pronouncements by establishing frameworks for resolution rather than anything like comprehensive blueprints."); Sturm, *supra* note 9, at 475 (arguing that "second generation problems cannot be reduced to a fixed code of specific rules or commands that establishes clear boundaries governing conduct.").

102. *See* Dorf, *supra* note 9, at 960 (arguing that problem-solving courts can operate as a solution to the problem of legal indeterminacy, because they create open-ended solutions that provide room for the affected parties to create workable solutions); Sturm, *supra* note 9, at 475 (arguing that "[r]ules developed externally and imposed unilaterally, whether by courts or regulatory bodies, cannot adequately govern the range of circumstances implicated by the general principal of non-discrimination" and arguing that the resolution of such problems requires problem solving, rather than clear and specific rules governing conduct).

For example, Professor Michael C. Dorf recently has argued that, rather than seeking theories to justify judicial interpretation of ambiguous texts, scholars and judges should seek to minimize the sphere of legal ambiguity through collaboration with other institutions, groups, and actors to reach workable solutions.[103] Dorf advocates the Supreme Court's approach in sexual harassment cases, which he argues "places courts in the role of monitoring employers' monitoring of the their workplaces," and the OSG approach to corporate misconduct as examples of the type of "experimentalist" or "problem-solving" approach that courts and agencies should adopt when faced with statutory ambiguity.[104]

Professor Dorf's proposal is closely related to recent fieldwork by Professor Susan Sturm, who compiles case studies of three employers experimenting, for a variety of reasons, with programs designed to reduce discrimination and harassment in the workplace and to retain or promote employees from underrepresented demographic groups.[105] Sturm concludes that, because successful strategies to combat "second generation" employment discrimination must be customized to fit the needs of each individual work setting, successful solutions must be internally generated. Externally-mandated solutions, by contrast, will not be "sufficiently sensitive to context or integrated into the day-to-day practice that shapes their implementation" to truly alter workplace customs and habit. As a result, laws governing such behavior should be flexible and open-ended, rather than specific and authoritative.[106]

Other proponents of negotiated governance embrace the model (and, sometimes, the contractual metaphor) without explicitly broaching the topic of legal incompleteness. For example, Professors Ian Ayres and John Braithwaite rely on civic republican theory[107] to advocate a system of

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103. Dorf, *supra* note 9, at 960.

104. *Id.* at 962-63 (discussing the Supreme Court's sexual harassment rulings) and at n.305 (discussing the OSGs).

105. The three employers are: Deloitte & Touche, Intel Corporation, and Home Depot. Sturm, *supra* note 9, at 492-520.

106. *Id.* at 475. To Sturm's credit, she does recognize the danger that "lower courts and lawyers may undercut the promise of [the problem-solving approach] by rubber stamping ineffective internal processes." *Id.* at 484. My criticism is merely that her optimism about the Supreme Court's approach to EEO law may be unwarranted, given the extent to which this has already occurred. My goal is thus not to question the results of Sturm's study, but their generalizability.

107. Civic republicanism contemplates that the parties to the lawmaking process—regulators and interest groups alike—do not act solely in their selfish best interests, but instead share a sense of "public spiritedness" that results in some collaborative decision regarding the best regulation to further the mutually shared goals identified during the regulatory process. CASS R. SUNSTEIN, AFTER THE RIGHTS REVOLUTION: RECONCEIVING THE REGULATORY STATE 12 (1990); Steven P. Croley, *Theories of Regulation: Incorporating the Administrative Process*, 98 COLUM. L. REV. 1, 76-78 (1998)

enforced self-regulation that "subcontracts" out to regulated firms much of the responsibility for their own regulation.[108] According to Ayres and Braithwaite:

> [E]nforced self-regulation envisions that in particular contexts it will be more efficacious for the regulated firms to take on some or all of the legislative, executive, and judicial regulatory functions. As self-regulating legislators, firms would devise their own regulatory rules; as self-regulating executives, firms would monitor themselves for noncompliance; and as self-regulating judges, firms would punish and correct episodes of noncompliance.[109]

Of all the negotiated governance advocates, however, it is perhaps Professor Jody Freeman who employs the contractual metaphor most explicitly, drawing on both critical theory and public choice theory[110] to

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[hereinafter Croley] (characterizing the modern regulatory process as "a kind of post-New Deal republicanism" that adheres to "the original belief in the governmental process as one of deliberation oriented toward the public good rather than as a series of interest group trade-offs."); Mark Seidenfeld, *A Civic Republican Justification for the Bureaucratic State*, 105 HARV. L. REV. 1511, 1514 (1992) (stating that "government's primary responsibility is to enable the citizenry to deliberate about altering preferences and to reach consensus on the common good."). Under civic republicanism, neither regulators nor interest groups come to the process with preconceived commitments to a particular regulatory outcome. Instead, each participant forms a preference during the collaborative process itself that incorporates the views and concerns of all other participants in the deliberation. Croley, *supra*, at 78. *See also* AYRES & BRAITHWAITE, *supra* note 9, at 93 (stating that the goal of regulatory partism is "to modify the deliberative habits and behavioral dispositions of actors, not just to tinker with payoffs of actors whose psychology is untouched."). As a result, regulation represents the group's consensus about what regulation will best serve all the represented goals of the group.

Civic republican theory is in many instances a normative theory about what regulation should look like in an ideal world. *See, e.g.*, AYRES & BRAITHWAITE, *supra* note 9 (advocating institutional reforms designed to encourage civic republican governance); Croley, *supra* note 107, at 81 (describing civic republican theory as primarily normative). Even the strictly aspirational civic republican account has been criticized, however, for failing to provide a theory that accounts for the emergence of public-spirited deliberators or that explains the means of avoiding decision-making impasse. Finally, civic republicans' attempts at descriptive claims have been criticized for a lack of empirical evidence confirming the theory. *Id.* at 81-85.

108. AYRES & BRAITHWAITE, *supra* note 9, at 101-32 (discussing enforced self-regulation). Professor Ayres and Braithwaite also propose a system of "regulatory tripartism" that encourages participation by "public interest groups" in the regulatory process, and a system of partial industry regulation under which only a firm or subset of firms within an industry is regulated. *Id.* at 54-100 (discussing regulatory tripartism) and at 133-57 (discussing partial industry regulation).

109. *Id.* at 103. Ayres and Braithwaite emphasize that the extent to which these regulatory functions are subcontracted out to the regulated firm should depend on the industry structure and regulatory history of the firm in question. *Id.*

110. Public Choice theory can be broadly divided into two branches: voting theory, based on the work of Kenneth Arrow, and interest group theory, based on the wok of George Stigler. *See* JERRY L. MASHAW, GREED, CHAOS, & GOVERNANCE 10 (1997) [hereinafter Mashaw]. Voting theory, based on Arrow's Impossibility Theorem, asserts that determinations based on majority rule may produce indeterminate, random, or shifting outcomes—a process known as "cycling." *See generally* Kenneth J.

develop a model that views governance as a set of negotiated relationships among a variety of public and private actors.[111] Although Freeman draws on public choice theory to develop the contractual governance model, her theory differs from public choice in its account of the impact of private actors on the regulatory process. Whereas public choice theory is deeply suspicious of the role of private actors in the governance system, Freeman emphasizes the benefits provided by the participation of private actors in the governance process.[112]

The foregoing discussion of negotiated governance scholarship is necessarily partial, at best. Indeed, prominent scholars and practitioners in nearly every field seem to have joined the negotiated governance crusade, either criticizing existing United States legal structures as overly formal and legalistic and urging a more negotiated approach, or applauding new U.S. legal developments as embracing the negotiated governance ideal.[113]

Arrow, *A Difficulty in the Concept of Social Welfare*, 58 (4) J. POL. ECON. 328 (1950). Interest Group Theory, on the other hand, views legal rules as the product of political bargains between special interest groups and lawmakers. *See generally* George J. Stigler, *The Economic Theory of Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971).

111. *See* Freeman, *Private Role*, *supra* note 9. Freeman's model is also consistent with modern corporate law theory. For example, corporate law scholars have long employed the "nexus of contracts" metaphor to describe the corporate enterprise. *See generally* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976). Furthermore, consistent with Freeman's decentralized approach to governance, some recent corporate law scholarship has challenged the conception of some identifiable nexus within the corporate enterprise and instead proposes that the corporate relationship is best viewed as a set of "connected contracts." *See* G. Mitu Gulati, et al., *Connected Contracts*, 47 UCLA L. REV. 887 (2000). *But see* Stephen M. Bainbridge, *The Board of Directors as a Nexus of Contracts*, 88 IOWA L. REV. 1 (2002) (challenging the connected contracts model).

112. Freeman, *Private Role*, *supra* note 9, at 548-49 (arguing that although the traditional view of private actors in the governance process is one of "menacing outsiders whose influence threatens to derail legitimate 'public' pursuits . . . private actors are also regulatory resources capable of contributing to the efficacy and legitimacy of administration."). Freeman envisions governance as a collaborative endeavor among the regulator, the regulated group, and interested private parties. In contrast to many other governance theories, however, she rejects the notion of governance as a "hierarchical, agency-centered conception." *Id.* at 547. Instead, she envisions a decentralized, dynamic environment of policy-making, implementation and enforcement in which information and influence may flow "downward, from agency to private actors; upward, from private actor to agency; and horizontally among public and private actors." *Id.* at 571. Importantly, Freeman also emphasizes that negotiation over policy, enforcement, and implementation is a continuous process such that there is no specific moment in time that can be identified as the seminal moment at which policy was made or enforced. *Id.* at 572.

113. *See generally* ARCHON FUNG & ERIK OLIN WRIGHT, DEEPENING DEMOCRACY: INSTITUTIONAL INNOVATIONS IN EMPOWERED PARTICIPATORY GOVERNANCE (2003) (advocating a form of "Empowered Participatory Governance," in which significant authority is given to local deliberative bodies and interested parties collaborate to reach workable solutions); ROBERT A. KAGAN, ADVERSARIAL LEGALISM (2001) (criticizing American "adversarial legalism" and urging more flexible regulatory approaches that promote participation by public and private interests, including the regulated industry); Michael D. Dorf & Charles F. Sabel, *A Constitution of Democratic*

As will be demonstrated in the following Part VI of this Article, these negotiated governance models provide important descriptive insights into the mechanisms by which internal compliance-based liability defenses gained legitimacy within many parts of the legal regime and within Title VII, in particular. A careful study of the internal compliance-based legal regime demonstrates that compliance-based liability defenses have to a large extent been developed by compliance professionals and business organizations in collaboration with policymakers, as implied by the negotiated governance model.

Simply accepting that negotiated governance models accurately describe some governance mechanisms, however, does not mean that one must also accept the benign view of private influence on the governance process envisioned by those models' proponents. Indeed, the empirical data presented in Part IV of this Article throws doubt on negotiated governance theories that emphasize only the benefits conferred by the involvement of private actors in the governance process.

As I elaborate further in the following Part VI of this Article, to the extent that governance is properly analyzed as a set of related contracts or negotiated relationships, such contracts and relationships—like law itself—are highly incomplete. Because the negotiated governance models largely fail to address this fact, they minimize the dangers of opportunistic behavior by private parties during renegotiation—that is, during the implementation and enforcement phases of governance. Accordingly, as demonstrated in Part VI,

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Experimentalism, 98 COLUM. L. REV. 267 (1998) (proposing "democratic experimentalism" as a form of self government in which regulatory standards are based on best practice standards provided by regulated industries themselves in exchange for the freedom to experiment with various regulatory solutions); Robert A. Kagan, *The Consequences of Adversarial Legalism*, *in* REGULATORY ENCOUNTERS: MULTINATIONAL CORPORATIONS AND AMERICAN ADVERSARIAL LEGALISM 372-413 (Robert A. Kagan & Lee Axelrad eds., 2000) (criticizing American "adversarial legalism" and urging more flexible regulatory approaches that promote participation by public and private interests, including the regulated industry); Bradley C. Karkkainen, *Collaborative Ecosystem Governance: Scale, Complexity, and Dynamism*, 21 VA. ENVTL. L.J. 189 (2002) (discussing "collaborative ecosystem governance," which depends on public-private collaboration and information sharing); Barbara J. Zabawa, *Making the Health Insurance Flexibility and Accountability (HIFA) Waiver Work Through Collaborative Governance*, 12 ANNALS HEALTH L. 367 (2003) (applauding the new HIFA waiver as a vehicle to implement collaborative governance, because it encourages public-private cooperation in the provision of health insurance). *But see* Dana, *supra* note 9, at 38-39 (arguing that contractarian approaches to environmental regulation, under which the regulator and regulated entity negotiate over policy, may not improve environmental quality because of the increased costs of participation by environmental groups); William Funk, *Bargaining Toward the New Millennium: Regulatory Negotiation and the Subversion of the Public Interest*, 46 DUKE L.J. 1351, 1356 (1997) (arguing that negotiated rulemaking undermines the public interest); Stewart, *supra* note 9, at 437, 448-54 (stating that although the agency-stakeholder networks model is a quasi-contractual working relationship among various governmental and nongovernmental actors designed to promote flexible problem solving, the model has numerous problems in theory and in practice).

large segments of the internal compliance-based legal regime can be attributed to the gap filling of incomplete law with terms favorable to those parties most influential in this gap-filling process: organizational defendants and legal compliance professionals.[114]

VI. INCOMPLETE CONTRACTS AND SELF-INTERESTED ACTORS

This Part expands through specific examples and empirical data the argument developed in Part V that the negotiated governance model, by analyzing the governance process as a set of negotiated relationships or related contracts, provides important descriptive insights into the process by which legal policy takes shape. Specifically this section argues that, as predicted by the negotiated governance model, the governance process can be usefully analyzed as a multi-stage reciprocal interaction among policymakers, the regulated group, and important private actors, namely the legal compliance professionals—lawyers, ethics and compliance consultants, and internal compliance and human resources personnel—that serve as the first-line interpreters of legal policy.

At the same time, however, this section demonstrates that proponents of the negotiated governance model, while embracing the contractual metaphor (and, sometimes, the incompleteness inherent in that metaphor) underestimate the opportunities for strategic behavior during the renegotiation of those metaphorical contracts. This contractual incompleteness (and corresponding opening for opportunistic behavior) inherent in the negotiated governance model implies two important points. First, the regulated group, in its efforts to comply with new legal commands, is left to fill in these contractual gaps through the formal or informal development of standard norms and practices. Second, regulated groups typically do not fill in these gaps on their own, but instead rely on the advice of legal compliance professionals in interpreting vague or incomplete law. In doing so, far from operating as the unbiased advocates of their clients' interests, as assumed by some negotiated governance advocates,[115] these

114. Although the Incomplete Contracts Governance Theory developed in this Article asserts that much of the compliance-based liability regime—and organizational defenses under Title VII, in particular—can be attributed to court or agency approved industry responses to vague or incomplete law, it does not suggest that judges and agency bureaucrats approve such measures in order to enhance their own power by currying favor with special interest groups. Instead, a careful analysis of the process by which internal compliance structures gained legitimacy within much of the legal regime suggests that it arises from the structural limitations (including limited time, budgets, and expertise) facing courts and regulators in the process of filling gaps in incomplete law, regardless of the motivations of judges and regulators.

115. *See, e.g.*, Dorf, *supra* note 9, at 875 (discussing the role of defense attorneys in problem-

legal compliance professionals often interpret contractual terms and gaps in a manner that enhances their own influence and importance to the regulated group—constrained, of course, by the regulated group's self interest in an interpretation that enhances its own welfare. As a result, large segments of the internal compliance-based legal regime can be attributed to the gap filling of incomplete law with terms favorable to those parties most influential in this gap filling process: organizational defendants and legal compliance professionals.

Although the policymaker retains the authority to reject these gap-filling interpretations as inconsistent with the initial contract terms, the policymaker often lacks the expertise to differentiate *ex post* a self-serving or inefficient interpretation from one that serves the public interest. As a result, even if one rejects public choice theory's notion of private interest capture of the governance process, its assertion that the self-interested behavior of private actors with a stake in policymaking will often manage to influence policy and implementation in a negative way, appropriating more than their fair share of the social benefits of legal policy, cannot be readily dismissed.

Analyzing this multi-stage governance process by phases helps to clarify the Incomplete Contracts Governance Theory. I should emphasize, however, that by dividing this discussion into numerical stages, I do not mean to imply that legal construction necessarily follows a sequential order or that the various aspects of the policymaking, implementation, and enforcement process can be so neatly separated from each other. Instead, legal construction is a fluid process of negotiation over legal content among all involved parties until some equilibrium agreement as to meaning is reached. Accordingly, the division into phases is for purposes of clarity only.

In Phase One, formal policy is enacted. As has been widely noted by commentators in law, economics, and political science, numerous interest groups, including the regulated population itself, are likely to exercise substantial involvement in the process of formal policy creation. Because formal policy is necessarily incomplete, however, much legal policy does not truly begin to gain content until renegotiation at Phase Two, when a variety of actors with an interest in the new law interpret the regulation, filling in contractual gaps. In Phase Three, diffusion and institutionalization take place as a single gap-filling interpretation begins to gain dominance within the legal and regulated community. In Phase Four, courts and regulatory agencies are called upon to evaluate the validity of these interpretations. By

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solving courts, who he argues zealously defend the rights of their clients, but tend to "accept a broader definition of client interest.").

placing their stamp of approval on a particular interpretation, courts and regulators lend further credibility to the interpretation, ensuring an even more wide-spread adoption. Finally, this interpretation becomes the industry standard, and members of the regulated group that fail to comply with that standard may be penalized, either by the legal system, by the marketplace, or by both.

A. Phase One: Formal Policy Enactment and Incomplete Law

In Phase One, new policy is formally enacted. As recognized by virtually every modern governance theory, numerous interest groups, including the regulated population itself, are likely to exercise substantial involvement in the process of formal policy creation. Unfortunately, commentators sometimes tend to analyze this portion of the governance process in isolation, examining the degree of interest group involvement and policy outcome, then concluding that the data is most consistent with a particular governance model. To continue with the contractual metaphor, the assumption is that the contract is now complete and that the parties can move on to the implementation and enforcement stages.

If law were fully articulated and authoritative, as assumed in some legal formalist models, such an analysis might permit a rich understanding of the relationship among the numerous parties involved in policy formation and the impact of that relationship on policymaking and enforcement.[116] Because regulation is frequently ambiguous, poorly articulated, or subject to differing interpretations, however, the process by which legal policy fully gains content is only beginning.[117] In other words, the contract is incomplete, and any gaps must be filled in through renegotiation during the implementation and enforcement phases.

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116. *Cf.* Mark C. Suchman & Lauren B. Edelman, *Legal Rational Myths: The New Institutionalism and the Law and Society Tradition*, 21 L. & SOC. INQUIRY 903, 905 (1996) (criticizing organizational theorists for treating law as "a distinctively explicit, authoritative, and coercive exogenous constraint on organizational behavior.") [hereinafter Suchman & Edelman].

117. *Id.* at 929 (stating that "[b]y treating law as explicit, institutional theory obscures the extent to which law is, in reality, obscure, fragmented and highly ambiguous."); Walter W. Powell, *Fields of Practice: Connections Between Law and Organizations*, 21 L. & SOC. INQUIRY 959, 959 (1996) (concurring with "Suchman and Edelman's contention that institutional analysis has treated law in an overly deterministic fashion" by "focusing on the letter of the law and its purported impact" rather than "the extent to which law and the legal environment are subject to negotiation, interpretation, and contestation.").

1. Contractual Incompleteness

The concept of incomplete contracts has been an important one in the legal and economic literature. According to many economists and legal scholars, contracts are necessarily incomplete for two basic reasons: the bounded rationality of the contracting parties and the problem of observable but unverifiable variables in the contract.[118]

Bounded rationality in this context stems not only from the inability of the parties to a contract to foresee all relevant future contingencies, but also from the fact that, even if the parties could foresee all future events, they would be unable to negotiate each of these points and reduce their agreement to a writing understandable and enforceable by a court.[119] The problem of observable but unverifiable contract terms stems from the fact that some of the contract variables (for example, the effort level of a contracting party) may be observable to the contracting parties themselves, but may not be verifiable by courts or other third-party enforcers.[120]

Additionally, some contracts may be left purposely incomplete, either for strategic reasons or because the transaction costs of contractual completeness may exceed the benefits.[121] Contractual incompleteness due to transaction costs is particularly likely if some contingencies have a low probability of occurrence or require particularly complex drafting.[122]

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118. *See* OLIVER HART, FIRMS, CONTRACTS, AND FINANCIAL STRUCTURE 23 (1995) [hereinafter HART, FIRMS]; Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87, 92-93 (1989) [hereinafter Ayres & Gertner]; Oliver Hart & John Moore, *Incomplete Contracts and Renegotiation*, 56 ECONOMETRICA 755, 757 (1988) [hereinafter Hart & Moore].

119. HART, FIRMS, *supra* note 118, at 23; Hart & Moore, *supra* note 118, at 757. Much of the economic literature ignores the problem of bounded rationality by the contracting parties because of the difficulty it presents for formal modeling. *See, e.g.*, Hart & Moore, *supra* note 118, at 757 (stating that "[w]e ignore the bounded rationality issue, not because we think it is unimportant, but because of the great difficulty of analyzing it formally."); Oliver Hart, *Norms and the Theory of the Firm*, 149 U. PA. L. REV. 1701, 1703 (2001) (stating that "[f]or reasons of tractability, most of the economics literature rules out bounded rationality among the contracting parties themselves.") [hereinafter Hart, *Norms*].

120. Louis Kaplow & Steven Shavell, *Economic Analysis of Law*, *in* HANDBOOK OF PUBLIC ECONOMICS § 4.1.4 (Alan J. Auerbach & Martin Feldstein eds., 2002) [hereinafter Kaplow & Shavell]; Hart, *Norms*, *supra* note 119, at 1702.

121. Ayres & Gertner, *supra* note 118, at 94 (arguing that a contractual party may sometimes withhold information that could make the contract more complete because silence may increase her share of the gains from contracting); Karen Eggelston et al., *The Design and Interpretation of Contracts: Why Complexity Matters*, 95 NW. U. L. REV. 91, 100-101 (2000) (distinguishing perfectly complete contracts, which differentiate among all relevant world states, and functionally complete contracts, which are as complete as possible, given problems of bounded rationality and unverifiability).

122. These transaction costs include legal fees, drafting and printing costs, and the opportunity cost of negotiation time. Ayres & Gertner, *supra* note 118, at 92-93. Eric Maskin and Jean Tirole have

Incomplete contracts create both *ex ante* and *ex post* problems. *Ex post*—that is, after contracting and at the renegotiation stage—there are gains from the trade between the two parties to be exploited and the contract may not fully specify how those gains are to be divided (or one of the contract variables on which such division depends may not be verifiable by a court). As a result, each party may attempt to appropriate the common *ex post* surplus.[123] This possibility raises *ex ante* implications: if a contracting party knows that *ex post* opportunism may take place, she may not make the efficient level of *ex ante* relationship-specific investments.[124]

2. Law As An Incomplete Contract

Drawing on this literature, other scholars have noted the similar constraints facing lawmakers and have argued that law is similarly, by definition, incomplete or indeterminate.[125] In addition, any law—like any

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argued that transaction costs need not prevent formation of complete contracts, given certain assumptions. Eric Maskin & Jean Tirole, *Unforeseen Contingencies and Incomplete Contracts*, 66 REV. ECON. STUD. 83, 84-85 (1999) [hereinafter Maskin & Tirole]. *But see* Oliver Hart & John Moore, *Foundations of Incomplete Contracts*, 66 REV. ECON. STUD. 115, 116 (1999) (arguing that the Maskin and Tirole critique does not undermine the transaction costs literature).

123. JEAN TIROLE, THE THEORY OF INDUSTRIAL ORGANIZATION 21 (2002) [hereinafter TIROLE].

124. *Id. See also* HART, FIRMS, *supra* note 118, at 26-27; Kaplow & Shavell, *supra* note 120, at § 4.1.9.

125. *See, e.g.*, Ian Ayres, *Preliminary Thoughts On Optimal Tailoring Of Contractual Rules*, 3 S. CAL. INTERDISC. L.J. 1, 14 (1993) (stating that "the same costs that prevent private parties from writing fully state-contingent contracts may all the more prevent lawmakers from providing these default provisions."); William M. Landes & Richard A. Posner, *The Independent Judiciary in an Interest-Group Perspective*, 18 J.L. & ECON. 875, 879 (1975) (stating that "the limits of human foresight, the ambiguities of language, and the high cost of legislative deliberation combine to assure that most legislation will be enacted in a seriously incomplete form."); Maskin & Tirole, *supra* note 122, at 83 (stating that "the mandates of agencies, courts, or legislators make almost no mention of the many contingencies that may affect the set of feasible options," and further noting that "this 'contractual incompleteness' appears to be important to understanding why the structure of government matters."); Katherina Pistor & Chenggang Xu, *Fiduciary Duty in Transitional Civil Law Jurisdictions: Lessons from Incomplete Law Theory*, European Corporate Governance Institute (Jan. 8, 2002) (unpublished working paper at 9, on file with the author) (arguing that "law is intrinsically incomplete, meaning that it is impossible to design a law that would specify all future contingencies) [hereinafter Pistor & Xu].

The notion that law is indeterminate has, of course, been a centerpiece of the Critical Legal Studies Movement. *See generally* Ken Kress, *Legal Indeterminacy*, 77 CAL. L. REV. 283 (1989) (criticizing critical legal studies scholars for this theory and arguing instead that law is only moderately indeterminate and that this indeterminacy does not undermine its legitimacy). *See also* Joseph William Singer, *The Player and The Cards: Nihilism and Legal Theory*, 94 YALE L.J. 1, 12-13 (1984) (arguing that "[l]egal doctrine is far more indeterminate than traditional theorists realize it is. If traditional legal theorists are correct about the importance of determinacy to the rule of law, then—by their own criteria—the rule of law has never existed anywhere.").

In short, the notion that law is fully determinate seems to have few adherents today. *See, e.g.*, Paul Schiff Berman, *The Cultural Life of Capital Punishment: Surveying the Benefits of a Cultural Analysis*

contract—may be left purposely incomplete, either for strategic or transaction cost reasons.[126] As such, one can predict similar *ex ante* and *ex post* problems with regard to legal commands. For example, if law is substantially incomplete, then we should expect to see *ex post*—that is, after formal policy enactment and at the implementation and enforcement phases of governance—opportunism by those with a stake in the *ex post* gains from new legal rules.[127] As discussed in the following Part VI.B, this incomplete contractual analogy is a nice metaphor for the *ex post* bargaining among various interested parties that takes place with respect to ambiguous legal rules.[128]

Specifically, an analysis of legal commands as incomplete contracts raises issues for legal interpretation and enforcement. When law is incomplete, successful implementation and enforcement will depend on the effectiveness with which the legal system handles the *ex post* bargaining process by which law fully gains content.[129]

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of Law, 102 COLUM. L. REV. 1129, 1133 (2002) (stating that "one is hard pressed to find too many doctrinaire legal formalists remaining among either academics or legal practitioners.").

126. For example, when new law is politically contested or presents the danger of substantial downside risks when events turn out poorly but provides few corresponding benefits for which legislators can credibly claim responsibility when things go well, legislators may seek to maximize their opportunities for re-election by opting for incomplete law, thus forcing *ex post* enforcers such as courts or regulatory agencies to fill gaps and resolve ambiguities. Scott Baker & Kimberly D. Krawiec, *The Penalty Default Canon* (2003) (working draft on file with author) [hereinafter Baker & Krawiec]. Law may also be left incomplete for socially beneficial reasons, such as reducing the transaction costs associated with defining *ex ante* all of the future contingencies to which the law must apply, and delegating to an agency with more time and expertise the responsibility for defining some terms. *Id.*

127. I do not mean to suggest here that rules, because of their greater specificity, are inevitably preferable to standards. Instead, the point is merely that standards have costs, as well as benefits, and that those costs and benefits must be balanced. *See generally* Louis Kaplow, *Rules Versus Standards: An Economic Analysis*, 42 DUKE L.J. 557 (1992) (discussing the relative costs and benefits of standards and rules).

128. *See infra* notes 130-63 and accompanying text. Similarly, an analysis of laws as incomplete contracts raises the possibility (not addressed in this Article) that the likelihood of *ex post* rent-seeking will alter the *ex ante* investment incentives to influence legal policy. As such, one might expect to find too little investment in the procurement of legal rules, too much, or investment primarily in non-specific lobbying efforts, depending on a variety of factors. *See* Baker & Krawiec, *supra* note 126.

129. Pistor & Xu, *supra* note 125, at 6. Pistor and Xu argue that a second-best efficient result can be achieved by properly delegating enforcement and residual policymaking authority to the correct policymaking body—that is, to a court, a legislature, or a regulatory body, depending on a variety of factors. *Id.* Rather than engaging the large existing literature on institutional choice, this Article merely argues that all three policymaking bodies face serious constraints to developing efficient policy in the face of legal incompleteness. This does not necessarily mean, however, that all policymaking bodies respond *similarly* to legal incompleteness. *See* Baker & Krawiec, *supra* note 126. *See also infra* notes 164-66 and accompanying text.

B. Phase Two: Contractual Gap Filling

In Phase Two, new law begins to gain content. To properly understand this process, it is important to recognize that members of the regulated group itself (for example, executives at business organizations) rarely learn of new law on their own.[130] In other words, many governance models implicitly assume that business organizations know what the law is. Although initially credible, this assumption misses an extremely important step in the regulatory process. The reality is that legal systems have no systematic apparatus for ensuring that the regulated population is aware of the laws governing it.[131] Although formal legal publications exist in abundance, they are generally only accessible to those with both the inclination and the expertise to understand them. As a result, business organizations tend to learn about new laws from a variety of unofficial sources: the media, legal compliance professionals, and networks of similarly situated business organizations.

The incompleteness of law complicates this process. When law is incomplete, the aforementioned legal "middlemen"—as well as policymakers, interest groups, and the regulated group itself—must all negotiate the meaning of law before the contract is fully articulated. Each of these actors, in turn, brings self-interested and partisan motives to the renegotiation process.

1. Legal Compliance Professionals

The role of legal compliance professionals is especially important in this process of legal interpretation. Observers should not make the mistake of assuming that legal compliance professionals are unbiased filters for new legal rules. Instead, legal compliance professionals bring a variety of motivations and biases to bear when constructing the legal regime.[132]

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130. Langevoort, *supra* note 51, at 823 (stating that most corporate directors have no first hand knowledge of the laws regulating their conduct as board members and instead rely on their lawyers' advice as to what the law requires of them); Daniel J. Givelber et al., *Tarasoff: Myth and Reality: An Empirical Study of Private Law in Action*, 1984 WIS. L. REV. 443, 443 (1984) (noting that "if the Court's ruling [in *Tarasoff*] was to enhance public safety, someone had to tell the therapists about their new obligation and how to meet it.") [hereinafter Givelber et al.].

131. Suchman & Edelman, *supra* note 116, at 930-31.

132. Legal compliance professionals are not the only professional group that may construct legal obligations in a self-interested manner. For example, psychiatric professional organizations may have constructed *Tarasoff v. Regents of the Univ. Of Cal.*, a 1976 case holding that psychotherapists owe a duty of care to third parties whom their patients have threatened to harm, in a manner that reflects the concerns of mental health care professionals. *See* Givelber et al., *supra* note 130, at 446. *See also* Tarasoff v. Regents of the Univ. of Cal., 13 Cal.3d 177, 529 P.2d 553 (1974), *withdrawn and replaced*

As a result, legal compliance professionals may value incompleteness in the law because, as the first-line interpreters of legal policy, they are able to fill any gaps in incomplete law with terms that enhance the welfare of the legal compliance profession. Although legal compliance professionals, like other special interest groups, can—and do—directly lobby legislatures for the provision of favorable legal rules, legal compliance professionals (because of their superior access, expertise, and understanding of the judicial and regulatory systems) may have more success at lower cost by gap-filling vague law, rather than by directly lobbying the legislature for statutes that explicitly favor the legal profession.[133]

Some commentators, for example, explicitly assert that, because legal professionals are able to appropriate the rents generated by incomplete law, they have an inherent interest in vague laws.[134] Others, such as Professors Donald Langevoort and Robert K. Rasmussen, suggest more indirect means by which legal professionals may benefit from vague legal standards. Specifically, Langevoort and Rasmussen predict that lawyers will systematically tend to overstate legal risks when advising clients—a prediction supported by some empirical evidence.[135] Presumably, this overstatement is easier to accomplish with a vague legal command, as opposed to a legal rule that clearly delineates legal obligations. In addition, legal compliance professionals have an incentive to recommend means of containing legal risk or legal ambiguity that require substantial involvement

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by 17 Cal.3d 425, 551 P.2d 334 (1976). Furthermore, the empirical data suggests that most therapists learned of the obligations imposed by *Tarasoff* through these professional organizations, rather than through lawyers or primary legal sources. Givelber et al., *supra* note 130, at 460.

133. Macey & Miller, *infra* note 134, at 473 (discussing the special expertise, access, and influence over the Delaware judiciary enjoyed by the Delaware bar). This is not to say that legal compliance professionals, and lawyers in particular, do not actively lobby the legislature when it is in their best interests to do so. Indeed, there is substantial evidence to the contrary. Instead, my point is merely that such lobbying will often be unnecessary due to legal compliance professionals' control over the gap-filling process.

134. *See, e.g.*, Ehud Kamar, *A Regulatory Competition Theory of Indeterminacy in Corporate Law*, 98 COLUM. L. REV. 1908 (1998); Jonathan R. Macey & Geoffrey P. Miller, *Toward An Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469, 505 (1987) (stating that "[t]he bar therefore has some interest in reducing the clarity of Delaware law to enhance the amount of litigation.") [hereinafter Macey & Miller].

135. Donald C. Langevoort & Robert K. Rasmussen, *Skewing the Results: The Role of Lawyers in Transmitting Legal Rules*, 5 S. CAL. INTERDISC. L.J. 375 (1997) [hereinafter Langevoort & Rasmussen]. *See infra* notes 146-51, 159-63, and accompanying text (discussing the empirical evidence supporting this theory). Although Macey, Miller, Langevoort, and Rasmussen specifically address only lawyers, their arguments should apply to non-lawyer legal advisers as well, such as human resource and other compliance personnel. The empirical evidence supports this prediction and indicates that—like lawyers—non-lawyer compliance professionals also value vague legal commands and respond to such commands by overstating legal risk. *See infra* notes 146-51, 159-63, and accompanying text.

by legal compliance professionals and fall squarely within their area of expertise such as drafting contracts, employee manuals, or other materials in a particular manner; observing certain hiring, firing, and promotion practices; or requiring certain types of employee training.

As noted by Langevoort and Rasmussen, legal compliance professionals may overstate legal risks because to do so is a wealth-maximizing strategy.[136] When legal risks are more severe, the more valuable are the services of professionals who can contain that risk. This is especially true if the containment strategy itself requires extensive legal work, thus increasing legal fees.[137] Legal compliance professionals may also overstate risks out of a rational concern for reputation protection.[138]

The fact that legal compliance professionals have economic incentives to overstate legal risks does not mean, however, that such overstatement is conscious or purposeful. Instead, legal compliance professionals may unconsciously overstate legal risks, either because professional norms dictate excessive caution[139] or because the legal resources from which many legal professionals gain their knowledge of the law are themselves biased.[140] Perhaps most importantly, legal professionals may overstate legal risk because the professional has truly convinced herself that what is in her own best interest is also in the client's best interest.[141] In other words, legal compliance professionals—like human beings generally—may suffer from a

136. Langevoort & Rasmussen, *supra* note 135, at 380. In the case of outside counsel or consultants, this wealth maximization takes the form of increased legal fees. In the case of in-house personnel, it takes the form of increased importance, prestige, and resources for the legal or compliance department. *Id.* at 416.

137. *Id.* at 392. Naturally, there are some market constraints on the ability of legal professionals to overstate risk. Professors Langevoort and Rasmussen convincingly demonstrate, however, that these constraints are not perfect for a variety of reasons, including information asymmetries in the market for legal services. *Id*. at 381.

138. *Id.* at 394. For example, legal professionals may be able to decrease the reputational penalty for structuring a transaction that turns out to be disallowed by courts or regulators by overstating the risk an event will occur. *Id.* at 396. Similarly, there may be an asymmetry between the observability of good and bad legal advice that renders lawyers rationally over-cautious. In other words, there is often no real evidence that legal advice has been correct, whereas the evidence that legal advice has been incorrect is often quite clear: the transaction is disallowed or the client is found liable. *Id.* at 377-78.

139. *Id.* at 413. For example, "lawyers might understand their proper role as one in which the primary duty is to warn clients about the presence of legal risks, to assure that no client ever underestimates the presence of prevailing legal rules or standards." *Id*. In the end, however, Langevoort and Rasmussen reject this explanation as being separate from the economic interest explanation. In other words, norms arise and survive only if they serve some purpose. The most obvious purpose served by the norm of overcaution is that it enhances the welfare of the legal profession. *Id.* at 414.

140. *Id.* at 434-36. *See also infra* notes 146-51, 159-63, and accompanying text (discussing a substantial bias in secondary legal sources toward overstating legal risk).

141. Langevoort & Rasmussen, *supra* note 135, at 428.

self-serving bias under certain circumstances.

A large body of psychological research indicates that desires often dramatically impact information interpretation, even by those who consciously strive for objectivity and impartiality.[142] Self-serving bias is particularly likely to emerge when information is ambiguous and thus subject to differing interpretations.[143] In addition, the self-serving bias is likely to be strongest when a person is endorsing another's biased opinion that comports with the listener's self-interest, as opposed to making an original decision on her own.[144] In this manner, it is easy to see how a biased interpretation of ambiguous law takes hold in the legal community and becomes reinforcing as more people subscribe to it—a phenomenon sometimes referred to as an information cascade.[145]

Researchers have identified several instances in which legal compliance professionals appear to have vastly overstated legal risk. One study, for example, analyzed articles in personnel journals, practitioner-oriented legal journals, and academic-oriented law reviews concerning the threat of wrongful discharge suits.[146] They found that personnel and legal practitioner journals significantly inflated the risk of wrongful discharge lawsuits, often through the use of alarmist or extreme language that overstated both the frequency of such suits and the rates at which plaintiffs prevailed.[147] This was

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142. MAX BAZERMAN, JUDGMENT IN MANAGERIAL DECISION MAKING 2 (4th ed. 1998) (arguing that audit failure is inevitable because it is psychologically impossible for auditors to maintain objectivity in the face of self-serving bias); Linda Babcock & George Lowenstein, *Explaining Bargaining Impasse: The Role of Self-Serving Biases*, 11(1) J. ECON. PERSP. 109-10 (1997) (stating, "although psychologists debate the underlying cause of self-serving bias, its existence is rarely questioned," and presenting results from empirical and field research work that documents the self-serving bias and establishes its connection to bargaining impasse); Max H. Bazerman et al., *Why Good Accountants Do Bad Audits*, HARV. BUS. REV. 97, 98 (Nov. 2002) [hereinafter Bazerman et al.]; David Messick & Keith Sentis, *Fairness and Preference*, 15 (4) J. EXPERIMENTAL SOC. PSYCHOL. 418 (1979) (finding that experiment subjects' decisions regarding the fair division of wages were biased in the direction of their own self-interests).

143. Bazerman et al., *supra* note 142, at 98.

144. *Id.* at 99. Kristina A. Diekmann et al., *Self-Interest and Fairness in Problems of Resource Allocation: Allocators Versus Recipients*, J. PERSONALITY AND SOC. PSYCHOL., 1061, 1062 (May 1997).

145. Timur Kuran & Cass R. Sunstein, *Availability Cascades And Risk Regulation*, 51 STAN. L. REV. 683, 721 (1999) (stating, "[a] strictly informational cascade occurs when people start attaching credibility to a proposition P (*e.g.*, a certain abandoned waste dump is dangerous) merely because other people seem to accept P.").

146. *See generally* Lauren B. Edelman et al., *Professional Construction of Law: The Inflated Threat of Wrongful Discharge*, 26 LAW & SOC'Y REV. 47 (1992) [hereinafter *Professional Construction of Law*].

147. *Id*. at 64. One article, for example, referred to "the explosion of wrongful discharge litigation." *See* Charles G. Bakaly, Jr. & Joel M. Grossman, *How to Avoid Wrongful Discharge Suits*, 73 MGMT. REV. 41, 41 (1984) (quoted in *Professional Construction of Law*, *supra* note 146, at 64). Another stated that "wrongful discharge lawsuits are proliferating across the country against

despite the fact that both the researchers' own statistics as well as a RAND study concluded that the cost to employers from wrongful discharge suits was slight.[148] Similar results have been found with respect to internal grievance procedures[149] and securities law.[150] Needless to say, the solutions to these threats advocated by legal compliance professionals are often within their field of expertise and could generate substantial revenues.[151]

Legal compliance professionals construct law and then pass that construction on to others with an interest in the meaning of law (such as courts, agencies, and the regulated group) through a variety of mechanisms, including: advising clients; writing journal or periodical articles; speaking at seminars; presenting legal arguments to courts and regulators; and lobbying policymakers or otherwise playing a direct role in policy drafting.[152] Perhaps most importantly, legal compliance professionals construct law through a variety of professional networks, a phenomenon discussed below in Part VI.C.

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employers." David A. Bradshaw & Linda Van Winkle Deacon, *Wrongful Discharge: The Tip of the Iceberg?*, 30 PERSONNEL ADMINISTRATOR 74, 74 (1985). Law practitioner-oriented journals were somewhat more accurate, but still on the whole substantially over-stated the legal risk of wrongful discharge suits. Academic-oriented law review articles, by contrast, were much more even-handed and tended to emphasize that the risk of such suits, while increasing, was still quite small. *Professional Construction of Law*, *supra* note 146, at 68-69.

148. *Professional Construction of Law*, *supra* note 146, at 53-60. The RAND study, for example, concluded that, "Despite the uproar over wrongful termination litigation, the aggregate legal costs are really not very large . . . [T]he annual cost of jury trials sums to $2.56 per worker." JAMES N. DERTOUZOS ET AL., THE LEGAL AND ECONOMIC CONSEQUENCES OF WRONGFUL TERMINATION ix (1988). The Edelman study returned even lower numbers than the RAND study for a variety of reasons. *Id.* at 52, 54-55.

149. *See infra* notes 172-77 and accompanying text (discussing legal professionals' construction of grievance procedures as a protection against EEO litigation).

150. For example, the district court case of Escott v. Barchris Construction Co., 283 F. Supp. 643 (S.D.N.Y. 1968), which imposed a heightened due diligence standard under section 11 of the Securities Act of 1933 on parties involved in a public offering of securities, generated an abundance of fairly alarmist commentary advising potentially liable parties on a variety of costly steps that should be undertaken in order to qualify for the due diligence defense. Langevoort & Rasmussen, *supra* note 135, at 435. Later case law, which signaled a more obliging attitude toward issuers and other potentially liable parties under section 11 did not receive comparable attention. This construction of section 11 liability may have added substantial costs to the public offering process. *Id.*

151. For example, the solutions advocated to control the risk of wrongful discharge suits typically include a variety of personnel practices, such as the formalization and standardization of hiring, firing, and evaluation practices in a manner that protects employers from claims of wrongful discharge, and the use of protective employment-at-will clauses in employee manuals, contracts, and other documents. *Professional Construction of Law*, *supra* note 146, at 76.

152. Suchman & Cahill, *infra* note 163, at 683.

2. The Regulated Group: Business Organizations

Business organizations, as the group subject to new policy, also play an important role in constructing the meaning of law. Although, as previously discussed, business executives are unlikely to learn about new laws directly from primary sources, this does not mean that they are uninvolved in constructing the legal regime by which their actions will be governed. Senior management of business organizations, for example, may seek to disrupt current practice as little as possible, while still assuring courts and regulatory agencies that they have met the goals of any new policy. As a result, they may press an interpretation of law that signals compliance with the relevant legal regime, but fails to fulfill the normative goals of regulation. Similarly, management may resist interpretations offered by other parties to the negotiation process (for example, legal compliance professionals, courts, or agencies) that they believe overly constrain management discretion or disrupt current business practices.

Organizational management thus may resist legal constructions that hold, for example, that the prohibition against discrimination contained in EEO law requires affirmative action or that the implied contract theory of wrongful discharge requires that employees be fired only for cause, because such constructions overly restrict management's hiring and firing authority. Instead, they may press—or at least be receptive to—a construction that holds that EEO law requires equal employment policies and diversity training in order to shield employers from liability, or holds that the implied contract theory of wrongful discharge requires employers to include "employment-at-will" clauses in employee manuals, in order to preserve management's discretion to fire employees without cause.[153] As these constructions are often likely to be more palatable to legal compliance professionals as well (because their implementation requires a greater involvement by such professionals), a consensus may develop relatively quickly as to what is the most appropriate response to new policy. In other words, the accepted gap-filling construction of an incomplete law represents an equilibrium agreement among legal professionals, the regulated group, and the regulator or court.

The role of interdepartmental rivalry as sub-units within the organization struggle for position, prestige, and access to limited resources should also not

153. *Professional Construction of Law*, *supra* note 146, at 79 (discussing the diffusion of this particular construction of wrongful discharge law). As previously discussed, EEO hiring policies and diversity training are liability mitigators only against certain claims under EEO law, such as hostile environment harassment or punitive damages for intentional discrimination. *See supra* Part III.B.

be overlooked when considering business organizations' construction of law. If one interpretation will enhance the power of a unit—say legal compliance—relative to other units, then it is likely that managers of that unit will actively advance the interpretation that most benefits their department.[154]

C. Phase Three: Diffusion and Institutionalization

The previous subsection explored the motivations of various groups affected by legal policy to fill any gaps in incomplete laws with terms that further their own self-interest. One might still question, however, why their interpretations are so similar. Surely there is more than one legal interpretation that would serve the interests of legal compliance professionals and the business community. How, then, does some consensus arise as to what the law "is"? In this subsection, I discuss the important role of professional networks in the standardization, diffusion, and ultimate institutionalization of a particular legal construction.

As a legal construction begins to emerge within the regulated group and the legal compliance professionals that serve it, professional networks play an extremely important role in the standardization and diffusion of that construction across the relevant community.[155] These networks include professional associations and their regular gatherings and newsletters; commercial workshops and education courses on legal compliance; professional communications via the internet; and professional publications such as periodicals, books, treatises, memoranda to clients' and articles in professional and academic journals.[156]

Like legal compliance professionals generally, producers of these items bring a self-interested agenda to bear when constructing the law. For example, legal constructions that are alarmist may generate more interest,

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154. For example, some empirical studies trace a proliferation of certain personnel practices, such as job evaluation and promotion testing, to attempts by personnel professionals to establish and maintain their strategic position within firms during the 1940s, a time when union activity was on the rise, and personnel professionals marketed themselves as having the ability to constrain union power. *See, e.g.*, James P. Baron et al., *War and Peace: The Evolution of Modern Personnel Administration in U.S. Industry*, 92 AM. J. SOC. 250 (1986).

155. Edelman et al., *The Endogeneity of Legal Regulation: Grievance Procedures as Rational Myth*, 105 AM. J. SOC., 406, 412 (1999) [hereinafter Edelman et al., *The Endogeneity of Legal Regulation*]. Other professions may be responsible for the diffusion and institutionalization of certain industry practices as well. For example, accountants may have played a role in the diffusion and institutionalization of certain financial reporting practices across Fortune 200 corporations. Stephen J. Mezias, *An Institutional Model of Organizational Practice: Financial Reporting at the Fortune 200*, 35 ADMIN. SCI. Q. 431 (1990).

156. Langevoort & Rasmussen, *supra* note 135, at 434; Edelman et al., *The Endogeneity of Legal Regulation*, *supra* note 155, at 412.

and thus higher sales, than legal constructions that are more measured.[157] Similarly, most readers of secondary sources may desire a short, clear, and understandable legal construction. As a result, qualifications and nuanced interpretations may be rejected in favor of a simplistic construction that misstates regulations and court rulings to a significant degree. Finally, many of these materials are produced by legal compliance professionals as a means to attract clients. Consequently, there is an incentive to overstate not only legal risk, but also the ability of legal compliance professionals to manage that risk through creative devices and interpretations.[158]

As a result, several studies have shown that personnel- and practioner-oriented legal journals tend to significantly overstate legal risk.[159] Furthermore, such publications tend to employ alarmist and unqualified language, especially in the title or headline, and rarely provide numbers or empirical data to back up their claims.[160] Even when statistical data is provided, the articles rarely include citations to the studies that produced the data, making the validity of the claims difficult to evaluate.[161] Finally, some of the reported data is so inconsistent with the findings of any known studies as to render the validity of their claims doubtful, or in some cases even absurd.[162]

Despite these problems, particular legal constructions seem to diffuse quickly and pervasively once legal compliance professionals have reached some consensus on the most appropriate interpretation. For example, as discussed in Part VII, legal professionals' construction of wrongful discharge law and the value of grievance procedures in Title VII litigation diffused

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157. Langevoort & Rasmussen, *supra* note 135, at 434; Langevoort, *supra* note 51, at 823.

158. Langevoort & Rasmussen, *supra* note 135, at 434.

159. *See, e.g.*, Edelman et al., *The Endogeneity of Legal Regulation*, *supra* note 155, at 446 (demonstrating that personnel- and practioner-oriented legal publications during the 1980s significantly overstated the legal benefits of internal grievance procedures); *Professional Construction of Law*, *supra* note 146, at 64-65. Academic journals, by contrast, present a more even-handed view of the law.

160. *Id.* at 64-65; Edelman et al., *The Endogeneity of Legal Regulation*, *supra* note 155, at 418 n.7 and accompanying text. Professor Marc Galanter has noted a similar phenomenon with respect to the accepted wisdom on litigation. *See* Marc Galanter, *Predators and Parasites: Lawyer-Bashing and Civil Justice*, 28 GA. L. REV. 633, 644 (1994) (discussing "a series of factoids or macro-anecdotes about litigation [that] became the received wisdom."); Marc Galanter, *Reading the Landscape of Disputes: What We Know and Don't Know (and Think We Know) about Our Allegedly Contentious and Litigious Society*, 31 UCLA L. REV. 4, 62 (1983) (discussing "familiar nuggets and favorite horror stories" designed to alarm the reader that eventually come to be taken as fact).

161. *Professional Construction of Law*, *supra* note 146, at 64-65; Edelman et al., *The Endogeneity of Legal Regulation*, *supra* note 155, at 418 n.7 and accompanying text.

162. *Professional Construction of Law*, *supra* note 146, at 64-65.

exponentially, despite evidence that these constructions had little basis in law at the time that they were made.[163]

D. Phase Four: Formal Legitimation—The Role of Courts and Agencies

Courts and regulatory agencies also play an important role in filling the gaps in incomplete law. As consensus on a particular gap-filling construction emerges and becomes institutionalized by the regulated group and the legal compliance community, courts and agencies are called upon to determine whether that interpretation comports with the contract terms as originally envisioned. Although in theory this is the point at which the court or agency could reject the emerging interpretation as inconsistent with the original policy goals (and thus with the contract terms), this may not happen for a variety of reasons.

Courts and agencies alike may be faced with limited expertise, time, budgets, and imperfect guidance on what will serve as compliance with law.[164] Business organizations and legal compliance professionals, in turn, do their best to package the chosen construction as consistent with the public interest and the original goals of regulation. As a result, courts and regulatory bodies frequently measure compliance with the law against the industry standard, with little inquiry into the role played by the regulated group and other self-interested actors in establishing those standards.[165] Furthermore, because courts are reactive, deciding only the cases and controversies brought before them, they rarely independently devise potential means of

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163. *See infra* Part VII. Not all examples of policy construction and diffusion by legal professionals carry such negative consequences for social welfare. For example, Mark Suchman and Mia Cahill have demonstrated the important role played by Silicon Valley lawyers in constructing positive norms of venture capital practice, many of which eventually became institutionalized in the national legal regime. Mark C. Suchman & Mia L. Cahill, *The Hired Gun as Facilitator: Lawyers and the Suppression of Business Disputes in Silicon Valley*, 21 L. & SOC. INQ. 679 (1996) [hereinafter Suchman & Cahill]. Similarly, Professor Ronald Gilson has documented the positive role played by lawyers in reducing transaction costs. Ronald J. Gilson, *Value Creation by Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239 (1984). For more on value creation by lawyers, see generally *Symposium: Business Lawyering and Value Creation for Clients*, 74 OR. L. REV. 1 (1995).

164. Suchman & Edelman, *supra* note 116, at 934. Although it is often argued that administrative agencies have an advantage over courts in terms of time and expertise, administrative agencies also suffer from these deficiencies to some degree and, in addition, are considered more susceptible to industry capture. MASHAW, *supra* note 110, at 21. As a result, although courts, administrative bodies, and legislatures may perform differently in the face of incomplete law, the point here is simply that all three governmental branches face serious constraints in their responses to legal incompleteness.

165. Suchman & Edelman, *supra* note 116, at 939. This is not to imply that courts and agencies inevitably rubber stamp all industry standards. Indeed, several prominent rulings have held that such standards and customs are inadequate to comply with the law. Instead, the point is that courts and agencies often provide some deference to apparently successful industry responses to law, thus favoring the status quo.

complying with the law. Although judicial rulings may indicate which existing methods of attempting compliance do or do not comport with a law, courts are unlikely to simply invent new methods of compliance that have not already been employed with apparent success by at least some members of the regulated group.[166]

VII. AN ILLUSTRATION: GRIEVANCE PROCEDURES AND WORKPLACE HARASSMENT

This Part analyzes the process by which internal grievance procedures gained legitimacy as an organizational defense against workplace harassment liability under Title VII. This analysis provides a concrete illustration of the Incomplete Contracts Governance Theory developed in the previous Part VI, and highlights the roles played by incomplete law, legal gap-filling, and private interest groups (especially legal compliance professionals) in the rise of internal compliance structures as a liability mitigator.

Title VII, along with the changing societal norms that led to its enactment, created important new rights for large categories of American workers. Title VII, however, is notoriously incomplete, leaving important categories of information undefined. For example, although the statute prohibits discrimination, it does not define what constitutes discrimination or how employers may demonstrate nondiscrimination in court. As a result, employers and other groups with an interest in the legislation were left to gap-fill the many incomplete terms of Title VII, by defining for themselves some of these categories in order to attempt compliance with the new law.

This Part VII will demonstrate that legal compliance professionals, in particular, played an active role in construing employers' new obligations and the protections from liability that the new laws afforded them.[167] As will be shown, the preferred construction relied heavily on internal compliance structures such as affirmative action offices and internal grievance mechanisms, which quickly proliferated.[168] Eventually, courts were called upon to determine whether, through the use of such mechanisms, employers had met their new obligations under Title VII. By and large, as predicted by the Incomplete Contracts Governance Theory, courts deferred to the policies and procedures that employers had developed and that were becoming commonplace in the business community.[169] As previously discussed,

166. *Id.* at 939.
167. *Id.* at 924.
168. *Id*.
169. *Id*.

however, the effectiveness of these internal compliance structures is largely unproven, and, in fact, several empirical studies throw doubt on their effectiveness. If it is true that internal compliance structures such as these are ineffective means of reducing workplace discrimination, then the gap-filling of Title VII with terms dependant on internal compliance structures as an organizational liability determinant represents not only a frustration of any public-regarding purposes of Title VII[170] but a wealth transfer from the intended beneficiaries of Title VII to business organizations and legal compliance professionals.

These phenomena are highlighted in detail in a recent study of grievance procedures and EEO law by Professors Lauren B. Edelman, Christopher Uggen, and Howard S. Erlanger that examined the relationships between formal pronouncements of law, professional construction of law, and the impact of that construction on later court determinations of legal requirements. In doing so, they reviewed articles in personnel, management, and legal journals from 1964 to 1989 that addressed grievance procedures in the context of EEO law.[171]

These articles tended to make two strong claims with regard to the impact of grievance procedures on legal liability. First, they claimed that because internal grievance procedures provided an alternative forum for dispute resolution, their presence reduced the incidence of complaints to external agencies and courts.[172] Second, these articles asserted that if external complaints were nonetheless filed against an employer with internal grievance procedures, courts would reward the organization for attempting to provide due process within the organization itself.[173]

At the time these articles were written, however, there was very little legal basis for such claims. Contrary to the predictions of the legal compliance literature, internal EEO grievance procedures had almost no impact on the

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170. This is not intended to imply that the legislature had such a public-regarding purpose when enacting Title VII. As recognized by public choice theorists, it is entirely possible that Congress purposely left Title VII incomplete in order to meet the demands of special interests groups such as business organizations, while at the same time providing the illusion of public service to other constituents. *See* Baker & Krawiec, *supra* note 126 (discussing strategic delegations).

171. Edelman et al., *The Endogeneity of Legal Regulation*, *supra* note 155, at 413.

172. *Id*. For example, a 1984 article claiming that "A good grievance procedure . . . deters employees from seeking representation by outsiders" is typical. Peter M. Panken, *What Every Company Should Have: A Formal Employee Complaint Procedure*, 73 MGMT. REV. 42-45 (1984) (quoted in Edelman et al., *The Endogeneity of Legal Regulation*, *supra* note 155, at 414). Similarly, a 1985 article claimed that "[i]f an employee can get a fair hearing through a grievance system, there is less chance this employee will be tempted to go to the courts." Thomas J. Condon, *Use Union Methods in Handling Grievances*, 64 PERSONNEL J. 72-75 (1985) (quoted in Edelman et al., *The Endogeneity of Legal Regulation*, *supra* note 155, at 412).

173. Edelman et al., *The Endogeneity of Legal Regulation*, *supra* note 155, at 412.

number of external complaints and actually increased the number of internal complaints.[174] Similarly, the literature's claims that employers could reduce or eliminate liability through the use of internal grievance procedures had little basis in law at the time they were made. At the time that the articles were written, almost all discrimination claims were decided under a vicarious liability standard. As such, the employer's liability should be automatic without regard to the presence of grievance procedures or other internal compliance structures.[175]

In fact, prior to the Supreme Court's 1986 decision in *Meritor Savings Bank v. Vinson*, the grievance procedure defense was raised in only thirteen employment discrimination cases, and only six of those courts indicated some willingness to consider grievance procedures as a mitigating factor when determining liability.[176] It is doubtful that these six district court cases, which received very little publicity, were responsible for (or could justify) the broad claims in the legal compliance literature regarding the value of grievance procedures as a litigation insulation device.[177]

Employers, however, seemed to be unaware that the advice rendered by legal compliance professionals was wrong. Edelman and her team document a steady diffusion of grievance procedures that coincides with the advocacy of such procedures in the legal compliance literature.[178] The institutionalization of grievance procedures as a response to EEO law apparently began with just a few employers likely to be most sensitive to their legal environments (principally federal contractors, federal agencies, universities, and organizations that had been the subject of a prior discrimination suit) and steadily spread throughout the time frame of the study.[179]

Perhaps most interesting, however, with the recognition in *Meritor Savings Bank v. Vinson* of a new theory of workplace harassment—hostile environment harassment—that replaced the vicarious liability standard with a

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174. *Id.* at 427. This should not be interpreted as a sign that discrimination actually increased in these organizations. Instead, it is likely that the presence of EEO grievance officers signaled a culture that encouraged attention to the problem of discrimination and in which aggrieved employees felt more comfortable asserting their rights. As a result, it is difficult to know the impact, if any, of grievance procedures on the incidence of discrimination within organizations. *Id*. at 420.

175. *Id.* at 432. In fact, very few cases prior to the mid-1980s even discussed grievance procedures. *Id.*

176. *Id.* at 439. Of those six, in only four did the court actually consider the employer's grievance procedures as a mitigating factor. In the other two cases, the grievance procedures in question were too inadequate to merit such consideration. *Id.*

177. This conclusion is reinforced by the fact that none of the publications cited any of the six cases. *Id.*

178. *Id.* at 451.

179. *Id.*

standard of direct liability, the previously erroneous claims of the legal compliance literature suddenly gained validity. When recognizing hostile work environment harassment as a viable claim in *Meritor*, the Supreme Court explicitly noted that, although Meritor's grievance procedures were inadequate to protect the defendant from liability (because they required the alleged victim to complain directly to her harasser), a more carefully conceived grievance procedure might provide legal protection.[180]

Edelman and her co-authors conclude that *Meritor* legitimated the grievance procedure defense. At the time of their study, there had been 116 cases decided since *Meritor* that raised the grievance procedure defense. In ninety-one percent of the cases, the court indicated that a well-structured grievance procedure could insulate the employer from liability, and in thirty-six percent of the cases the employer's grievance procedures did so insulate the employer.[181] The study data further show that courts are becoming increasingly likely to defer to employers' grievance procedures when determining liability.[182] As a result, courts are not only accepting, but are reinforcing, a construction of discrimination law that includes grievance procedures.

The legal compliance professionals' claims as to the insulating effects of internal grievance procedures became fully entrenched within the formal legal structure with the Supreme Court's 1998 case of *Faragher v. City of Boca Raton*, which established an affirmative defense based on the defendant employer's grievance procedures.[183] With *Faragher*, the process of constructing EEO law came full circle, as legal compliance professionals invoked *Faragher* in stepping up their advocacy for grievance procedures as a protection against EEO liability, and business organizations predictably responded by implementing grievance procedures to an even greater degree.[184]

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180. Meritor Savings Bank v. Vinson, 477 U.S. 57, 72 (1986). As the Court stated:

> [T]he bank's grievance procedure apparently required an employee to complain first to her supervisor, in this case Taylor. Since Taylor was the alleged perpetrator, it is not altogether surprising that respondent failed to invoke the procedure and report her grievance to him. Petitioner's contention that respondent's failure should insulate it from liability might be substantially stronger if its procedures were better calculated to encourage victims of harassment to come forward.

Id. at 72-73.

181. Edelman et al., *The Endogeneity of Legal Regulation*, *supra* note 155, at 440.

182. *Id.* at 442.

183. 524 U.S. 775, 807-08 (1998). *See also supra* notes 62-67 and accompanying text (discussing the affirmative defense).

184. *See, e.g.*, Ellen McLaughlin & Carol Merchasin, *Training Becomes Important Step to Avoid Liability*, NAT'L. L.J. Jan. 29, 2001, at B10 (stating that "[t]raining a work force on a company's anti-discrimination/harassment policy has thus become arguably the most important tool for an employer

One should not assume, of course, that merely because grievance procedures were advocated by legal compliance professionals for arguably self-serving reasons that they are necessarily an ineffective response to the demands of EEO law. Unfortunately, this is a difficult empirical point to resolve because only the incidence of discrimination complaints—and not the incidence of discrimination itself—is observable.[185]

Nonetheless, there are reasons to approach the Court's legitimization of such procedures with caution. First, the unencouraging data, discussed in Part IV, regarding the effectiveness of other types of internal compliance structures should raise suspicions regarding grievance procedures until empirical data documenting their effectiveness emerges. Second, courts are not well-situated to make *ex post* determinations regarding whether a particular organization's grievance procedures are effective, and a review of the case law indicates that some courts do not even attempt this task.[186] Finally, employees may have valid reasons for foregoing internal grievance procedures, such as a fear of retaliation or not being believed, as well as concerns about the pro-management bias of complaint handlers.[187]

VIII. CONCLUSION

This Article analyzes the role of one type of extremely prevalent and quickly growing negotiated governance mechanism—internal compliance structures—as a liability determinant in a variety of legal contexts, including environmental, tort, employment discrimination, corporate, securities, and health care law. An examination of the empirical evidence surrounding the

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that wants to protect itself from Title VII liability and punitive damages"); *Training's Impact on Harassment Lawsuits*, MANAGING TRAINING & DEV., Feb. 1, 2002, at 1 (stating that "a swift response, including diversity training, can save employers from expensive and costly liability lawsuits.").

185. As previously noted, the presence of internal grievance procedures increases the incidence of discrimination complaints. This is likely attributable, however, to the fact that aggrieved employees are more aware of their rights and more willing to bring complaints in an environment where discrimination law has been made more salient by the presence of EEO grievance officers. *See supra* note 174 and accompanying text (discussing this point).

186. *See supra* notes 64 and 66-67, and accompanying text (discussing several lower court cases).

187. Linda Hamilton Krieger, *Employer Liability for Sexual Harassment–Normative, Descriptive, and Doctrinal Interactions: A Reply to Professors Beiner and Bisom-Rapp*, 24 U. ARK. LITTLE ROCK L. REV. 169, 181-85 (2001) (noting that survey data reveals that only 2-15% of sexual harassment victims utilize employers' official internal complaint processes for reasons that include: beliefs that informal avenues are more effective; fear of blame, retaliation, or not being believed; and concerns regarding the effectiveness of internal complaint procedures); Theresa M. Beiner, *Sex, Science, & Social Knowledge: The Implications of Social Science Research on Imputing Liability to Employers for Sexual Harassment*, 7 WM. & MARY J. WOMEN & L. 273, 307-23 (2001) (discussing a variety of reasons for the underreporting of sexual harassment, including a failure to identify the relevant conduct as legally constituting harassment, and fears of retaliation, harm to their career, or not being believed).

efficacy of internal compliance structures in deterring prohibited conduct leads to the conclusion that the available empirical evidence does not support the legal regime's enthusiastic embrace of such structures. Indeed, the most large-scale and methodologically sound studies to date provide no evidence that internal compliance structures reduce the incidence of prohibited conduct within firms. Instead, these studies provide empirical support for the conclusion that internal compliance structures are largely window-dressing mechanisms implemented by corporate management to reduce liability or provide the appearance of legitimacy to corporate stakeholders and the marketplace at large.

This leads to a broader, related conclusion: the negotiated governance model faces both empirical and theoretical hurdles that its proponents have not yet overcome. First, as an empirical matter, although internal compliance structures are only one form of negotiated governance, the poor empirical showing of internal compliance structures in reducing prohibited conduct calls into question the increasing influence of negotiated governance models that seek a more cooperative approach to the regulation of business organizations. Second, as a theoretical matter, the negotiated governance model contains an internal inconsistency in that the theory itself, if taken to its logical conclusion, implies results at odds with those predicted by the model's proponents. Specifically, to the extent that governance is properly viewed as a set of negotiated relationships or related contracts, these contracts and relationships—like contracts generally—are highly incomplete. Accordingly, the economic and legal literature on incomplete contracts predicts the likelihood of opportunistic rent-seeking behavior during renegotiation.

Drawing on this literature, the Incomplete Contracts Governance Theory developed in this Article predicts and empirically documents similar opportunistic behavior during the renegotiation of incomplete law—that is, during the implementation and enforcement phases of governance. This is in contrast to most proponents of the negotiated governance model, who either ignore the incompleteness inherent in the contractual metaphor they adopt or welcome such incompleteness as an opportunity for collaboration and cooperation among interested public and private parties.

In short, the incompleteness of law creates room for interpretation and manipulation by a variety of public and private actors. As such, it presents a political opportunity for those with a stake in regulation to push their agenda through renegotiation during the implementation and enforcement phases of governance by constructing a gap-filling interpretation that serves the group's self-interest. This gap filling proves to be an important mechanism by which various actors outside of the regulated organization (for example,

lawyers and consultants) and within it (for example, senior management, internal compliance and human resources personnel, and in-house legal departments) advance their own interests.

Notably, however, the interest groups most conspicuously underrepresented during this process are those that may represent the public interest.[188] To the extent that public involvement in the political process may enhance the content of legal policy, therefore, this situation should cause a re-evaluation of the mechanisms by which legal and political institutions in the United States confront the problem of incomplete law.

A few caveats are necessarily in order. First, most negotiated governance theories embrace self-regulatory mechanisms other than internal compliance structures, such as industry standard setting and cooperative approaches to enforcement, that are not specifically addressed in this Article.[189] However, the poor empirical showing of internal compliance structures, combined with the opportunities (highlighted by the Incomplete Contracts Governance Theory) for private parties to appropriate any social benefits created by legal policy, should cause a more cautious approach to such proposals than is currently evidenced in the legal literature.

Second, the Incomplete Contracts Governance Theory is developed primarily by reference to the rise of internal compliance structures as a liability determinant under EEO law. Other legal regimes that embrace internal compliance structures as a liability determinant may have developed through different mechanisms. For example, the OSGs and some, but not all, aspects of corporate and securities law relating to internal compliance developed primarily through legislative and administrative action, rather than through judicial interpretation, as did much of EEO law.

Nonetheless, these differences should not be overstated. For example, although the OSG recommendations were promulgated by the Federal Sentencing Commission (with substantial input and influence from the Business Roundtable), as originally enacted they were notoriously incomplete, requiring substantial interpretation by legal compliance professionals and business organizations.[190] In addition, as discussed in Part III, regulatory agencies, courts, and legislatures have all embraced internal

188. Professors Ayres and Braithwaite have also noted that representatives of the public are typically unrepresented in many aspects of the governance process and have advocated the development of political and legal structures that include them in *ex-post* governance. *See* AYRES & BRAITHWAITE, *supra* note 9, at 57-60 (noting that Tripartism involves "unlocking to PIGs the smoke-filled rooms where the real business of regulation is transacted.").

189. *See, e.g.*, Freeman, *Private Role*, *supra* note 10; AYRES & BRAITHWAITE, *supra* note 9.

190. *See* Note, *supra* 8, at 1786 (stating that "critics assert that the Guidelines provide inadequate guidance for corporations seeking compliance.").

compliance structures in a wide variety of legal fields without evaluating the evidence concerning their lack of efficacy in deterring prohibited conduct, indicating that all three political branches may suffer from substantial shortcomings when attempting to implement cooperative approaches to the regulation of business organizations.

Finally, one should not rule out an attitudinal component to the results discussed in this Article. If judges and regulatory agencies are reluctant to impose liability in certain cases based on personal policy preferences—for example, a belief that employment discrimination suits are often meritless or that organizational entities should not be subjected to criminal liability—then they may be more likely to approve largely symbolic attempts at compliance in those types of cases than in others.