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Empowering Employees to Prevent Fraud in Nonprofit Organizations

John M. Bradley

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EMPOWERING EMPLOYEES TO PREVENT FRAUD IN NONPROFIT ORGANIZATIONS

*John M. Bradley**

ABSTRACT

This Article examines the significant problem of fraud within nonprofit organizations and demonstrates that current anti-fraud measures do not adequately reflect the important role employees play in perpetuating or stopping fraudulent activity. Psychological and organizational behavior studies have established the importance of (1) participation and (2) peers in shaping the behavior of individuals within the organizational context. This Article builds on that research and establishes that to successfully combat fraud, organizations must integrate employees into the design, implementation, and enforcement of anti-fraud strategy and procedures. Engaged, empowered employees will be less likely to commit fraud and more likely to dissuade their peers from fraudulent behavior. After examining the theory underlying the proposed approach, this Article sets forth directions and specific suggestions for designing an anti-fraud program that empowers employees.

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INTRODUCTION

Reports of employees defrauding nonprofit organizations headline the news in communities every day: “An administrative assistant admitted Monday to stealing more than \$5million from the Association of American Medical Colleges”;¹ “The payroll supervisor at a charity in Reynoldsburg, Ohio . . . used her position to embezzle \$588,121 from the organization”;² “An Oxnard woman accused of embezzling more than \$400,000 from a Ventura nonprofit group pleaded guilty”³

Fraud perpetrated against nonprofit organizations by their employees is part of a consistent and, by some reports, growing ethical problem within nonprofit organizations. Yet despite the attention of lawmakers, regulators, and sector watchdogs, the lack of regulatory resources demands that the task of confronting problematic ethical issues such as fraud largely falls to the organizations themselves.⁴

Fraud is a troublesome aspect of a nonprofit sector that continues to advance in size and scope. Since the mid-twentieth century, the nonprofit sector has steadily grown as a percentage of United States

¹ Ann E. Marimow & Mary Pat Flaherty, *Md. Woman Admits Stealing Millions from D.C. Nonprofit*, WASH. POST, Nov. 23, 2013, http://www.washingtonpost.com/local/crime/md-woman-admits-stealing-millions-from-dc-nonprofit/2013/11/25/723a7c14-55f6-11e3-835d-e7173847c7cc_story.html.

² *Ohio Woman Gets 2 Years for \$588,000 Theft at Nonprofit*, THE CHRON.OF PHILANTHROPY (Aug. 26, 2014), <http://philanthropy.com/blogs/philanthropytoday/ohio-woman-gets-2-years-for-588000-theft-at-nonprofit/89871>.

³ *Oxnard Woman Admits to Embezzling from Ventura Nonprofit*, VENTURA CNTY. STAR, Oct. 3, 2013, <http://www.vcstar.com/news/oxnard-woman-admits-to-embezzlement-from-ventura>.

⁴ See Suzanne Perry, *Government Regulators Need More Money and Data, Experts Say*, CHRON. PHILANTHROPY (Feb. 12, 2013), <http://philanthropy.com/article/Government-Regulators-Need/137269/> (reporting that officials and experts believe that “both state and federal regulatory systems were inadequate to the task of monitoring more than 1 million charities”); Kevin P. Kearns, *Accountability in the Nonprofit Sector*, in THE STATE OF NONPROFIT AMERICA 587 (2d ed. 2012) (“Well documented that the IRS lacks the resources and management capacity to effectively performs its oversight role.”).



economic activity.⁵ Some two million organizations are now engaged in efforts to end homelessness, provide cancer treatments, preserve ecosystems, improve education, and contribute to a number of other worthwhile endeavors.⁶ More than thirteen million people work for these organizations.⁷ Yet in the midst of the real good accomplished by these dedicated organizations and people, fraud may be costing the sector some \$40 billion—5% of the sector's revenues—each year.⁸

Despite the complicity of employees in this problem, this Article proposes that the solution depends upon enlisting the assistance of the employees themselves. The dominant efforts to prevent fraud have approached the problem by focusing on oversight mechanisms or the example of those in leadership, with employee involvement playing a much smaller role—if at all—in the overall strategy. By concentrating on employees, this Article sees fraud as an outgrowth of ethical decision-making, and examines how an organization can positively affect its personnel's ethical decision-making by fully integrating employees in its fraud prevention strategy.

Integration and empowerment entails more than simply giving employees codes of conduct, reporting mechanisms, and training—although each of those are important parts of a comprehensive program. Empowering employees means soliciting and incorporating their ideas into the organization's fraud prevention strategy and their participation in its investigatory framework. It means issuing codes and policies that employees have co-authored—not simply received—and designing trainings with employees as leaders—not just attendees. It means making them part of the structure that is expected to stop fraud.

Lawyers who advise nonprofit organizations may instinctively object that placing employees in a position to help protect the organization against employee wrongdoing is the proverbial fox guarding the

⁵ KATIE L. ROEGER ET AL., *THE NONPROFIT ALMANAC 9-13* (Kathleen Courrier et al. eds., 2012) (nonprofit sector percentage of GDP steadily grew over past 60 years and now accounts for more than 5.5% the U.S. GDP).

⁶ *See id.* (reporting that in 2012, there were approximately 2.3 million nonprofits: 1.6 million organizations were registered with the IRS, 300,000 were religious corporations, and a final 400,000 were smaller organizations); National Center for Charitable Statistics, *Number of Nonprofit Organizations in the United States, 2003-2013*, URB INST., <http://nccsweb.urban.org/PubApps/profile1.php?state=US> (reporting that in 2013, there were 1,407,459 nonprofit organizations in 2013).

⁷ LESTER M. SALAMON, *The Resilient Sector: The Future of Nonprofit America*, in *THE STATE OF NONPROFIT AMERICA* 3, 8 (2012).

⁸ *See infra* § I.

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henhouse. But, as this Article demonstrates, social psychology and organizational behavior research suggests that employee involvement uniquely contributes to preventing fraud. To capture this effect, those charged with preventing and stopping employee fraud should include employees as co-owners invested in anti-fraud efforts.

In Section I, this Article sets forth the fraud problem facing nonprofit organizations and the nonprofit sector as a whole. While there is a need for researchers to collect more data specific to the nonprofit sector, the available information demonstrates a fraud problem that is significant to intended beneficiaries of nonprofit work, all nonprofit organizations (whether or not they have been a victim), and society. Section II reviews the current approaches that dominate anti-fraud efforts (II.A.) and explains why the suggested approach of empowering employees should be adopted (II.B.). In so doing, the Article relies on research in the psychology and organizational behavior disciplines. Section III, taking direction from the cited research, provides specific advice for integrating employees into a fraud prevention program.

I. THE NONPROFIT SECTOR'S FRAUD PROBLEM

Nonprofit organizations suffer significant losses each year to occupational fraud.⁹ By some estimates, more than \$40 billion of nonprofit funds are misused or misapplied for personal enrichment rather than nonprofit work within the United States each year.¹⁰ To put that figure in context, the amount of nonprofit assets lost to fraud each year is equivalent to the combined revenue of twenty of the largest and most well-known United States-based nonprofits: the United Way, Salvation Army, Catholic Charities USA, Goodwill Industries International, YMCA, World Vision, St. Jude's Children's Research Hospital, Boys & Girls Clubs of America, American Red Cross, Habitat for Humanity In-

⁹ Throughout this article, I use the terms "occupational fraud" and "fraud" interchangeably to stand for any scheme in which a person "use[s] . . . one's occupation for personal enrichment through the deliberate misuse or misapplication of the employing organization's resources or assets." ASSOCIATION OF CERTIFIED FRAUD EXAMINERS, REPORT TO THE NATIONS ON OCCUPATIONAL FRAUD AND ABUSE: 2014 GLOBAL FRAUD STUDY 6 (2014).

¹⁰ *Id.* The estimate of \$40.24 billion is reached by multiplying the amount U.S. nonprofits contributed to U.S. GDP in 2010 (\$804.8 billion) by the percentage of revenue that was estimated to be lost to occupational fraud in ACFE Reports from 2010 to 2014 (5%); see also, Janet Greenlee et al., *An Investigation of Fraud in Nonprofit Organizations: Occurrences and Deterrents*, 36 NONPROFIT & VOLUNTARY SECTOR Q. 676, 677 (2007) (estimating that fraud loss to the nonprofit sector in 2004 was \$40 billion).

ternational, Feed the Children, Nature Conservancy, American Heart Association, United States Fund for UNICEF, Mayo Clinic, Care USA, Boy Scouts of America, and Susan G. Komen for the Cure.¹¹ This is a staggering amount of financial loss.

Given the furtive nature of fraud, a confident estimate is difficult to provide,¹² but the available data shows that fraud-attributable losses to nonprofit organizations are neither rare nor insignificant. Britain's National Fraud Authority put fraud losses to its charitable sector in 2013 at 0.22% of the income of all charities.¹³ Applied to United States nonprofits, the loss to fraud would be \$1.7 billion—a still substantial figure.¹⁴ Another way to view the problem is by considering the number of organizations affected. The Washington Post found that from 2008 to 2012, more than 1,000 tax-exempt organizations had disclosed on their annual IRS Form 990 that they had “discovered a ‘significant diversion’ of assets, disclosing losses attributed to theft, investment fraud, embezzlement and other unauthorized uses of funds.”¹⁵ Only diversions of more than \$250,000 or five percent of annual gross receipts or total assets are required to be reported to the IRS.¹⁶ Given organizations' interests in keeping losses quiet as well as their simple failure to uncover every fraud, such filings likely severely underreport fraud. Whatever the final numbers, what is certain is that fraud is hurt-

¹¹ *The 50 Largest U.S. Charities*, FORBES (Nov. 2013), www.forbes.com/top-charities/list, (combined revenue for the twenty selected charities is \$40.27 billion).

¹² See Leslie Lenkowsky, *Despite High-Profile 'Three Cups' Controversy, Nonprofit Fraud Isn't Widespread*, CHRON. PHILANTHROPY (Apr. 27, 2011), <http://philanthropy.com/article/Nonprofit-Fraud-Isn-t/127268> (calling into question the assumptions built into the \$40 billion loss figure).

¹³ NATIONAL FRAUD AUTHORITY, ANNUAL FRAUD INDICATOR 23 (2013), available at www.gov.uk/government/uploads/system/uploads/attachment_data/file/206552/nfa-annual-fraud-indicator-2013.pdf (fraud includes both external and internal fraud).

¹⁴ The \$1.7 billion figure is reached by multiplying \$804.8 billion by .0022. For an estimate in the middle of these extremes, see, GERARD ZACK, FRAUD AND ABUSE IN NONPROFIT ORGANIZATIONS: A GUIDE TO PREVENTION AND DETECTION xvi (2003) (estimating loss to nonprofit sector of \$10 billion).

¹⁵ Joe Stephens & Mary Pat Flaherty, *Inside the Hidden World of Thefts, Scams and Phantom Purchases at the Nation's Nonprofits*, WASH. POST (Oct. 26, 2013), http://www.washingtonpost.com/investigations/inside-the-hidden-world-of-thefts-scams-and-phantom-purchases-at-the-nations-nonprofits/2013/10/26/825a82ca-0c26-11e3-9941-6711ed662e71_story.html.

¹⁶ IRS instructions only require disclosure of losses “if the gross value of all diversions (not taking into account restitution, insurance, or similar recoveries) discovered during the organization's tax year exceeds the lesser of (1) 5% of the organization's gross receipts for its tax year, (2) 5% of the organization's total assets as of the end of its tax year, or (3) \$250,000.” INTERNAL REVENUE SERVICE, DEPARTMENT OF THE TREASURY, FORM 990: INSTRUCTIONS 21 (2013), available at <http://www.irs.gov/pub/irs-pdf>.

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ing individual organizations, intended beneficiaries, and the reputation of the nonprofit sector.

Employees commit more fraud than any other group—and have for quite some time.¹⁷ They commit fraud in a number of ways: for example, by pocketing fees for services before they are recorded in the organization's books, by having a fictitious entity paid for services not actually rendered, by filing false expense reports, by gaining from an undisclosed conflict of interest, or by falsifying financial statements.¹⁸ All of these schemes have resulted in an ongoing problem, despite increasing attention and efforts to combat it.¹⁹

Fraud perpetrated against nonprofits presents particularly troubling problems for society given the direct impact on social welfare. Services that the nonprofit sector provides—such as in health, education, social services, or cultural activities—go unfulfilled when fraud is committed. If, as occurred in 2010, \$5.7 million of Columbia University's funds are stolen for an accounting clerk's and associates' personal use instead of going to New York Presbyterian Hospital, then a community's health suffers.²⁰ Or if, as was discovered in 2012, an employee

¹⁷ ASSOCIATION OF CERTIFIED FRAUD EXAMINERS, REPORT TO THE NATIONS ON OCCUPATIONAL FRAUD AND ABUSE: 2014 GLOBAL FRAUD STUDY (2014) 40 (noting that 42% of reported frauds were committed by employees in a most recent survey and that this “has remained remarkably consistent from year to year”).

¹⁸ See ASSOCIATION OF CERTIFIED FRAUD EXAMINERS, REPORT TO THE NATIONS ON OCCUPATIONAL FRAUD AND ABUSE: 2014 GLOBAL FRAUD STUDY 11 (2014); accord ASSOCIATION OF CERTIFIED FRAUD EXAMINERS, REPORT TO THE NATIONS ON OCCUPATIONAL FRAUD AND ABUSE: 2012 GLOBAL FRAUD STUDY 12 (2012).

¹⁹ ASSOCIATION OF CERTIFIED FRAUD EXAMINERS, REPORT TO THE NATIONS ON OCCUPATIONAL FRAUD AND ABUSE: 2014 GLOBAL FRAUD STUDY 6, 8 (2014); (reporting that a typical organization is estimated to lose 5% of revenues each year); ASSOCIATION OF CERTIFIED FRAUD EXAMINERS, REPORT TO THE NATIONS ON OCCUPATIONAL FRAUD AND ABUSE: 2012 GLOBAL FRAUD STUDY 8 (2012) (5%); ASSOCIATION OF CERTIFIED FRAUD EXAMINERS, REPORT TO THE NATIONS ON OCCUPATIONAL FRAUD AND ABUSE: 2010 GLOBAL FRAUD STUDY 4 (2010) (5%); ASSOCIATION OF CERTIFIED FRAUD EXAMINERS, REPORT TO THE NATIONS ON OCCUPATIONAL FRAUD AND ABUSE: 2008 GLOBAL FRAUD STUDY 8 (2008) (7%); ASSOCIATION OF CERTIFIED FRAUD EXAMINERS, REPORT TO THE NATIONS ON OCCUPATIONAL FRAUD AND ABUSE: 2006 GLOBAL FRAUD STUDY 4 (2006) (5%); ASSOCIATION OF CERTIFIED FRAUD EXAMINERS, REPORT TO THE NATIONS ON OCCUPATIONAL FRAUD AND ABUSE: 2004 GLOBAL FRAUD STUDY 8 (2004) (6%); ASSOCIATION OF CERTIFIED FRAUD EXAMINERS, REPORT TO THE NATIONS ON OCCUPATIONAL FRAUD AND ABUSE: 2002 GLOBAL FRAUD STUDY 4 (2002) (6%); ASSOCIATION OF CERTIFIED FRAUD EXAMINERS, REPORT TO THE NATIONS ON OCCUPATIONAL FRAUD AND ABUSE: 1996 GLOBAL FRAUD STUDY 5-6 (1996) (6%); see also JOSEPH T. WELLS, CORPORATE FRAUD HANDBOOK: PREVENTION AND DETENTION (4th ed. 2013).

²⁰ Press Release, Cyrus R. Vance, Jr., District Attorney, New York County, *Four Defendants Found Guilty of Defrauding Columbia University Out of \$5.7 Million* (Aug. 7, 2012), <http://manhattan>

of a small substance abuse organization diverts \$20,000 to his personal use, then someone goes without needed treatment.²¹

In addition to the direct monetary loss, fraud may have a multiplier effect on an institution by causing contributors to turn away. Nonprofits rely to a significant extent on the goodwill and confidence of donors and volunteers.²² That confidence and goodwill may quickly erode when an organization is victimized by fraud.²³ For example, donors suspended their commitments to the Global Fund to Fight AIDS, Tuberculosis and Malaria when the Associated Press publicized reports of fraud within the organization.²⁴ As a result, the Global Fund's ability to meet its operational goals was threatened.²⁵ The Global Fund is not alone in suffering a multiplied loss from fraud: 27% of British charities reported that fraud negatively impacted their reputation, ability to fund projects, volunteer recruitment, fundraising, or some other operational aspect.²⁶

Fraud may also work to the detriment of the nonprofit sector as a whole. Particularly in the United States, nonprofits and the tax benefits

da.org/press-release/four-defendants-found-guilty-defrauding-columbia-university-out-57-million.

²¹ See Community Alcohol Information Program, Inc., IRS Form 990: Schedule O (2011), available at <http://www.washingtonpost.com/wp-srv/special/local/nonprofit-diversions-database> (reporting \$20,000 diversion).

²² See Eleanor Brown & David Martin, *Individual Giving and Volunteering*, in THE STATE OF NONPROFIT AMERICA 495, 497 (2d ed. 2012) (stating that private giving accounts for 12.3 percent of revenue across the nonprofit sector, but accounts for as high as sixty-seven percent of revenue for a subset of nonprofits, specifically those involved in international and foreign affairs); *id.* at 498 (stating that “[v]olunteer labor is an important resource for the nonprofit sector: in 2008, an estimated 61.8 million people volunteered a medial amount of time equal to one hour per week).

²³ Kristy Holtfreter, *Determinants of Fraud Losses in Nonprofit Organizations*, NONPROFIT MGMT. & LEADERSHIP, Fall 2008, at 1 (“Compared to other organizations, nonprofits rely more heavily on public trust, so they have more to lose when fraud is revealed.”); see also, e.g., Ian Wilhelm, *Fraud Investigations Raise New Questions for Beleaguered Red Cross*, CHRON. PHILANTHROPY, Apr. 6, 2006, at 46.

²⁴ Jonathan C. Brown & Wilfred Griekspoor, *Fraud at the Global Fund? A Viewpoint*, 28 INT’L J. HEALTH PLAN. & MGMT. 138, 139 (2012); Ann Danaiya Usher, *Donors Continue to Hold Back Support From Global Fund*, 378 LANCET 471 (2011); see also Sarah Boseley, *Can the Global Fund Weather the Corruption Storm?* GUARDIAN (Jan. 28, 2011), <http://www.theguardian.com/society/sarah-boseley-global-health/2011/jan/28/aids-infectiousdiseases>; Bernard Rivers, *The Global Fund at Ten Years: Not a Happy Birthday*, AIDSPAN (Feb. 6, 2012), www.aidspace.org/gfo_article/global-fund-ten-years-not-happy-birthday.

²⁵ See Usher, *supra* note 24.

²⁶ FRAUD ADVISORY PANEL, FRAUD IN THE CHARITABLE SECTOR 28 (2009), available at www.fraudadvisorypanel.org/pdf_show_129.pdf.

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they enjoy exist in part because they are viewed as more reliable and responsive than the government²⁷—an idea that suffers if nonprofits are seen as unable or unwilling to shepherd their resources. Frauds suggest to donors that the exalted trust in nonprofits may be misplaced.²⁸ Thus, a Gresham's Law, that is, "bad money drives out good," may develop, "where publicized fraud cases may result in an unwillingness of donors to give to any nonprofit."²⁹ The ongoing occurrence of fraud may thus be eroding confidence not only in individual nonprofit organizations but also in the ability of the whole sector to perform its work: the "ineffective[ness of the nonprofit sector] at routing out real and perceived corruption, fraud, governance and ethics problems" has resulted in the loss of "the public's trust in its ability to carry out its mission."³⁰

The heightened problems that fraud creates for nonprofits are sufficient reason to focus on the sector, but another reason exists: fraud and unethical conduct in general may be on the rise within the nonprofit sector. A 2007 study by the Ethics Resource Center concluded that "[t]he nonprofit sector that for so long enjoyed a better reputation with regard to its ethics now exhibits many of the shortcomings . . . found in . . . the public and private sectors."³¹ With respect to the categories of fraud measured, ERC found rates similar—and in some cases higher—than business or government.³² For instance, survey results indicated that 8% of employees in nonprofit organizations observed alteration of financial records, as compared to 5% of employees in businesses and

²⁷ See LESTER M. SALAMON, *AMERICA'S NONPROFIT SECTOR: A PRIMER* 13 (2d ed. 1999) (stating that there is often, and particularly in the United States, a "preference for some non-governmental mechanism to deliver services and respond to public needs because of the cumbersomeness, unresponsiveness, and bureaucratization that often accompanies government action").

²⁸ Margaret Gibelman, *A Loss of Credibility: Patterns of Wrongdoing Among Nongovernmental Organizations*, 15 *VOLUNTAS* 355 (2004) (concluding that the "vaulted societal status" of nongovernmental organizations "may render them more susceptible than other types of organizations to public disillusionment").

²⁹ Greenlee et al., *supra* note 10, at 677.

³⁰ Scott Harshbarger & Steven Netishen, *Watchdog Wanted: Making the Case for Internal Oversight of the Nonprofit Sector*, *NONPROFIT Q.* (Dec. 21, 2008), <https://nonprofitquarterly.org/governancevoice/1063-watchdog-wanted-making-the-case-for-internal-oversight-of-the-nonprofit-sector.html>.

³¹ ETHICS RESOURCE CENTER, *NATIONAL NONPROFIT ETHICS SURVEY: AN INSIDE VIEW OF NONPROFIT SECTOR ETHICS* iv (2007), available at http://www.ethics.org/files/u5/ERC_s_National_Nonprofit_Ethics_Survey.pdf.

³² *Id.* at 3-4.

6% in government.³³ Furthermore, within nonprofits, the more general category of “misconduct” has seen rates, which once were below business and government, catch up: 55% of nonprofit employees observed one or more acts of misconduct in 2007, compared to 56% and 57% for business and government, respectively.³⁴ Moreover, a significant number of nonprofit employees do not report observed misconduct: about two out of five do not report, a number similar to their for-profit counterparts.³⁵ Anecdotally, regulators have also reported higher levels of nonprofit fraud cases.³⁶ Despite such problems, nonprofit leaders may not be recognizing or responding adequately.³⁷

II. COMBATING FRAUD WITHIN NONPROFIT ORGANIZATIONS

Faced with the ongoing problem of employee fraud, what have nonprofit organizations done to stop it?³⁸ Nonprofit organizations appear to have focused their efforts on management and external agents to design, implement, and enforce fraud prevention strategies. But

³³ *Id.* at 4.

³⁴ *Id.* at 2-3; see also MARQUET INTERNATIONAL, THE 2012 MARQUET REPORT ON EMBEZZLEMENT 3, 23-4 (2013), available at <http://www.marquetinternational.com> (finding that over the previous five years, nonprofits and religious organizations experienced 12.2% of all cases of employee theft in the United States in which at least \$100,000 was misappropriated, putting the sector behind only the financial services industry in prevalence of embezzlements).

³⁵ ETHICS RESOURCE CENTER, NATIONAL NONPROFIT ETHICS SURVEY, *supra* note 31, at 3 (38% of nonprofit employees did not report); compare with ETHICS RESOURCE CENTER, NATIONAL BUSINESS ETHICS SURVEY: AN INSIDE VIEW OF PRIVATE SECTOR ETHICS 3 (2007) http://www.ethics.org/files/u5/The_2007_National_Business_Ethics_Survey.pdf (42% of private sector employees did not report) and ETHICS RESOURCE CENTER, NATIONAL BUSINESS ETHICS SURVEY OF THE U.S. WORKFORCE 26 (2013), <http://www.ethics.org/downloads/2013NBESFinalWeb.pdf> (37% of private sector employees did not report).

³⁶ Greenlee et al., *supra* note 10, at 679 (stating that the Massachusetts Attorney General’s State Charity Office reported that nonprofit fraud cases have been higher during the first half of the 2000s as compared to the previous decade).

³⁷ Brennen Jensen, *Are Charity Leaders Ignoring a Spike in Nonprofit Fraud*, CHRON. OF PHILANTHROPY (May 30, 2009), <http://philanthropy.com/blogPost/Are-Charity-Leaders-Ignorin/10149>.

³⁸ The focus of this article is on what nonprofit organizations can do themselves, as opposed to relying on external authority. The current ability of regulators to monitor nonprofits is limited, see *supra* note 4, although calls for more robust intervention is growing. See generally Lloyd Hitoshi Mayer & Brendan M. Wilson, *Regulating Charities in the 21st Century: An Institutional Choice Analysis*, 85 CHI.-KENT L. REV. 479, 480, n.4 (2010) (noting the “heightened interest” in expanding federal and state oversight of nonprofit governance); Woods Bowman, *Nonprofit Accountability and Ethics: Rotting From the Head Down*, NONPROFIT Q. (Oct. 26, 2012), www.nonprofitquarterly.org/management/21259-nonprofit-accountability-and-ethics-rotting-from-the-head-down.html.

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those efforts are not bringing about sufficient success.

This Article proposes that the current, dominant approaches to combating fraud undervalue and underutilize employees. Fraud would be more often prevented with processes designed to empower employees. This section reviews the current anti-fraud approaches and then examines the theoretical bases for empowering employees, establishing that employee involvement should play an integral role in every organization's fraud prevention efforts.

A. *Review of Current Approaches: Monitoring, Leadership Tone, Directives to Employees*

Mandates from legal authorities, pressure from interested constituencies, and academic research have produced a range of methods seeking to stop or reduce fraud. The available data and the oft-repeated advice indicate that there are two predominant current approaches: (1) monitoring mechanisms and (2) articulating standards from top leadership. Providing employees with resources for identifying and reporting fraud is a distant third approach, although, as this Article argues, even these efforts are incomplete.

The most recent Association of Certified Fraud Examiners ("ACFE") Global Fraud Survey shows that monitoring methods dominate nonprofit organizations' approach to fraud prevention. The ACFE inquired as to the frequency of eighteen anti-fraud controls for its 2014 report. Only five controls were used by more than half of the surveyed nonprofits: external audit (77.1%), code of conduct (67.2%), management certification of financial statements (64.8%), independent audit committee (54.5%), and internal audit department (52.1%).³⁹ With the exception of the code of conduct, which is best categorized as part of the second dominant approach (articulating standards from top leadership), each of these methods employs a monitoring approach.

Three major criticisms have been leveled at the reliance on monitors. First, if monitoring is the dominant aspect of a fraud prevention program, it conveys the message that the reason not to transgress the rules is to avoid punishment. Because the goal is to avoid punishment, the impetus for anti-fraud controls is merely instrumental, stripping away any moral import to the fraud rules. As a consequence, employ-

³⁹ *Report to the Nations on Occupational Fraud and Abuse: 2014 Global Fraud Study: Anti-Fraud Controls*, ACFE, <http://www.acfe.com/rtnn/docs/2014-report-to-nations.pdf>.



ees are subtly encouraged to think like economically rational actors—pursue your self-interest—rather than pursuing what is the morally correct thing to do.⁴⁰ Second, monitoring tells employees that they are not trusted. This may lead to employees seeing management/the organization as something in opposition to them and result in lower employee performance.⁴¹ It may also push employees to behave consistently with how they believe they are being treated, i.e., as not worthy of trust.⁴² Finally, monitoring entails significant economic costs that can make it infeasible for many organizations, particularly the numerous nonprofits that are small in terms of capital and people.⁴³ Each of these criticisms supports the idea that monitoring should not be the primary focus of an entity's anti-fraud approach.

In response to the problems with monitoring, the idea of developing an ethical culture and an organizational values-first orientation arose.⁴⁴ This Article espouses an approach consistent with that orientation, but criticizes the typical method used to create that culture. That typical approach focuses on articulating standards from top leadership, yet fails to fully integrate employees in the cultural change effort.⁴⁵

One of the earliest and still most popular attempts for creating such a culture is to issue an organizational code of conduct. But culture or orientation—and a resulting reduction of fraud—does not arise simply out of issuing an organizational statement or code. In the ACFE study, 67.2% of nonprofit organizations victimized by fraud had a code of conduct—the second most prevalent control. Previous ex-

⁴⁰ Scott Killingsworth, *Modeling the Message: Communicating Compliance Through Organizational Values and Culture*, 25 GEO. J. LEGAL ETHICS 961, 967 (2012); see also Sumantra Ghoshal, *Bad Management Theories Are Destroying Good Management Practices*, 4 ACAD. MGMT. LEARNING & EDUC. 75, 85 (2005).

⁴¹ See Killingsworth, *supra* note 40, at 968; Milton C. Regan, Jr., *Moral Intuitions and Organizational Culture*, 51 ST. LOUIS U. L.J. 941, 970-973 (2007).

⁴² Killingsworth, *supra* note 40, at 968.

⁴³ Marla Cornelius & Patrick Corvington, *Nonprofit Workforce Dynamics*, in THE STATE OF NONPROFIT AMERICA 639, 642 (2d ed. 2012) (noting that 74% of nonprofit organizations are operating with expenses under \$500,000).

⁴⁴ CHRISTOPHER A. MYERS, HOLLAND & KNIGHT LLP, CORPORATE COMPLIANCE ANSWER BOOK §8B.2.1 (2010) [hereinafter CORPORATE COMPLIANCE ANSWER BOOK] (“Research has shown that integrity-based programs that address ethics and culture are more effective than narrower compliance-based programs in reaching positive outcomes for organizations.”).

⁴⁵ See, e.g., Daniel Alcott, *Preventing and Responding to Fraud and Financial Mismanagement: Not for Profit – Safeguards*, 38 WESTCHESTER B.J. 71, 74 (2012) (“In dealing with fraud, the tone is set at the top; therefore, the board must set the proper example by designing and enforcing policies and procedures for management to implement and employees to follow.”).

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aminations of codes suggest that, by themselves, codes do not impact ethical behavior.⁴⁶ Codes may be important as an articulation of a company's ethical orientation, and thus helpful if part of a consistent, comprehensive approach.⁴⁷ However, if the organizational response to potentially unethical behavior does not align with the code, the existence of the code may produce a cynical response, in turn leading to more unethical behavior.⁴⁸

While values-based communication and exemplary behavior by organizational leadership is important to establishing the culture, this often-espoused "tone at the top" is insufficient because of the distance between leadership and those at lower rungs of the organization. Between top leadership and most employees lie a number of other potential influencers: lower-level managers and peers. If the "mood in the middle" and "buzz at the bottom" are not consistent with the tone at the top, the disconnect can encourage fraudulent behavior.⁴⁹ Thus, as will be argued below, in addition to those at the top of the organization, those in the middle and bottom of the everyday work of the organization must be better integrated into the anti-fraud efforts.⁵⁰

To be sure, employees have not been entirely left out of current anti-fraud efforts, although methods that include employees are significantly less prevalent than methods focused on monitors or top leadership. For instance, 37.8% of nonprofit organizations conducted fraud training for employees, 38.8% provided a reporting hotline, and 45.8% provided employee support programs.⁵¹ Thus, in some organizations, employees may be the object of education efforts, they may be asked to report unethical or noncompliant behavior to senior management or internal auditors, and they may be offered support services to help

⁴⁶ Margaret Anne Cook & Sherry Lynn Leonard, *Can Corporate Codes of Ethics Influence Behavior*, 17 J. BUS. ETHICS 619, 625 (1998).

⁴⁷ Timothy L. Fort, *Steps for Building Ethics Programs*, 1 HASTINGS BUS. L.J. 197, 199-200 (2005).

⁴⁸ Linda Klebe Trevino et al, *(Un)Ethical Behavior in Organizations*, 65 ANN. REV. PSYCHOL. 635, 639 (2014) (discussing Jennifer J. Kish-Gephart et al., *Bad Apples, Bad Cases, and Bar Barrels: Meta-Analytic Evidence About Sources of Unethical Decisions at Work*, 95 J. OF APPLIED PSYCHOL. 1 (2010)).

⁴⁹ CORPORATE COMPLIANCE ANSWER BOOK, *supra* note 44, at §8B2.1 ("A powerful influencer of behavior in most organizations—sometimes even more powerful than messages or tone from leadership—is peer pressure.")

⁵⁰ *Id.*

⁵¹ *Frequency of Anti-Fraud Controls by Type of Victim Organization*, ACFE, <http://www.acfe.com/rttm-controls.aspx>.

them through difficult personal or household financial situations.⁵² Through such efforts employees are expected to learn and abide by rules and guidelines established by management, auditors, or legal authorities. As a result, to the extent that employees are included within the anti-fraud controls, it is often as the recipients of directives constructed and distributed by others—not as active participants in creating, disseminating, and evaluating the policies themselves.

Yet despite the relative infrequency of including employees in fraud prevention efforts, employees are the most frequent source for uncovering fraud. In the ACFE study, in which 81.4% of all organizations (and 77.1% of nonprofit organizations) underwent an external audit of their financial statement, only 3.0% of frauds were uncovered by the external audit.⁵³ Other heavily used oversight mechanisms were more effective (e.g., management review uncovered 16% of frauds; internal audit uncovered 14.4%).⁵⁴ But employee tips bettered them all. Employees revealed more than 20% of all frauds—exposing more frauds more than any other method.⁵⁵ Employee tips were this effective despite that only 47.8% of companies offered fraud training for employees and only 54.1% provided a reporting hotline (as noted above, even less nonprofit organizations provided either training or a hotline).⁵⁶

Because of this effectiveness, employers would be advised to implement more hotlines and employee education. That would be a valuable, though incomplete, incorporation of employees into the anti-fraud efforts. But treating employees merely as recipients of directives misses

⁵² See, e.g., Daniel Lucien Buhr, *Five Fundamentals for Taking Compliance Management Seriously*, ACC DOCKET, Jan.-Feb. 2011, at 39, 42-44 (including in the “basic structure of a compliance program” that the company “informs and regularly trains its staff” about the code of conduct and “ensures that the staff and third parties can contact a reporting body, maintaining anonymity if requested”). Compare William H. Devaney et al., *Protecting Your Nonprofit from Embezzlement & Fraud*, VENABLE (Oct. 6, 2010), www.venable.com/nonprofits (discussing ten control measures to consider), with Jeffrey Tenenbaum & William Devaney, *Detecting and Preventing Fraud and Embezzlement*, VENABLE (Mar. 2013), www.venable.com/nonprofits (adding employee training as an eleventh suggested control measure).

⁵³ ASSOCIATION OF CERTIFIED FRAUD EXAMINERS 2014, *supra* note 17, at 19 (ACFE report did not break down the detection method by type of organization).

⁵⁴ *Id.*

⁵⁵ *Id.* at 19-21 (reporting that 20.6% of fraud initially detected by employee tips.) Moreover, this likely undercounts the number of tips from employees. Fraud was initially detected by tips 42.2% of the time. While 49% of these tips were identified as coming from employees, a further 14.6% were anonymous; a figure that presumably includes some employees as well. See *id.*

⁵⁶ *Id.* at 31; see *supra* note 51 and accompanying text.

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an opportunity to more effectively instill a fraud-free mentality and drive in the workforce.

Employees should not merely be told what the organization's values are and how to behave accordingly; instead, they should be given a participating role in the process of designing, implementing and enforcing the fraud prevention strategy. The next section explores why this is an effective approach.

B. *Theoretical Support for the Proposed Approach of Empowering Employees*

The important role that employee tips play in exposing fraud is proof that the success of an anti-fraud strategy depends to a large extent on employee cooperation. Employees must decide whether to participate in a fraud, stand idly by while suspecting a fraud, or act to prevent or stop a fraud. They also make decisions whether to participate in or allow avoidance of anti-fraud controls. Although employees' intentions in allowing circumvention of the rules may be innocent (e.g., to allow a faster than normal response to a co-worker or third party or pursue what they believe is a more important organizational end) the effect may be to provide the opportunity for fraud to occur. Consequently, employees' understanding of the rationale for the anti-fraud control mechanisms, their dedication to upholding the integrity of those measures, and their input in determining when a particular measure could be better designed are critically important to ensure control effectiveness.

Certainly, surveillance can make an errant employee's nefarious plans more difficult to put into action, and the work of internal auditors and lawyers can be useful in uncovering and investigating suspected frauds. Proposing that employees be included in anti-fraud efforts does not mean that these fraud mechanisms and experts should be excluded from the process. Rather, incorporating employees in crafting and enforcing corporate anti-fraud rules adds a critical and otherwise lacking component to an anti-fraud program. And, if implemented as suggested in Section III below, this approach would be part of a comprehensive ethics system. It also may enable fewer resources to be used on enforcing control mechanisms.⁵⁷

⁵⁷ See Tom R. Tyler, *Promoting Employee Policy Adherence and Rule Following in Work Settings: The Value of Self-Regulatory Approaches*, 70 BROOK. L. REV. 1287, 1295 (2005) (noting the significant costs of a command-and-control system).

Social psychology and organizational behavior research supports the idea that active employee participation in anti-fraud efforts—beyond just the occasional employee tip hotline—would be a valuable addition to a nonprofit organization’s response to economic crime. In the following sections, this Article explains the two theories supporting the full incorporation of employees in anti-fraud efforts.

The first theory relates to employee participation as a means to secure each individual’s buy-in to the organization’s goals (one of which presumably is to prevent the illicit use of organizational funds). Incorporating an employee in relevant processes has a powerful effect on the employee. When she is empowered through opportunities to participate, she will scrupulously attend to anti-fraud rules and work for compliance by other employees. The second theory relates to the concept of peer group influence, which helps create a culture of compliance in the entire workforce. Employees committed to a fraud-free workplace send a signal to their peers, and that signal influences the behavior of other workers—making all employees less likely to commit fraud.

i. Employees Who Participate in Decision-Making Scrupulously
Attend to the Rules and Seek Compliance by Others

Employee participation in fraud-prevention efforts is likely to lead to positive behaviors, such as meticulous rule-following and internal whistleblowing, beyond what the organization is able or willing to enforce with sanctions or rewards. The key connection is the role that employee participation plays in creating procedural justice, which in turn enhances an employee’s affective commitment to organizational objectives.

Procedural justice is defined as the perceived fairness of the procedures or means used to determine an outcome.⁵⁸ Procedural justice is different from distributive justice, which is concerned with the perceived fairness of the outcomes.⁵⁹ Participation in decision-making is vital because it is one of the primary elements that bring about procedural justice.⁶⁰

⁵⁸ Chockolingam Viswesvaran & Deniz S. Ones, *Examining the Construct of Organizational Justice: A Meta-Analytic Evaluation of Relations with Work Attitudes and Behaviors*, 38 J. BUS. ETHICS 193, 193 (2002).

⁵⁹ *Id.*

⁶⁰ Tom R. Tyler, *Justice*, in GROUP PROCESSES 111, 124-125 (John M. Levine ed., 2013). The others are “a neutral forum, trustworthy authorities, and treatment with dignity and respect.” *Id.*

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With procedural justice comes an employee's affective commitment,⁶¹ that is, an emotional attachment to and identification with an organization.⁶² Because the employee feels attached to the organization and senses that she belongs, the affectively committed employee wants the organization to succeed.⁶³ Consequently, an affectively committed employee seeks to act for the betterment of the organization even when such behavior is not required or rewarded.⁶⁴ This includes observing group rules, even when there is no fear that errant behavior will be detected.⁶⁵

The link between procedural justice and affective commitment has been observed in the nonprofit context. In a study of decision-making within French social enterprises—akin to U.S. nonprofits—a significant positive relationship between procedural justice and affective commitment was found.⁶⁶ The process of contributing to organizational decision-making encouraged employees' commitment to their organization.⁶⁷

In addition to following rules, an affectively committed employee is more likely to take voluntary steps to ensure that group resources are not lost through fraud committed by other employees. For example, an employee might report that she suspects an ongoing fraud—even

⁶¹ *Id.* at 119 (“[S]tudies of procedural justice indicate that it plays an important role in motivating commitment to organizations.”); see also Marc Ohana, *Decision-Making in Social Enterprises: Exploring the Link Between Employee Participation and Organizational Commitment*, 42 *NONPROFIT & VOLUNTARY SECTOR Q.* 1092, 1096, 1100 (2012) (finding that procedural justice was positively related to affective commitment in the context of social enterprises); Viswesvaran & Ones, *supra* note 58, at 199 (finding correlation between procedural justice and organizational commitment).

⁶² John P. Meyer et al., *Affective, Continuance, and Normative Commitment to the Organization: A Meta-Analysis of Antecedents, Correlates, and Consequences*, 61 *J. VOCATIONAL BEHAV.* 20, 21 (2002); accord Ohana, *supra* note 61, at 1096.

⁶³ Tom R. Tyler & Steven L. Blader, *COOPERATION IN GROUPS: PROCEDURAL JUSTICE, SOCIAL IDENTITY, AND BEHAVIORAL ENGAGEMENT* 55 (2000).

⁶⁴ *Id.*

⁶⁵ Meyer et al., *supra* note 62, at 37 (finding a positive correlation between affective commitment and organizational citizenship behaviors, including “compliance/conscientiousness”); see Philip M. Podsakoff et al., *Organizational Citizenship Behaviors: A Critical Review of the Theoretical and Empirical Literature and Suggestions for Further Research*, 26 *J. OF MGMT.* 513, 517-18 (2000) (summarizing the Organizational Citizenship Behaviors (OCB) literature’s understanding of “organizational compliance” as “capturing a person’s internalization and acceptance of the organization’s rules, regulations, and procedures, which results in a scrupulous adherence to them, even when no one observes or monitors compliance”).

⁶⁶ Ohana, *supra* note 61, at 1100.

⁶⁷ Ohana, *supra* note 61, at 1101-02.

though reporting is not strictly required of her. Ideally, from the organization's perspective, the employee would report her concerns internally rather than publicly blowing the whistle, thus allowing the organization to respond proactively to combat the fraud rather than reacting to an outside probe by legal authorities or journalists.⁶⁸ A recent study of nonprofit organizations found that employees were less likely to believe that they must publicly blow the whistle if they perceived that their supervisor was "open to their participation in decision-making and relatively democratic in their practices."⁶⁹ Thus, an organization that is participatory—one of the key components of procedural justice—is more likely to be alerted to a potential fraud before public disclosure results in reputational harm.

Consequently, employee participation should make it more likely that each individual will abide by the organization's anti-fraud rules and policies and encourage them to promote anti-fraud success throughout the entity, but a final question remains: participation in what? Most studies look at participation generally in the organization, not participation in any particular strategy or program.⁷⁰ But beyond including employees in the general decision-making framework of the organization, this Article proposes that employees participate in designing, implementing, and enforcing anti-fraud measures. An employee's everyday work is affected by the construction of rules designed to prevent fraud, e.g., how much documentation is necessary for expense reimbursement, what vetting needs to occur before contracting with a new vendor,

⁶⁸ Benisa Berry, *Organizational Culture: A Framework and Strategies for Facilitating Employee Whistleblowing*, 16 EMPLOYEE RESPONSIBILITIES & RIGHTS J. 1, 1 (2004) (noting that internal reporting benefits an organization over external whistleblowing because the former "facilitates early detection of misconduct and creates opportunity for timely investigation and corrective action").

⁶⁹ Joyce Rothschild, *The Fate of Whistleblowers in Nonprofit Organizations*, 42 NONPROFIT & VOLUNTARY SECTOR Q. 886, 891 (2013).

⁷⁰ Importantly, this suggests that participation and fairness with respect to anti-fraud measures cannot be separated out from fairness in the workplace generally. One implication for nonprofit organizations, which typically pay their employees less than what they could earn in the private sector, is to consider whether employees perceive that pay decisions are made in a procedurally just manner. While resource limitations may make salary increases impossible, the outcome may be less important than the process. See Tyler & Blader, *supra* note 63, at 10 (stating that "prior research has suggested that procedural justice judgments often have more influence on people's attitudes and behaviors than do their assessments of their personal self-interest"). Nonprofit organizations would therefore be well advised to be transparent with their employees about the financial pressures on the organization and the process used to reach salary and pay decisions, thus contributing to the practice of procedural justice generally.

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what rules apply to working with government officials in developing countries. It is precisely because the anti-fraud measures impact everyday duties that employees should be included in their construction, dissemination, and prosecution. Developing an employee who will operate ethically even when not watched requires allowing him to participate in decision-making about his work.⁷¹ If the employee understands that the rules and procedures were a product of a fair process in which he had the opportunity for involvement, he will be more likely to conform to them and seek to have fellow workers similarly comply.

ii. Employee Commitment Sends an Influential Peer Message

In addition to the enhanced anti-fraud commitment that participation engenders in individual employees, participation sends a powerful social signal to all employees that fraud is not accepted within the organization. This social signal is critically important to influencing and directing ethical decision-making because most people look outside themselves for guidance when making ethical decisions.⁷² Organizations must recognize the typical appeal to external referents and seek to influence their personnel's decision-making accordingly, by providing markers such as the behavior and language of other people (leaders, peers) and the establishment of rules (codes, guidance documents, procedures).⁷³

In other words, ethical decisions are not made in a vacuum in which the actor dispassionately and rationally decides merely between personal risk and reward. Rather, the decision-maker is influenced by personal/individual and contextual variables.⁷⁴ Even the simple *awareness* of the ethical dimensions of a decision is affected by contextual variables.⁷⁵ Awareness is theorized to be important for ethical decision-

⁷¹ See Melissa S. Baucus & Caryn L. Beck-Dudley, *Designing Ethical Organizations: Avoiding the Long-Term Negative Effects of Rewards and Punishments*, 56 J. BUS. ETHICS 355, 363 (2005) (contending that a "necessary characteristic of corporate communities" is allowing employees to participate in the decisions that affect "how their work gets done").

⁷² Trevino et al., *supra* note 48, at 637.

⁷³ See *id.* (stating that ethical decision-making within organizations implicates influential "power and authority structures . . . organizational, leader, and peer influences and constraints").

⁷⁴ See generally *id.*; see also DAN ARIELY, *THE (HONEST) TRUTH ABOUT DISHONESTY: HOW WE LIE TO EVERYONE—ESPECIALLY OURSELVES* 237-38 (2012).

⁷⁵ Kenneth D. Butterfield et al., *Moral Awareness in Business Organizations: Influences of Issue-Related and Social Context Factors*, 53 HUMAN RELATIONS 981 (2000); Celia Moore & Francesco

making as the first of four steps that lead to an ethical action: (1) moral awareness, (2) moral judgment, (3) moral intent, and (4) moral action.⁷⁶

Among relevant variables, social norms (i.e., the behavioral expectations that people hold in a particular context) are a particularly powerful influence on whether the decision-maker is aware or neglectful of the ethical aspects of a decision.⁷⁷ In one study, participants were given two business decision scenarios and tested to see which factors influenced whether they recognized the moral nature of the situation. The researchers found that when the participants perceived that others in their organization or profession would see the issue as ethically problematic, the participants themselves were more likely to be aware of and consider the ethical issues involved.⁷⁸ Moreover, the effect of this “perceived social consensus” on participants’ moral awareness was stronger than other factors.⁷⁹ Prior studies also support the strength of perceived social consensus.⁸⁰ Accordingly, the researchers concluded that, “although previous normative and descriptive writings have tended to suggest that . . . ethical decision making is an individual or personal process, this research suggests that, in organizational contexts, it is very much a social process.”⁸¹

This socially influenced, ethical decision-making process is particularly shaped by peers: those whom we identify as similar to ourselves. Across a number of studies that examined cheating in higher education, the degree to which students perceived that fellow students cheated had “the most significant relation with student cheating” compared to a range of other factors, such as the existence of sanctions, the likelihood of being caught, and disapproval by authority figures.⁸²

The university cheating studies provide a useful analog to fraud

Gino, *Ethical Adrift: How Others Pull Our Moral Compass from True North, and How We Can Fix It*, 33 RES. IN ORGANIZATIONAL BEHAV. 53, 56 (2013).

⁷⁶ Butterfield, *supra* note 75, at 982; accord Sean Valentine & Tim Barnett, *Perceived Organizational Ethics and the Ethical Decisions of Sales and Marketing Personnel*, 27 J. PERS. SELLING & SALES MGMT. 373, 383 (2007).

⁷⁷ Moore & Gino, *supra* note 75, at 56.

⁷⁸ Butterfield et al., *supra* note 75, at 1001.

⁷⁹ *Id.* at 1008 and Table 3.

⁸⁰ *Id.* at 1008 (citing previous studies).

⁸¹ *Id.* at 1001; see also, e.g., Francesco Gino et al., *Contagion and Differentiation in Unethical Behavior*, 20 PSYCHOL. SCI. 397 (2009) (concluding that: “peer influence is an important factor in unethical behavior”).

⁸² Donald McCabe et al., *Cheating in Academic Institutions: A Decade of Research*, 11 ETHICS & BEHAV. 219, 222 (2001).

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committed against nonprofit organizations. Many of the aspects studied in the higher education context are either directly applicable or easily analogized to the organizational context; for example, honor code: code of conduct; faculty support: management support. And, of course, the students in those studies go on to populate the nonprofit organizations that are the concern of this Article. Finally and perhaps most significantly, the nature of cheating is similar to fraud—in each, an individual gains in violation of the rules and at the expense of a mission-driven institution.

Across almost two decades of research into cheating, students' perceptions of peer behavior consistently emerged as the most influential variable affecting cheating. In the initial study, encompassing more than 6,000 students from thirty-one U.S. colleges and universities, the effect of variables such as the existence of a honor code, student understanding and acceptance of an academic integrity policy, the certainty of being reported, and the severity of penalties were measured.⁸³ Subsequent studies focused on potential individual influencers (e.g., age, gender, academic achievement) and contextual influencers (e.g., degree of faculty support for academic integrity policies).⁸⁴ Across the studies, the perception of peer behavior was the most influential factor on whether students cheated.⁸⁵

The finding was the same when cheating was investigated among graduate business school students, a population that has additional similarities to the workforce because it typically consists of older students with previous work experience who do not live in communal housing.⁸⁶ The diffuse community aspect might be expected to lessen the impact of peer-related contextual factors on cheating, but that was not the case in this study. For the study's graduate business school students, the most significant factor in the level of cheating was the per-

⁸³ Donald L. McCabe & Linda Klebe Trevino, *Academic Dishonesty: Honor Codes and Other Contextual Influences*, 64 J. HIGHER EDUC. 522, 528, 530-531 (1993).

⁸⁴ See, e.g., Donald L. McCabe et al., *Honor Codes and Other Contextual Influences on Academic Integrity: A Replication and Extension to Modified Honor Code Settings*, 43 RES. IN HIGHER EDUC. 357, 358, 372 (2002) ("perception of peers' behavior had the most influence under all three code conditions"); Donald L. McCabe & Linda Klebe Trevino, *Individual and Contextual Influences on Academic Dishonesty: A Multicampus Investigation*, 38 RES. HIGHER EDUC. 379, 387, 391 (1997).

⁸⁵ See, e.g., McCabe et al., *supra* note 82, at 223-224.

⁸⁶ See McCabe et al., *Academic Dishonesty in Graduate Business Programs: Prevalence, Causes, and Proposed Action*, 5 ACAD. MGMT. LEARNING & EDUC. 294, 303-304 (2006).

ception of their peers' academic dishonesty.⁸⁷

In the organizational context, coworkers make up an important peer group,⁸⁸ and, as such, coworkers are likely to share attributes, connections, and identities with each other. Such commonalities influence ethical decision-making, for good and ill, by bringing about psychological closeness: "feelings of attachment and perceived connection toward another person or people."⁸⁹ Within a nonprofit organization, psychological closeness may be generated through common group membership (as members of the same organization, unit, or department) or identity (as persons mutually engaged in a particular mission).⁹⁰

The resulting psychological closeness between coworkers significantly influences behavior, even when the norm for behavior seems otherwise apparent. For example, a person's evaluation of the moral appropriateness of cheating is influenced by whether he feels psychologically close to the cheater. If he feels close to the cheater, he is more likely to view the behavior as morally acceptable and act likewise.⁹¹ But there is an upside as well—if the person feels psychologically close to someone who has acted virtuously, he is more likely to act virtuously.⁹²

Because perceived peer behavior is extremely important in shaping ethical decision-making, every organization should seek to create and propagate the (accurate) perception that fraud and other unethical behavior is considered unacceptable by the agents' relevant peer group. That perception can be created among the workforce by demonstrating that employees are devoting their time, knowledge, and effort to combat fraud within the organization. The dedication of employees should be made evident through formal and informal channels, thus supporting the acculturation of fraud prevention and ethical norms in general throughout the organization.

⁸⁷ *Id.* at 299.

⁸⁸ Trevino et al., *supra* note 48, at 642.

⁸⁹ Francesco Gino & Adam D. Galinsky, *Vicarious Dishonesty: When Psychological Closeness Creates Distance from One's Moral Compass*, 119 ORGANIZATIONAL BEHAV. & HUM. DECISION PROCESSES 15, 16 (2012).

⁹⁰ *See Id.* (identifying ways in which psychological closeness can be brought about).

⁹¹ *Id.* at 21, 23.

⁹² *Id.* at 23.

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III. IMPLICATIONS FOR DESIGNING A FRAUD PREVENTION PROGRAM

The theoretical bases supporting the inclusion of employees in an organization's anti-fraud program also provide direction for what that participation should entail. Organizations characterized by procedural justice will work to have their employees participate meaningfully in the process of seeking to prevent fraud. Entities cognizant of the distinct importance of peers to ethical decision-making will harness the power of those peer relationships. Additionally, they will provide forums for the development of ethical leadership among employees. Of course, as with any ethics effort, the unique attributes of the particular organization must be taken into account when designing or reforming a fraud prevention program.⁹³

A. *Employees Should Play Meaningful and Visible Roles in Fraud Prevention*

Effectively incorporating employees into organizational anti-fraud efforts requires that employees participate in those efforts in meaningful and visible ways. For participation to be meaningful, employee views must be considered (although they do not need to control the outcome). Employees must be given the opportunity for their ideas to be heard in the decision-making process.⁹⁴ Participation becomes empowering when employees are part of the authorized and accountable anti-fraud decision-making process.⁹⁵

Consequently, the legal or audit functions (internal or external) or upper management cannot wholly own the fraud prevention program, which is not to say that those groups should not play a role. Indeed, these groups can bring particular and valuable expertise, set the tone, convene and drive the agenda, and act to prevent possible collusion among actors. Rather than anti-fraud measures emanating from any single group, employees should be brought in as co-owners of the fraud prevention strategy. All employees should be targeted for ideas, feedback, and training and employee representatives should be part of a

⁹³ See Linda Klebe Trevino & Katherine A. Nelson, *MANAGING BUSINESS ETHICS: STRAIGHT TALK ABOUT HOW TO DO IT RIGHT* 189 (6th ed. 2014) (asserting that changing the ethical culture requires "an in-depth analysis of the company and its current ethical climate.").

⁹⁴ See *supra* § II.B.i.

⁹⁵ See Benisa Berry, *Organizational Culture: A Framework and Strategies for Facilitating Employee Whistleblowing*, 16 *EMPLOYEE RESP. & RTS. J.* 1, 7 (2004) (defining empowerment as "a process that gives employees both the authority to make decisions and the responsibility for outcomes.").

standing ethics committee responsible for overseeing ethical issues throughout the organization.⁹⁶

In addition to being meaningful, employee participation should be visible, due to the important role the perception of peer behavior and attitudes plays in ethical decision-making.⁹⁷ By making employee commitment observable, organizations allow dissemination of the message that the employees themselves believe in and are committed to a fraud-free workplace.

The importance of employee-action for successfully preventing fraud within an entity suggests that such meaningful and visible inclusion be extended to every aspect of the anti-fraud process: design, implementation and enforcement. With respect to design, all employees should be encouraged to submit their ideas for how to improve anti-fraud measures, identify procedures that might have gaps, and suggest where controls might be missing their target or creating unacceptable and unanticipated problems. The logistics of that process may vary according to the organization's size, complexity, and geographic reach; for example, some may rely mainly on anonymous, computerized submission systems while others may convene periodic meetings to review the procedures. The ethics committee, consisting in part of select employees, would consider these ideas on a regular basis. This review ensures a quality control check, though which ideas are exchanged and vetted in a transparent way, and demonstrates to all employees that they are a valued part of the process.

Implementation should include using employees as part of training efforts. Employees could be identified to help lead periodic, formal ethics conversations exploring the issues most salient for the personnel in their areas and in functions that interface with each other. And to further enhance the visibility of employee participation, the membership of the ethics committee should be prominently stated on all policies and procedures.

Finally, enforcement entails including employees in the investigation of suspected frauds. This presents the most sensitive aspect of employee participation, given the need to protect those being investi-

⁹⁶ See Linda Klebe Trevino et al., *Managing Ethics and Legal Compliance: What Works and What Hurts*, 41 CAL. MGMT. REV. 131, 147 (1999) (recommending that because of the importance of establishing an ethical culture, the "responsibility for ethics and compliance management should be held broadly within the organization").

⁹⁷ See *supra* § II.B.ii.

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gated and to maintain confidentiality requirements. But select employees can be part of the investigation procedure by, for instance, serving a term as part of a formally constituted investigation review panel. Proper instruction in the need for confidentiality and treatment as part of the control group for the investigation should alleviate concerns as to employee involvement.

B. *Employees Should Be Engaged in Ongoing Conversations About Fraud Prevention and Ethics*

In addition to involvement in the mechanisms and formal structures developed to address fraud, formal conversations should be periodically convened and informal conversations encouraged to discuss ethical questions, including fraud, relevant to the type of work engaged in by particular employees, the organization, and similar nonprofits. Engagement in such conversations works to accomplish three goals: (1) establishing ethics as a relevant and welcomed part of organizational decision-making; (2) enabling employees to take virtuous action; and (3) developing ethical leaders within the organization.

First, the simple existence of ethical conversations makes it clear to employees that their decisions within the workplace should include ethical considerations. This is critical because decision-making has been shown to vary depending on how the person frames the issue. If the decision is perceived to not involve ethical considerations, then the person is unlikely to take into account ethics into her decision—even when ethical problems exist.⁹⁸

Even minimal conversations can have an effect on the way a person frames an issue. In a recent study, participants confronted a “right-wrong” decision, akin to those decisions inherent in employee fraud, by having the opportunity to tell a lie or truth to a supposed fellow participant. If the participant told a lie, it could result in a financial windfall. Participants were primed for the decision by engaging in a single email exchange with a supposed peer (actually a computer program) that either evoked a moral truth-telling norm or a self-interested norm. The results were significant: participants were four times more likely to tell

⁹⁸ See Blake E. Ashforth & Vikas Anand, *The Normalization of Corruption in Organizations*, 25 RES. ORG. BEHAV. 1, 6 (2003) (stating that when “ethical issues . . . are not perceived or are subordinated to or reframed as economic, legal, public relations, or other kinds of ‘business’ issues, . . . managers [are] free to engage in amoral reasoning.”).

the truth when they had a moral exchange than if they had a self-interested exchange.⁹⁹ The experiment was limited to a single decision; organizational conversations likely need to be ongoing and more robust if the effect is to last. But the idea is important because non-profit organizations cannot assume that their employees intuitively know that ethical considerations are welcomed in the workplace. This may be particularly true given the pressures to have nonprofits act more like businesses,¹⁰⁰ which have demonstrated plenty of notable frauds and ethical lapses in recent years.

Second, conversations make it easier to act once the individual has identified the action she wants to take. Recall that moral awareness, judgment, and intent can all exist and still not result in action.¹⁰¹ To stop fraud, individuals must act, but conversations entered into before a particular situation arises can make it more likely that they will respond as needed. That is the conclusion of the *Giving Voice to Values* program, founded by the Aspen Institute of Business and Society Program and Yale School of Management. Wrestling with ethical questions enables people to act because the conversations demonstrate that they have allies and give opportunity to develop their understanding of how they would effectively address an unethical situation.¹⁰² In short, conversation is preparation.

Finally, conversations are crucial for developing ethical leaders within the organization. Ethical leaders must be able to engage in ethical reasoning beyond reference to group norms, which, as discussed above, is how most adults conduct ethical inquiries.¹⁰³ Such leaders are therefore important for guiding the organization's adherence to laws, socially beneficial principles, and universal values.¹⁰⁴

Interpersonal dialog is critical for preparing people for ethical decision-making.¹⁰⁵ This is part of the approach at the United States Mili-

⁹⁹ Brian C. Gunia et al., *Contemplation and Conversation: Subtle Influences on Moral Decision Making*, 55 ACAD. MGMT J. 13, 24 (2012).

¹⁰⁰ Dennis R. Young, Lester M. Salamon, & Mary Clark Grinsfelder, *Commercialization, Social Ventures, and For-Profit Competition*, THE STATE OF NONPROFIT AMERICA 521 (2d ed. 2012).

¹⁰¹ See *supra* note 76.

¹⁰² MARY C. GENTILE, *GIVING VOICE TO VALUES* xxxii, 57-58, Appendix C (2010).

¹⁰³ See *supra* § II.B.ii.

¹⁰⁴ This list corresponds to Stages Four, Five, and Six in Lawrence Kohlberg's stages of moral development theory.

¹⁰⁵ Leslie E. Serkerka, *Organizational Ethics Education and Training: A Review of Best Practices and their Application*, 13 INT'L J. TRAINING & DEV. 77, 91 (2009); see Baucus & Beck-Dudley, *supra* note 71, at 363.

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tary Academy at West Point, where cadets are both students and employees of the U.S. Army. A recent qualitative study at West Point examined the institution's ethical system to determine how the components contributed or inhibited the success of the system.¹⁰⁶ The study concluded that West Point seeks to form soldiers who would behave ethically by exposing past mistakes and encouraging debate, dialogue and reflection.¹⁰⁷ This learning process accepts the tensions inherent in some of the values espoused, such as loyalty and honor, and seeks to develop people who can make ethically complex decisions.¹⁰⁸

Returning to the studies of cheating within universities, the researchers concluded that the highest cheating levels are "usually found at colleges that have not engaged their students in active dialogue on the issue of academic dishonesty—colleges where the academic integrity policy is basically dictated to students and where students play little or no role in promoting academic integrity or adjudicating suspected incidents of cheating."¹⁰⁹ Accordingly, the researchers recommended that institutions consider "creating a 'hidden curriculum' in which students not only receive formal ethics instruction but also learn by actively discussing ethical issues and acting on them . . . allowing students to participate in the many opportunities for teaching and learning about ethical issues that arise in the day-to-day operations" of the institution.¹¹⁰

In most organizations, such opportunities for ethical learning are rare. Most employers focus on disseminating applicable rules, policies, standards, and regulations, rather than "helping people learn and explore ethical frameworks."¹¹¹ The need for better fraud prevention outcomes within nonprofit organizations calls out for introducing ethical conversations in the workplace and incorporating employees throughout the organization's anti-fraud efforts.

¹⁰⁶ Evan H. Offstein et al, *Reconciling Competing Tensions in Ethical Systems: Lessons from the United States Military Academy at West Point*, 37 *GROUP & ORG. MGMT.* 617, 618 (2012).

¹⁰⁷ *Id.* at 642-44.

¹⁰⁸ *Id.*

¹⁰⁹ Donald L. McCabe & Gary Pavela, *New Honor Codes for a New Generation*, *INSIDE HIGHER ED.* (Mar. 11, 2005), available at <https://www.insidehighered.com/views/2005/03/11/pavela1>.

¹¹⁰ McCabe et al., *supra* note 82, at 228-29.

¹¹¹ Leslie E. Sekerka, *Organizational Ethics Education and Training: A Review of Best Practices and their Application*, 13 *INT'L J. TRAINING & DEV.* 77, 81, 90 (2009) (study of selected organizations in Silicon Valley).

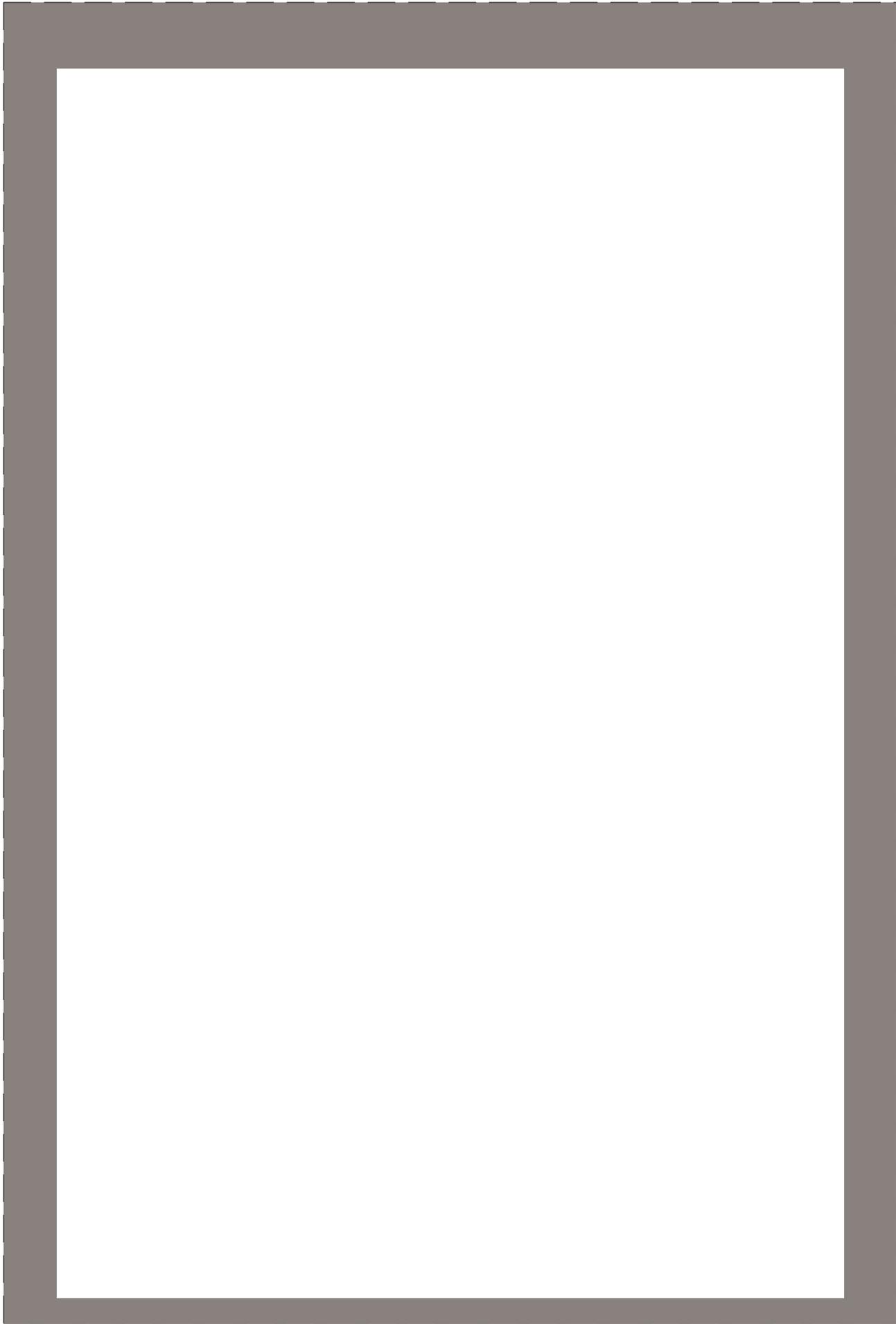
CONCLUSION

Including employees in the design, implementation and enforcement of an organization's anti-fraud strategy demands resources above what is required for a small group of designated persons—the legal department, the internal audit department, the board—to do so the same. This Article has not examined all of the costs and benefits of fraud prevention approaches. But given the expense of effective monitoring, the costs of including more people may be less expensive than purely top-down approaches—even leaving aside potential savings from preventing a fraudulent scheme.

This Article has revealed that employees are often overlooked yet vitally important to improving fraud outcomes. Empowering employees moves the locus of the anti-fraud measures from someone or something external to the employees themselves—a move towards internalization. Thus, the decision to act in accordance with the rules becomes a personal decision, reinforced by peer influence, and reduces resistance to uninspiring “ethical edicts from top management”¹¹² and reliance on financially- and socially-costly command-and-control systems.¹¹³ This process of internalization may be particularly salient for non-profit workers, many of whom chose to be part of a cause or mission-driven body. Given the opportunity, they will likely respond to overtures to be more integrated into the organization's governance, allowing the organization to not only improve its anti-fraud efforts, but also refine its ethical focus and build a more committed workforce.

¹¹² Timothy Fort, *Steps for Building Ethics Programs*, 1 HASTINGS BUS. L. J. 197, 200 (2005).

¹¹³ *Cf.* Tyler, *supra* note 57, at 1295-1296; *cf.* TOM R. TYLER, *WHY PEOPLE OBEY THE LAW* 65 (2006) (“Democratic societies require normative commitment to function effectively. Authorities cannot induce through deterrence alone a level of compliance sufficient for effective social functioning. Society's resources are inadequate to such a task and some base of normative commitment to follow the law is needed.”).



COURT ARBITRATION BY COMPROMISE: RETHINKING DELAWARE'S STATE SPONSORED ARBITRATION CASE

Yuval Sinai and Michal Alberstein***

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INTRODUCTION

The adjudicative system is undergoing significant change as a result of the widespread introduction of various judicial dispute resolution (JDR) modes, which employ innovative hybrid methods of adjudicative decision making, combining elements of adjudication with those of alternatives dispute resolution (ADR).¹ This trend may be viewed in

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¹ See, e.g., Tania Sourdin & Archie Zariski, *The Multi-Tasking Judge: Comparative Judicial Dispute Resolution* (2013) [hereinafter *The Multi-Tasking Judge*].

light of what Judith Resnik recently defined as “the privatization of process” — the reconceptualizing of adjudication by introducing the multitasking judge who manages, settles, mediates, and promotes new forms of alternative dispute resolution.² This phenomenon corresponds with the fact that “most cases settle”³ and that the traditional trial is vanishing (“trial as error”).⁴ Hybrid methods of judicial dispute resolution exist in many countries.⁵ An interesting hybrid method is used in Delaware: a state-sponsored arbitration program—a binding arbitration before a judge that takes place in a courtroom—which is an alternative to trial for resolving certain kinds of (business) disputes.⁶ Although Delaware’s state-sponsored arbitrations program share characteristics such as informality, flexibility, and limited review with private arbitrations, they differ fundamentally from other arbitrations because they are conducted before active judges in a courthouse,⁷ because they result in a binding order of the Chancery Court, and because they allow only limited right of appeal. Delaware’s special arbitration program was

² Judith Resnik, *The Privatization of Process: Requiem for and Celebration of the Federal Rules of Civil Procedure*, 162 U. Penn L. Rev. 1793, 1802-1814 (2014) (arguing that the new forms of ADR should be understood as a “New Private Process”).

³ Marc Galanter & Mia Cahill, *Most Cases Settle: Judicial Promotion and Regulation of Settlements*, 46 Stanford L. Rev. 1339 (1994) [hereinafter “Most Cases Settle”].

⁴ Judith Resnik, *Trial as Error, Jurisdiction as Injury: Transforming the Meaning of Article III*, 113 Harv. L. Rev. 924 (2000).

⁵ The various JDR modes and processes used in the Court of Queen’s Bench of Alberta have stimulated a great deal of interest and provide a good example for judges’ new roles. See, e.g., John D. Rooke, *The Multi-Door Courthouse is Open in Alberta: Judicial Dispute Resolution is Instituted in the Court of Queen’s Bench*, in *The Multi-Tasking Judge*, *supra* note 1. This JDR program introduces a voluntary and consensual process whereby parties to a dispute, following the filing of an action in the court, seek the assistance of a JDR justice to help settle the dispute before trial in a mini-trial, facilitative or evaluative mediation or binding JDR. In the German legal tradition there are methods of judging and conciliation (“Richten oder Schlichten”), which also consist of hybrid forms containing elements of judging as well as elements of conciliation, for example the arbitration procedure. See Peter Collin, *Judging and Conciliation – Differentiations and Complementarities* 10, Max Planck Institute for European Legal History Research Paper Series No. 2013-04 (2013), available at <http://ssrn.com/abstract=2256508>. For examples from other countries, especially China and Canada see Part II of *The Multi-Tasking Judge* (Global Practices of Judicial Dispute Resolution). See also *infra* note 18.

⁶ The proceeding of Delaware’s state-sponsored arbitration is governed both by statute and by the Rules of the Delaware Court of Chancery. See 10 Del. Code Ann. Tit. 10, § 349 (2009); Del. Ch. R. 96-98.

⁷ In Common law judges may sit as arbitrators, in special circumstances. See, e.g., DAVID ST. JOHN SUTTON & JUDITH GILL, 4 RUSSELL ON ARBITRATION 25-28 (22nd ed. 2003) (indicating that under English law, in special circumstances, a judge of the Commercial Court or the Technology and Construction Court may accept appointment as arbitrator).

recently challenged by the US Court of Appeals for the Third Circuit.⁸ Although the Court appreciated some of the virtues of Delaware's state-sponsored arbitration,⁹ its decision was that the arbitration process, which permits the proceedings to be kept confidential, violates the US Constitution's First Amendment right of access of the public to civil trials, which applies to Delaware's proceedings.

Our paper calls to rethink the Delaware decision while discussing an innovative perspective which was not considered by the court in its decision. Many pointed out the main merits of arbitration (speed, cheapness, secrecy, informality, expertise etc.) when compared with proceedings before the ordinary courts.¹⁰ We would like to point out some other merits of state sponsored hybrid judicial dispute resolution processes, such as Delaware's arbitration program, by using the JDR processes as an opportunity to apply a broader scheme of judicial discretion. Such a discretion, we suggest, combines formal legal considerations with other considerations such as equity, peace, conflict resolution and social justice. The possibility of a broad judicial discretion, based on equity and justice, authorized by parties consent is found in Delaware's state-sponsored arbitration program in which the Chancery Court judge presiding over the proceedings "[m]ay grant any remedy or relief that [s/he] deems just and equitable and within the scope of any applicable agreement of the parties."¹¹ This possibility of a broad judicial discretion is found in the Common law concept of "equity" clauses, which allows the arbitral tribunal, when specifically instructed by the arbitration agreement, to decide the dispute on some basis other than the strict law.¹²

In general, arbitration is distinguished from adjudication in that the hearings are often more informal in arbitration than in court adjudication, and arbitrators are not required to explain how their rulings are

⁸ See Delaware Coalition for Open Gov't, Inc. v. Strine, 733 F.3d 510 (3d Cir. 2013) *cert. denied*, 134 S. Ct. 1551 (2014).

⁹ *Id.* at 22 (Judge Sloviter agrees with Judge Roth on the virtues of arbitration, and appreciates the difference between adjudication and arbitration, i.e., "that a judge in a judicial proceeding derives her authority from coercive power of the state, while a judge serving as an arbitrator derives her authority from the consent of the parties.").

¹⁰ See, e.g., Fleming James, Jr. et al., Civil Procedure 348 (2001); Neil Andrews, Principles of Civil Procedure 551-552 (1994).

¹¹ Del. Ch. R. 98(f)(1).

¹² SUTTON & GILL, *supra* note 7, at 165-66.

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in accordance with prior formal legal principles.¹³ As a consequence, both the sources of decisions and the outcomes of the arbitration may be at variance with what adjudication might have constructed. Furthermore, while adjudication is often described as a win/lose activity, decisions by some arbitration programs often entail *compromises*.¹⁴

In light of the creation of the new various judicial dispute resolution methods, among them Delaware's arbitration program, a jurisprudential account of these methods is required. The emerging innovative practices require a coherent theory that focuses on the inherent tension between aspects of adjudication and ADR, and that proposes a structured model of judicial discretion in these methods. Not only is such a theory able to explain existing practices, but it will also demonstrate how they can provide reconstructive solutions to basic limitations of legal rules and conventional legal decision making. This paper introduces such a jurisprudential analysis while discussing the merits of one unique version of judicial dispute resolution: "court arbitration compromise verdicts". This version is an adjudication conducted by a judge-arbitrator presiding in the case to terminate a conflict by rendering a final decision based on "compromise considerations".¹⁵ Such an activity combines authority with consent in a unique way, in which the judge-arbitrator decides cases based on considerations that deviate from the regular legal rules, and this imposition is validated by the parties' prior consent.¹⁶ Court compromise verdicts are not merely a matter of theory. They are a matter of necessity on terms of the high rate of settlement and the pressure on judges to reach them.¹⁷ In some common

¹³ OWEN M. FISS & JUDITH RESNIK, ADJUDICATION AND ITS ALTERNATIVES 44 (2003).

¹⁴ *Id.* at 45-46 (dealing with the difference between *court-annexed arbitration* and regular adjudication).

¹⁵ Martin P. Golding, *The Nature of Compromise: A Preliminary Inquiry*, in COMPROMISE IN ETHICS, LAW, AND POLITICS 4, 20-22 (James R. Pennock & John W. Chapman eds., 1979) [hereinafter Golding, *Compromise*]. On the law of settlement in general see, e.g., FISS & RESNIK, *supra* note 13, at 633-754.

¹⁶ It should be noted that although the compromise consent verdicts discussed in this paper are not absolutely identical to the Delaware's state-sponsored arbitration program, they do have much in common in the sense that they all combine consent and adjudication, resulting in a binding judicial decision. The Delaware's arbitration processes may have been inspired by the ideas expressed below.

¹⁷ "Most cases settle", and increasing obligations of judges to press parties toward settlement are found in rules and policy statements of the judiciary in common law systems, as well as phrases in judicial reported decisions such as "a bad settlement is almost always better than a good trial," which resembles the view of "trial as error." See Resnik, *supra* note 4, at 926.

law systems, a compromise consent verdict process, which is a sort of court arbitration, is available as part of the binding judicial dispute resolution methods.¹⁸

The participating parties in a judicial dispute resolution process in general, and a court arbitration by compromise in particular, may agree on the rules to be followed in the process, including rules¹⁹ regarding the nature of the process, the matters constituting the subject of the process, the manner in which the process will be conducted, the role of the judge and any outcome expected of that role, and any practice or procedure related to the process. The present article is focused more on the role of the judge-arbitrator, the outcome of the compromise—the judicial decision sharing/dividing the pie amongst the parties—and the judicial considerations and discretion leading to the outcome rather than the practice or procedure relating to the process.

Most of those who write on the subject of judicial dispute resolution and compromise verdicts²⁰ have ignored the advantages of the possibility of combining the element of consent with the element of authority to grant the court the power to decide by way of compromise. Articulating the advantages of this court arbitration process of compromise verdicts, and the attempt to regulate and conceptualize the process and determine its bounds, is the challenge facing the authors of this article. The article elaborates a structured hybrid vision of modes of compromise as forms of justice, which transcend efficiency and procedural concerns. It defines new modes of arbitration which are guided by variety of standards. The innovative modes of compromise proposed in this paper contribute to a more pluralistic notion of judicial discretion which enriches the boundaries of adjudication.

¹⁸ Some of the methods of the Alberta JDR and Delaware's arbitration program were mentioned above. In Delaware there is a specific process for a settlement option. *See* Del. Ch. R. 98(e). A compromise consent verdict method is found in another legal system based on the common law tradition. In Israel, with the enactment of sec. 79A of the Courts Law [New Version] 1984 by virtue of the Courts (Amendment no. 15) Law, 1992, a court hearing a civil matter was given the authority to rule, in respect of the matter before it in whole or in part, by way of compromise, provided that it obtained the consent of the parties.

¹⁹ Such as those indicated in the Alberta Rules of Court. *See* Rooke, *supra* note 5, at 181.

²⁰ *See, e.g.*, John E. Coons, *Approaches to Court Imposed Compromise – The Uses of Doubt and Reason*, 58 Nw. U. L. Rev. 750 (1964) [hereinafter Coons, *Compromise*]; John E. Coons, *Compromise as Precise Justice*, 68 Cal. L. Rev. 250 (1980) [hereinafter Coons, *Precise Justice*]; J. Jaconelli, *Solomonic Justice and Common Law*, 12 Oxford J. Leg. Stud. 480 (1992) [hereinafter Jaconelli, *Solomonic Justice*]; M. Abramowicz, *A Compromise Approach to Compromise Verdicts* 89 Cal. L. Rev. 231 (2001).

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The use of different modes of compromise consent verdicts suggested in the present article is capable of promoting greater justice (precise justice, social justice and equity) by integrating new considerations into judges' discretion. With more regulated forms of compromise offered to the parties, who have the freedom to choose between different court arbitration modes of compromise,²¹ the legal system may become more pluralistic and nuanced when responding to the complexity of legal cases.

In cases of compromise verdicts it appears that the parties seek a decision based not only on legal arguments; they seem rather to be interested in other modes of decision making, based on conflict analysis, social justice or other considerations. This new pluralistic mode of judicial performance preserves the authoritative pre-emptive effect while expanding the variety of schemes from which the parties can choose.²²

In this paper we offer a model for formulating the court's discretion in court arbitration consent compromise verdicts by suggesting several modes of compromise which reflect and integrate various interests and policy considerations. These modes are based on clear guidelines and reflect considerations of law, justice, efficiency as well as principles of negotiation.

The first mode reflects the existing situation: *Compromise as a shortcut and prediction*. The usual way of understanding judicial actions aimed at compromise is as an attempt to arrive at an approximate decision in the case without the need to conduct the case in its entirety. The judges-arbitrators assess the case and its value, and accordingly decide (when the parties authorize them to do so) with a ruling that in their estimation is close to what would have been the outcome had the case been conducted in its entirety. Such an attempt focuses on quick and efficient determination of the superficial legal dispute, and does not seek to resolve it in a deep manner. This article will not deal with the mode of compromise as a shortcut and a prediction; rather, it will deal primarily with four other innovative modes that present additional possible uses of the process of compromise. These diverse tracks of decision making can be regulated and encouraged institutionally, and will

²¹ On the connection between democracy and compromise see Arthur Kuflik, *Morality and Compromise*, in *COMPROMISE IN ETHICS, LAW, AND POLITICS*, *supra* note 15, at 38, 41 [hereinafter Kuflik, *Compromise*].

²² The party-preference arguments are among the major reasons for saying that compromises are good. See "Most Cases Settle", *supra* note 3, at 1350.

enhance legal pluralism. Our article will deal with the conceptualization of the following four modes of compromise verdicts:

1. Compromise as conflict/dispute resolution
2. Compromise as precise justice
3. Compromise as Equity
4. Compromise as social justice

Section I will present, in a general manner, the four modes of compromise verdicts. The other chapters will discuss in detail each of the four modes. Section II will deal with compromise as conflict resolution. Section III will deal with compromise as precise justice. Section IV will deal with compromise as Equity, and Section V will deal with compromise as social justice. The last chapter of the article is a conclusion.

I. FOUR MODES OF COMPROMISE

When must the court arbitrator decide on the basis of the special considerations of compromise and deviate from decision making on the basis of substantive law?

We suggest four modes of court arbitration by compromise as follows:

1. *Compromise as a hybrid process that combines judicial authority with modes of conflict resolution:* Because judges are faced with disputes whose complex nature usually extends beyond the confines of the pleadings and reaches their courtroom, it is to be assumed that their activity is not exhausted by mere prediction, even if it is declared to be such. Judges who conduct negotiations in the courtroom, attempt to mediate, conduct dialogue or introduce conciliatory practices usually do so alongside their authority to decide on the dispute.

2. *Compromise as precise justice:* Compromise can provide a philosophical answer to situations in which justice according to the law is unattainable in principle. These are situations in which the idea of “such is the law, no matter the consequences” or “winner takes all” are fundamentally inappropriate for the legal or factual situation.²³ From a jurisprudential point of view, too, compromise is able to offer more precise justice, which can answer theoretical criticism that has been lev-

²³ See generally Coons, Precise Justice, *supra* note 20.

elled at the law.

3. *Compromise as Equity*: The tension between equity and formal rules exists mainly when a decision by way of equity is imposed upon the parties without their prior consent, whereas they expect a purely legal solution. In such cases, equity may indeed interfere with stability and equality before the law. It may be considered arbitrary and as causing instability in the system. There is no room for such a concern, according to our view, when the parties have agreed in advance to an equity-based decision. In such cases parties ask for rules which fit the unique nature of their conflict.

4. *Compromise as a balancing of legal rulings with considerations of social justice*: Implementation of the law is also liable to be fundamentally problematic when the law appears to be clear and certain but its implementation appears to be unjust. Legal decision making may sometimes harm the weak party, or a one-time litigant as opposed to a seasoned one, and invoking compromise verdicts may well correct the absence of social justice by means of a verdict that combines these considerations.

As long as the parties approach the court having agreed to reach an arbitration decision by way of compromise they should again be offered various structured alternatives for reaching a decision. It is important that the parties and the court agree on the nature of the compromise and choose one of the aforementioned four modes of compromise in a way that reflects informed consent and choice. The parties may also choose a mixture of the modes, such as compromise focused on interests (mode 1) and social justice (mode 4). They may also indicate the weight of each of the compromise considerations

We will now discuss each of these four modes of compromise separately, and present a structured court arbitration process of proper judicial discretion.

II. COMPROMISE AS CONFLICT RESOLUTION

Legal disputes are usually framed as narrow controversies about facts and norms, which call for strict assignment of rights by judges through reference to reason and law.²⁴ The conflicts which underlie legal disputes are usually much broader than what appear as the controversies in courts, and they involve economic, emotional, cultural and

²⁴ See Lon L. Fuller, *The Forms and Limits of Adjudication*, 92 Harv. L. Rev. 353 (1978).

other various aspects which cannot be captured through legal lenses.²⁵ The interest in the broader picture of legal conflicts goes together with an effort to engage deeply in their constructive transformation. It has its roots in the ADR movement, and continues with contemporary innovations referring to judging, lawyering and institutional reforms. New movements such as the Therapeutic Jurisprudence Movement emphasize the therapeutic and managerial aspects of judges' and lawyers' activities.²⁶ New institutional reforms such as the establishment of Problem-Solving Courts propose structural methods to address the complexity of some legal (mostly criminal) conflicts in ways which affect the roles of judges and lawyers.²⁷ Innovations in conflict-resolution judging such as "solution-based judging"²⁸ and "procedural justice"²⁹ approaches flourish in Australia and the US and offer judges new roles when dealing with criminal and civil conflicts. In Alberta Canada, the notion of judicial dispute resolution (JDR) has been introduced to regulate the role of judges in reaching settlement, while possibly addressing some aspects of the broadest conflicts.³⁰ These innovations and reforms remain on the margins and so far, no explicit discussion has been devoted to the judges' role in resolving conflicts. The pursuit of settlement rather than a deep constructive transformation of the conflict at hand is the prevailing goal according to cur-

²⁵ The distinction between "disputes" and "conflicts" is defined by John Burton, one of the founding fathers of the field of Conflict Resolution in the following way: "A generalization would be that *disputes* which are confined to interpretations of documents, and disputes over material interests in respect of which there are consensus property norms, fall within a traditional legal framework. *Conflicts* which involve non-negotiable human needs must be subject to conflict resolution processes. These would include many cases of crime and violence". See John W. Burton, *Violence Explained: The sources of Conflict, Violence and Crime and Their Prevention* 97 (1997). In our discussion a legal dispute is the narrow framing of a broader conflict which is based on various interests and needs which are not fully reflected in the claims before the courts. Conflicts are many times polycentric. See Fuller, *supra* note 24, at 371-72.

²⁶ See generally BRUCE J. WINICK & DAVID B. WEXLER, *JUDGING IN A THERAPEUTIC KEY: THERAPEUTIC JURISPRUDENCE AND THE COURTS* (2003).

²⁷ Bruce J. Winick, *Therapeutic Jurisprudence and Problem Solving Courts*, 30 *Fordham Urb. L.J.* 1055 (2002); Betsy Tsai, *The Trend Toward Specialized Domestic Violence Courts: Improvements on an Effective Innovation*, 68 *Fordham L. Rev.* 1285 (2000).

²⁸ MICHAEL KING, *SOLUTION FOCUSED JUDGING BENCH BOOK* (2009), available at <http://www.ajja.org.au/Solution%20Focused%20BB/SFJ%20BB.pdf>.

²⁹ The Journal of American Judges Association, *A Special Issue on Procedural Justice*, 44 *Court Rev* (2007-2008), available at aja.ncsc.dni.us/courtrv/cr44-1/CR44-1-2.pdf.

³⁰ *The Multi-Tasking Judge*, *supra* note 1, at 157-80. See also JUSTICE JOHN A. AGRIOS, *A HANDBOOK ON JUDICIAL DISPUTE RESOLUTION FOR CANADIAN LAWYERS* 7 (2004), available at <http://cdm16064.contentdm.oclc.org/cdm/ref/collection/p266901coll4/id/1378>.

rent regulation of judicial activities.³¹

As Kuflik suggests, compromise has a broader sense than regular adjudication (or prediction of the adjudicative outcome).³² In regular adjudication the judge considers a matter that happens to be a dispute, leaving aside any consideration of the fact that there *is* an underlying conflict; in a compromise, however, additional considerations are weighed. When an issue is in conflict, and a compromise method is used, “there is more to be considered than the issue itself—for example, the importance of peace, the presumption against settling matters by force, the intrinsic good of participating in a process in which each side must hear the other side and try to see matters from the other’s point of view.”³³ Even if the regular judicial activity ought to remain focused upon reaching settlement, which relates more to the legal dispute, we argue that with parties’ consent and through the use of compromise verdicts, various considerations of conflict resolution can become part of the judicial enterprise.

This chapter assumes that when a judge-arbitrator decides cases by compromise she may use various conflict resolution methods. It also assumes that, based on the parties’ consent,³⁴ judges can expand the horizons of their judicial work in order to capture some of the various contexts which characterize the conflict before them.³⁵ This means that after the parties have failed to reach settlement or mediation agreement outside the court, and after the efforts of judges to help them settle in the courtroom (in a settlement conference) or to mediate between them have not succeeded, judges can use their authority, combined with the explicit consent of the parties,³⁶ to incorporate conflict resolution con-

³¹ The role of lawyers as resolving conflicts, both in criminal and civil cases, has been discussed as part of the spread of ADR and other movements, but judges were considered as more bounded by legal constraints and as striving for compromise in the shadow of the judicial prediction.

³² Kuflik, *Compromise*, *supra* note 21, at 38, 51 (1979).

³³ *Id.*

³⁴ Although the parties failed to reach a settlement on their own, Kuflik argues that the agreement to submit the matter to the judgment of a disinterested third party (the judge or arbitrator) could well constitute a significant compromise in its own right: “first, the parties concede, in effect, that they are not the best judges of their own dispute; second, they affirm that they are prepared to make concessions to one another if, in the considered judgment of a competent judge, that is what they ought to do.”

³⁵ Kuflik, *Compromise*, *supra* note 21, at 53 (1979).

³⁶ Indeed, as stated by Kuflik, “people cannot always work out their differences on their own. But even when negotiations fail to produce the terms of settlement, the parties may come

siderations into their decision in a court arbitration process.³⁷ Such an authorization will redirect the judge's broad discretion as to the use of legal procedure and legal rules and will enable her to focus on the conflict aspects of the case. The unique consent-based adjudication which is not bound by the classic perception of rational, external balancing of parties' claims through legal principles (based on rights only) may produce new and interesting roles for judges in promoting the resolution of conflicts.

A. *Five Types of Arbitration*

Differentiating between outcome and process when dealing with compromise is important and useful.³⁸ Conflict resolution studies and ADR literature offer modes of transforming conflicts, and we would like to use common alternatives to adjudication as relevant for compromise consent verdicts and as helpful tools for judges to promote constructive reconstructions of conflicts. Compromise settlements can be reached in two ways—by negotiation or by arbitration.³⁹ A negotiated settlement will sometimes involve services of a mediator—someone who has no binding authority (but who acts as a go-between). Arbitration may be undertaken either by a person who has been selected by the parties themselves or, as in the concern of the present article, by

away convinced that a compromise solution is in order. For it is often easier to acknowledge that what others have to say has some merit and even to concede that one's own view is not immune to reasonable criticism than to see just how competing claims ought to be adjusted. So although an agreement on the substance of the matter is not immediately forthcoming there may yet be a mutually agreeable third party whose informed, impartial, and sympathetic concern commands the respect of all sides." *Id.*

³⁷ It should be noticed, as asserted by Kuflik, that in some cases, even if the parties should manage to reach a settlement on their own, "there is some danger that it will be a settlement of the wrong sort." *Id.* "The parties to a dispute are sometimes simply too biased by their own involvement in the matter to be able to give each other a fair hearing," and therefore "they are liable to take one another's strengths and weaknesses more seriously than their reasons and arguments." *Id.* In such cases, argues Kuflik, "one hopes that the balance of morality relevant considerations, and not the balance of force, will be more nearly reflected in the judgment of a disinterested third party." *Id.*

³⁸ Golding, *Compromise*, *supra* note 15, at 7 (distinguishing between the end-state and the process. The first looks to the result or outcome and tries to see how it compares with the original situation for which it is alleged to be a compromise. The second looks to ways and means, the methods by which the result is reached, and it characterizes the result as a compromise in virtue of the process by which it is achieved).

³⁹ For a discussion of the methods of settlements: arbitration vs. negotiation see Kuflik, *Compromise*, *supra* note 21, at 52-55.

someone, a judge in a court, who acts under authority of the state. Parties' authorization for conflict resolution by a court arbitration in a way of compromise can be regulated and may include explicit reference to a closed list of hybrids and types of arbitration such as the following:⁴⁰

Arbitration under a high-low contract: Parties in this arbitration try to minimize the risk in the outcome by providing a high and a low limit to the judge's decision. The process reduces the risk to both sides by converting a "win-lose" situation into a "partial-win partial-lose" situation.⁴¹

Final offer Arbitration: This method helps to encourage creative and collaborative thinking and here the arbitrator may not compromise but must, rather, choose the final offer of either one party or the other. This should advance the prospects of successful bargaining. The parties, knowing that the arbitrator cannot compromise, are likely to assume that he will select the more reasonable offer.⁴² In legal cases, judges can offer parties such a process when opportunities for collaborative thinking seem possible but the parties cannot reach agreement by themselves.

Arbitration based on analysis of interests and barriers: This method of arbitration is the most innovative and the least explored judicial activity in promoting settlement. It may also be considered as the most intriguing and inspiring role of judges in imposing compromise. Judges can function, with the parties' consent, as experts in conflict resolution, and can impose genuine solutions based on conflict resolution considerations when exercising their judicial role. Typical analysis of conflict resolution will typically include two types of questions:⁴³

What are the interests/goals of the parties? In conflict resolution literature the interests are "the secret movers" behind the legal positions and therefore, an important question which a judge may ask the parties when the investigating the core of the conflict is "why?" Why do you claim you are entitled to a certain outcome? What is important

⁴⁰ The following types of arbitration may be used in legal systems which have a state-sponsored arbitration program (such as in Delaware).

⁴¹ STEPHEN B GOLDBERG, FRANK A SANDER & NANCY H ROGERS, *DISPUTE RESOLUTION: NEGOTIATION, MEDIATION AND OTHER PROCESSES* 225 (1992).

⁴² *Id.* at 223-24.

⁴³ Frank A. Sander & Lukasz Rozdeiczer, *Matching Cases and Dispute Resolution Procedures: Detailed Analysis Leading to a Mediation-Centered Approach*, 11 Harv. Negot. L. Rev. 1 (2006). The authors in this paper suggest a third question which is related to conflict qualities but for the sake of this form of arbitration we find it less relevant.

for you and what underlies your positions in the way they are framed before the court? Parties may care about various interests such as speed, privacy, public vindication, maintaining relationships, improving understanding of conflict, creating new solutions and so forth. Interests can be addressed.

What are the impediments which prevent the parties from resolving this conflict by themselves? Common barriers are identified in conflict resolution literature as: poor communication, the need to express emotions, different views of facts/norms, important principles, the jackpot syndrome; psychological barriers, unrealistic expectations and so forth.

Using conflict resolution considerations to adjudicate a legal case is not always possible. If some of the interests or needs of the parties are related to the processing of their case, and they need communication, apology or active listening in order to deal effectively with their conflict, an authoritative decision may not suffice to answer these needs. The same is true in relation to impediments to settlement, which sometimes depend on subjective perceptions such as optimistic overconfidence which judges cannot truly overcome. In some cases, such as communication problems, arbitration and adjudication are not the right processes for overcoming the difficulty. Nevertheless, our claim is that awareness of such considerations and incorporation of some of them into court arbitration compromise verdicts, even if only as relevant considerations that are mentioned within the written decision, may encourage more conflict resolution outside the courtroom. Judges may write in such hybrid decisions that they perceive the conflict as reflecting a lack of communication or involving diverse subjective perspectives of facts which can be bridged, and try to decide based on a more nuanced narrative of the facts. They can also emphasize the need of one party for acknowledgement and give it to her in their writing without jeopardizing neutrality or displaying bias. Such decisions can promote peace since they are oriented towards achieving such a goal. The actual outcome may be splitting the difference, but the argumentation may be based on conflict resolution considerations which are intended to bring the parties closer to each other.

Med-arb.: This is a special framework for reaching a verdict, whereby the parties begin mediation on the basis of interests, and if the

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process fails, arbitration follows on the basis of rights.⁴⁴ In this way, the parties know that if they cannot solve the case on their own, they will be given a solution based on rights, which was drafted at the beginning of the procedure. This process, when conducted in court, will provide the parties with assurance that even if the mediation does not succeed, they will have the benefit of an authoritative decision which resolves the conflict, or at least puts an end to the legal dispute. The problem with such a process is that it usually discourages parties from speaking openly about their interests and from revealing information, since they know that a judge will decide the case and are afraid to be taken advantage of by the other party, who will not reveal her own interests and will claim for the value they created without offering anything on her part. To overcome such an inclination, an alternative process of arb-med was developed.

Arb-med.: This is a process in which the court rules based on rights, but keeps the decision concealed and conducts negotiations to try to bring the parties to an agreement.⁴⁵ The parties know that they have a solution if they cannot reach an agreement, but they are not afraid to cooperate because even if their concealed interests are revealed, the decision based on their rights has already been made and is not affected by this information. In this case the first decision may be a prediction-based analysis of the case based on a short presentation. The later stage will be an open-ended discussion of the complexities of the case, including interests, emotions and relationships. Parties can freely develop a nuanced constructive solution while remaining assured that a fixed solution is at hand if they fail to reach it. This process has similarities with “post-settlement-settlements” as described by Howard Raiffa.⁴⁶

Indeed, as Jaconelli writes in his “Solomonic Justice and Common Law” article, “adjudication and conciliation, at any rate as far as modern legal systems are concerned, are entirely distinct processes.”⁴⁷ He comments, however, that there are societies “where the function of the judge is conceived as conciliatory; that is, to effect a compromise between litigants in the interest of retaining intact the web of social relationships.”⁴⁸ Surprisingly or not, an excellent example of a legal sys-

⁴⁴ GOLDBERG ET AL., *supra* note 41, at 226-27.

⁴⁵ *Id.* at 228.

⁴⁶ Howard Raiffa, *Post Settlement-Settlement*, 1 *Negotiation J.* 9 (1985).

⁴⁷ Jaconelli, *Solomonic Justice*, *supra* note 20, at 484.

⁴⁸ *Id.* at 484, n. 17.

tem that combines adjudication and conciliation is perhaps King Solomon's Jewish legal tradition.

B. *Compromise as a Peace Adjudication Process*

In the modern theoretical literature dealing with compromise verdicts, the term "Solomonic justice" appears frequently, referring to the biblical story recounting the manner of judgment of Solomon, King of the Jews. Now, it appears that the famous biblical story about King Solomon's ruling does not refer to the compromise consent verdict discussed in this article, but undoubtedly it is possible to find in the classical Jewish sources very extensive discussions about the process of judicial compromise verdicts.⁴⁹ An analysis of several of these sources, which will be undertaken in the present section, will afford us a better understanding of the manner in which the compromise may be used as a peace adjudication process.

According to Jewish law, one of the goals of compromise is to make peace between the parties. Compromise is defined in the Talmud as "law making which contains peace,"⁵⁰ though it may seem the combination of law and peace is inherently contradictory. On the one hand there is the familiar discourse of rights so common to legal thinking. Such a discourse differentiates between the parties and posits the boundaries between them as the subject for authoritative decision. On the other hand there is the discourse of peace which aims at reconciliation, connection and collaboration, without searching for the ultimate truth or the right argument. Peace, in that sense, is a separate category from law.⁵¹ In order to promote peace, personal involvement of parties is required, subjective impressions need to be transformed, engagement in constructive interactions is needed and deep emphasis on relationship, interests and emotional acknowledgement is encouraged. Aspiration for peace is not usually a goal in itself in law making, and only "public order" is legitimate cause for modifying strict legal applications. Peace, according to Lifshitz, compensates for inherent gaps within law. It enables people to waive their rights or to acquire rights which they do not have, not only for the sake of public order, but to overcome a

⁴⁹ See, e.g., MENACHEM ELON, *Compromise, in THE PRINCIPLES OF JEWISH LAW* 570-73 (1975).

⁵⁰ B.T. *Sanhedrin* 6b.

⁵¹ Itay E. Lipshits, 'P'shara' in *Jewish Law* 137 (July 2004) (unpublished Ph.D. dissertation, Bar-Ilan University Ramat-Gan, Israel) (on file with author).

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bias or distortion within the law itself. Peace considerations include fraternity, friendship, relationship, and trust.⁵² Based on the parties' consent, judges can incorporate peace considerations into their decision, or they can promote a conflict resolution process or a peace-oriented outcome within conference settlement.

Rabbi Abraham Itzhak Hakohen Kook (1865-1935), the first Ashkenazic Chief Rabbi of the Land of Israel, argued that as a matter of legal policy, the court may incorporate peace considerations into its decision in cases where, in its opinion, ruling by law may not resolve the conflict.⁵³ If a legal decision based on the law is liable to leave bitterness and hostility between the parties, a peace-oriented legal decision should aspire to avoid these outcomes. Rabbi Naftali Zvi Yehuda Berlin (Lithuania, 19th century) wrote in the same spirit, saying that if law cannot bring peace to the conflict, a compromise decision is sometimes desirable.⁵⁴ His decision related to a public controversy between two communities who had an argument based on ethnic differences. Berlin realized that deciding by law would not resolve the conflict and bring peace and tolerance between the communities in the multicultural society, and therefore he deviated from the law and rendered a compromise verdict. The same ruling was given in a case involving young orphans. The goal of "reducing the conflict"⁵⁵ was mentioned as being in the best interest of the orphans, who would have an on-going relationship throughout their lives.

III. COMPROMISE AS PRECISE JUSTICE

A. *Court Imposed Compromise as "Precise Justice" – Major Arguments and Difficulties*

In legal theory court compromise verdicts or court imposed compromise have been praised by some scholars as a more justified method which overcomes the traditional dichotomic all-or-nothing or "winner takes all" method of judicial decision making. Some perceive the merits of the court imposed compromise as reflecting "Solomonic justice"⁵⁶ and some have viewed compromise as "precise justice", emphasizing

⁵² *Id.* at 133.

⁵³ *Responsa Orab Mishpat*, H.M. 1, s.v. *vebine be'inyan*.

⁵⁴ *Responsa Meshiv Davar* 3:10 (Jerusalem, 1968).

⁵⁵ *Sb.Ar. H.M.* 12:3.

⁵⁶ See Jaconelli, *Solomonic Justice*, *supra* note 20.

the element of equality.⁵⁷ According to this view there are cases in which judges should render a court imposed compromise as the preferred and more justified legal resolution of the dispute. Indeed, there are cases, especially if the law and the facts in the case are unclear, where there may be sound reasons of policy and justice for splitting the difference between the parties.⁵⁸ Parties in those cases may be considered as having the right to receive a compromise verdict. If this is the case, argues Joseph Jaconelli, we are dealing “not with compromise *of* one’s legal right, but rather with compromise *as being* one’s legal right.”⁵⁹

These arguments depict the court imposed compromise as a more accurate decision making process in a world in which dichotomic decisions are not always possible. They posit decisions by compromise as a deep answer to critical approaches in law, such as Legal Realism and Critical legal studies, which have challenged the objectivity of legal decision making by referring to the indeterminacy of legal rules and to the social and economic barriers which they reinforce.⁶⁰

This approach in favor of court imposed compromise and various versions of it, has challenged the conventional dichotomic approach to legal decision making and has evoked rich discussions among scholars, who have pointed to some downsides of the new concept. Some have criticized the compromise verdicts approach by invoking utilitarian considerations. Others have appealed to justice or due process. Even some of the proponents of court imposed compromise verdicts have developed some modified and narrower notions of such verdicts, sometimes in response to the criticism against them. Under such modified versions, courts may use this mode of decision making only for very specific cases, whereas in other cases the traditional dichotomic decision making method will apply. Abramowitz, for example, has offered an intermediate model of a “system of mixed verdict”, which benefits from the relative advantages of both modes of decision making – dichotomic and compromise alike.⁶¹ He offered a scheme of analysis to choose among the modes of decision making in different cases. According to his suggestion, the dichotomic method should be applied

⁵⁷ See Coons, *Compromise*, *supra* note 20; Coons, *Precise Justice*, *supra* note 20.

⁵⁸ See Golding, *Compromise*, *supra* note 15, at 21.

⁵⁹ See Jaconelli, *Solomonic Justice*, *supra* note 20 at 485.

⁶⁰ In this sense, compromise verdicts can provide a reconstructive answer to the critique of legal formalism.

⁶¹ See Abramowicz, *supra* note 20.

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when there is no doubt about the plaintiff's chances of winning or losing the lawsuit, i.e., when the threshold of probability is high (a situation in which one party's version is significantly and compellingly superior to that of the other party). By contrast, when the plaintiff's chances of winning are unclear or balanced, the compromise method should be chosen. Coons deals with a compromise that applies a 50-50 division in cases of factual doubt, when it is not possible to rule in favor of one side as opposed to the other.⁶² Scholars who favor the compromise method have recommended it in cases of evidentiary balance (Abramowicz), or advocated a regime of proportional liability in tort claims based on causal probability,⁶³ as well as liability based on probability in cases of unclear causation.

B. *Court Arbitration Compromise Verdict as an Opportunity for Performing Precise Justice*

We argue that the opposition to court compromise verdicts is much more convincing in relation to court *imposed* compromise verdicts which are not authorized in advance by the parties. Indeed, in such cases, the legitimate expectation of the parties is for a decision based on a determination of legal rights, which reflects a dichotomic all-or-nothing approach. Trying to overcome the shortcomings in such dichotomic decisions based on strict legal rules cannot be done by courts deviating from these rules, through imposition of compromise verdicts on the parties. In these cases the parties also feel that there is a lack of procedural justice, because they are not really aware of what are the considerations for the court imposed compromise verdicts.

On the other hand, if parties acknowledge the shortcomings of law both from a jurisprudential perspective and due to efficiency considerations, the possibility of the judge-arbitrator rendering compromise consent verdicts may be much more justified. The parties in such cases are aware of their legal rights and of their chances of winning in court, and they nevertheless choose to authorize the court to render compromise verdicts in a court arbitration process. The parties may choose to enjoy the benefits of compromise verdicts, and can decide which mode of compromise they authorize the judge to impose.

⁶² See Coons, *Compromise*, *supra* note 20.

⁶³ John Makdisi, *Proportional Liability: A Comprehensive Rule to Apportion Tort Damages based on Probability*, 67 N.C. L. Rev. 231 (1989).

The advantages of court arbitration compromise *consent* verdicts over court *imposed* compromise verdicts, insofar as we are dealing with the goal of precise justice, extend well beyond the justification and authorization perspectives alone. Expanding the range of possible compromise verdicts is a significant improvement to legal decision making. Imposed compromise verdict are justified, even according to Coons, only in specific cases,⁶⁴ and he lists ten examples in which, due to a factual doubt, the dichotomic legal solution cannot be considered justified and right in the circumstances. Splitting the difference between the parties in such cases (which Coons defines as “doubt-compromise”) should be preferred, but this equally-divided fifty-fifty compromise, Coons insists, should be strict and not amenable to different divisions.⁶⁵ Some scholars have challenged that view and called for different types of divisions, such as seventy-thirty or sixty-forty compromises.⁶⁶ Others claim that Coons’ proposal does not really overcome the “winner takes all” perception of law: “You can say that in this particular case we will compromise for various reasons, but this is a very rare and special instance where we will allow such a result.”⁶⁷ Our claim is that adding the *consent* element to compromise verdicts will allow the parties to authorize the judge to provide a compromise decision in a court arbitration process which will accurately reflect the parties’ rights or their evidence. It will afford the court broader discretion to approve various divisions of the pie (not only fifty-fifty) and to do so in a broad range of cases. Factual controversies require a much more complex perspective based on partiality and probability. According to Fuller:

Except that I think, characteristically, truth questions are closer to the negligence question than we imply. That is to say something happened; neither one of may be lying. Each is putting his best foot forward; each has improved on the story in remembering it. So you are asking yourself, well, let’s see, which of these stories is the closest—and perhaps neither is very close—but you are ready to accept. You are dealing with probabilities.⁶⁸

⁶⁴ Coons, *Compromise*, *supra* note 20, at 753-54.

⁶⁵ The reason for this, Coons argues: “As long as we confine our attention to instances of balanced probability, any division other than fifty-fifty would discriminate against one party. In other words, it would offend the equality principle”. *Id.* at 759.

⁶⁶ *See id.* at 800.

⁶⁷ *Id.* at 802; *see also id.* at 802-03 (“I am not suggestion this would be an across the board proposition, You have to be very careful about the areas you select”).

⁶⁸ *Id.* at 800.

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When parties agree to accept compromise-based decisions in a court arbitration process they may be considering the possibility of endorsing a decision which takes into account critical claims about legal decision making.

During the previous century, a famous attack on legal objectivity and on legal formalism in general was launched by the Legal Realism movement during the 1920s, followed by the Critical Legal Studies movement during the 1970s.⁶⁹ The Realists developed a theory of rule skepticism and claimed that legal decisions cannot be explained as being “based on mechanistic applications of rules.” Instead, they argued, it is more realistic to claim that rules are indeterminate and that legal doctrine is filled with gaps, ambiguities and multiple interpretational possibilities, which make it impossible to objectively decide cases without exercising a broad discretion. Some of the Realists and their predecessors, like Llewellyn and Kennedy, claimed that behind each rule there are conflicting principles which call for opposite interpretations, and that judges can never decide by a pure reference to rules, since balancing between these principles is part of the process of legal decision making. This balancing cannot be structured rationally, according to Realists or critical scholars. It is affected by personal or ideological motivations. Another major claim which Realists and other critical writers developed was that legal facts cannot be determined objectively, and that judges suffer from biases and multiple perspectives which make their factual determinations biased and subjective.⁷⁰ These critiques of and challenges to basic legal tenets produced turmoil in legal academe and have been followed by various efforts at reconstruction. One possibility of overcoming the indeterminacy of rules and facts is to propose a court arbitration judgment based on compromise and not on pure legal reasoning. The possibility of working with critical claims as constructive paradoxes has never been discussed by the Realists, and in arbitration studies, but there may be agreement among the parties that rule and fact skepticism will guide judges’ decisions when they try to give a nuanced decision which does not claim for full objectivity. Such a decision can be called “precise justice” since it overcomes the “winner takes all” assumption of mainstream jurisprudence. It is more sensitive to gaps and doubts while remaining pragmatic and constructive when

⁶⁹ ROBERTO M. UNGER, *THE CRITICAL LEGAL STUDIES MOVEMENT* (1986).

⁷⁰ JEROME FRANK, *COURTS ON TRIAL: MYTH AND REALITY IN AMERICAN JUSTICE* (1973).

working with them.

IV. COMPROMISE AS EQUITY

Although ruling by compromise based on equity is mentioned in some places when the development of the common law is reviewed, the basic rule which remained throughout common law history is that the winner takes all,⁷¹ and equity has not developed as an independent cause.⁷² Even in more recent times, again with a few notable exceptions, the traditional rule of “winner takes all” continues to hold sway.⁷³

Why the option of compromise on the basis of equity is not used widely in common law? This may be related to the struggle between law and equity. The nature of law is to determine rules, and to provide solutions which are intended to be applied in future to an unlimited number of cases. This feature of law creates a unique problem of correlation between case and rule. There are cases, and maybe most of legal cases are such, in which the particular circumstances of the case do not slot into the strict rules. Aristotle dealt with these situations and suggested overcoming them through the use of equity, or *epieikeia*, which means to amend the law in such a way as to prevent its generality from interfering with the need to do justice in the concrete case. The dialectic between legal formality and other considerations is regulated differently within each legal system. Our efforts are aimed at articulating a certain balance which is appropriate for consent compromise verdicts, and which may expand the traditional perception of the role of law. But first, let us discuss further the relationship between common law and equity.

Traditionally, as shown by Atiya, in the English legal tradition there exist two widely differing approaches to dispute resolution and the law.⁷⁴ One approach requires cases to be decided according to generalized and inflexible rules. The second approach emphasizes the importance of individualized justice, of adjudication of the specific facts of the case in question. Throughout much of English legal history these two approaches have been embodied in the systems of the common law and Equity respectively. With the crystallization of Equity laws, and

⁷¹ Jaconelli, *Solomonic Justice*, *supra* note 20, at 487.

⁷² Coons, *Compromise*, *supra* note 20, at 767.

⁷³ Jaconelli, *Solomonic Justice*, *supra* note 20, at 488.

⁷⁴ P. S. ATIYA, *FROM PRINCIPLES TO PRAGMATISM: CHANGES IN THE FUNCTION OF THE JUDICIAL PROCESS AND THE LAW* (1978).

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especially after their inclusion within the common law system during the 19th century,⁷⁵ they became more general and predictable. This process of formalization helped to prevent arbitrariness and at the same time made these laws less case-sensitive. Some have described the development of the ADR movement as representing the formalization of a new Equity approach, this time based on the procedural processing of disputes.⁷⁶

Our main argument is that the tension between equity and formal rules exists mainly when a decision by way of equity is imposed upon the parties without their prior consent, while they expect a purely legal solution. In such cases, equity may indeed interfere with stability and equality before the law. It may be considered arbitrary and as causing instability in the system. There is no room for such a concern, according to our view, when the parties have agreed in advance to an equity-based decision in a court arbitration process. In such cases parties ask for rules which fit the unique nature of their conflict. The relation between equity-based decision and parties *consent* is found in Delaware's state-sponsored arbitration program mentioned above, in which, as we had seen in Chapter I, the Chancery Court judge presiding over the proceedings "[m]ay grant any remedy or relief that [s/he] deems just and equitable and within the scope of any applicable agreement of the parties."⁷⁷ Still, equity as an open-ended aspiration of law remains a separate category within our framework.

The limits of formal law have been extensively described and debated in jurisprudential thinking and legal theory in general. We have tried to present some of the challenges to the formality of law within the various modes of compromise consent verdicts we proposed for court arbitration. We believe that these new modes offer new regulated forms of equity and they all enable various new balances between rules and discretion. Nevertheless, even after parties consider each of the three modes on its own merits, we believe that the possibility going back to Equity as a law making method which incorporates general considerations of justice may still exist within the system we propose. A court arbitration by compromise based on ethics will be a return to

⁷⁵ For a more extensive discussion of this topic, see C. K. ALLEN, *LAW IN THE MAKING* 399-441 (1964).

⁷⁶ Austin Sarat, *The 'New Formalism' in Disputing and Dispute Processing*, 21 *Law & Soc'y Rev.* 695 (1988).

⁷⁷ Del. Ch. R. 98(f)(1).

the old role of law making as doing justice, reviving it through the parties' endorsement.

V. COMPROMISE AS SOCIAL JUSTICE

The incorporation of distributive justice considerations into legal decision making is usually considered problematic, since the common assumption is that the legislator determines the consensual distributive principles in the law and the judges apply them in an equal way. Cases of court imposed compromise verdicts have also been criticized when they invoked such considerations.⁷⁸ We argue, however, that this criticism is less applicable to court arbitration compromise consent verdicts.

The role of law in promoting social justice has been a major concern of many jurisprudential schools, both from a critical and a normative perspective. A major sociological claim in this context is that within the reality of legal disputes handled in the court, the "haves" have various advantages over the "have nots", and that repeat players and big organizations are more likely to utilize the system to acquire gain and to win long-term benefits, often at the expense of the disadvantaged.⁷⁹ From a normative perspective, some have argued that the role of law is to institute structural reforms, to transform society, and to use legal decision making to promote a form of justice which is transformative and has an educative value.⁸⁰ Inequalities in society have been a major concern for many legal scholars, and traditionally courts and judges have been considered responsible for balancing them. Although adjudication is not supposed to favor the poor over the rich on the individual level, and judges are supposed to apply a balanced principled measure in the concrete case, as a policy matter new rules and precedents are intended, according to some legal thinkers, to promote greater equality in society and to prevent the oppression of the weaker communities.

A judicial policy of promoting social justice has also been broadly criticized by some legal scholars and philosophers as anti-democratic, against integrity and biased. If a certain distribution of goods or as-

⁷⁸ Jaconelli, *Solomonic Justice*, *supra* note 20, at 498-504.

⁷⁹ Marc Galanter, *Why the 'Haves' Come out Ahead: Speculations on the Limits of Legal Change*, 9 L. & Soc'y 95 (1974).

⁸⁰ Owen M. Fiss, *The Supreme Court 1978 Term Forward: The Forms of Justice*, 93 Harv. L. Rev. 1 (1979).

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signments of rights in society was approved by the legislator or has an historical foundation, how can a judge use her biased interpretive skills to challenge this distribution and to demarcate the social boundaries in society? These critics have often described the social justice interpretation as activism, and have called for greater restraint and neutral policy in applying legal rules.

Our discussion shifts this debate about the role of law in promoting social justice to the more pluralistic terrain of many types of conflicts and many possible legitimate standards for legal decision making. The recourse to court arbitration compromise consent verdicts may open a legitimate and unique track for introducing social justice considerations into judicial dispute resolution legal decision making. We are not suggesting here a policy of promoting social justice while creating *new rules*, as some legal scholars have suggested, and therefore we are not interfering with the majoritarian principle nor with the official distribution principles as provided by the state. Instead we propose a bottom-up market of individual compromises, in which social justice considerations are consensually incorporated into the court arbitration legal decision making process. Such developments may fit certain types of disputes, and may promote a more pluralistic consent-based perception of justice within the legal system.

Cases which include big organizations facing small citizens may call for an offer to the parties to authorize the judge-arbitrator to incorporate social justice principles in a compromise consent verdict. Such considerations may anyway infiltrate judges' decisions, when they deal with a severe perceived imbalance in a case before them, but usually their compassionate treatment may be interpreted as biased and as going against the rule of law principle. Organizations' representative experience in such cases as receiving unfair treatment and as being coerced to give what they do not owe according to the law. In contrast to the usual mode of adjudication, when social compassion is legitimate and authorized by the parties as part of the decision making, such judgment may be good for all parties involved. The weak party will receive acknowledgement and material recognition as a lone gun-man taking on the big organization. The repeat player organization will gain a reputation and acknowledgement as having a social justice agenda and as activist in terms of protecting customers and weak populations. Society will gain greater equality and the closing of systemic gaps from which it suffers. The legal system may benefit from a pro-social image

which signifies generosity and social responsibility as publicly encouraged by the court. Such developments may flourish when offered by law, and may become mainstream modes of decision making in some areas of law.

Three contemporary examples of compromise verdicts given by Israeli rabbinical court arbitrators may serve to illustrate the potential in compromise consent verdicts based on social justice. In these cases the consent of the parties for such a decision was given by litigants by choosing the religious court—authorizing it to render a compromise verdict as an arbitrator—and by preferring it over the general secular system. We argue that the legal considerations weighed by the religious court reflect legal pluralism,⁸¹ which can become a model of mainstream legal decision making.

The first is the case of a teacher who was fired unfairly at a time when it was hard for him to find a job.⁸² Although the school had the right to fire him according to the contract, and although the teacher was not poor according to formal criteria, the court ruled “beyond what the law requires” (*lifnim mishurat badin*) that the school should compensate the teacher. The court said that the school has wealthy donors and its pockets are deeper, so therefore it should compensate the individual in the name of social justice.

A second example is the case of another teacher who was fired after two years of employment in a school in Safed (northern Israel). Following his dismissal he had to relocate his family to the south of Israel to his new workplace. After a year the school asked the teacher to come back and rehired him to teach, but one year later he was fired again. The teacher sued for compensation for his three years of work and also for the costs of relocation. The court granted both demands; among the reasons for its ruling, the court wrote that the plaintiff had not found a job yet, and since he is considered a pauper the decision should go “beyond what the law requires” (*lifnim mishurat badin*) based on social justice considerations.⁸³

A third example actually comprises a group of cases in which religious courts enabled debtors to spread out their repayments, even though from a strict legal perspective they were obligated to repay their

⁸¹ See Adam Hofri-Winogradow, *A Plurality of Discontent: Legal Pluralism, Religious Adjudication and the State*, 26 J.L. & RELIGION 101-33 (2010).

⁸² YOEZER ARIEL, LAWS OF ARBITRATION 224 (2005) (Heb.).

⁸³ *Id.* at 225-26.

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debt immediately. Such cases were interpreted as following the principle of going beyond what the law requires; taking into account the economic situation of the debtor was within the court's discretion, since the parties had agreed in advance to be judged by law or by compromise.⁸⁴

These examples, which stem from a communal and religious system of law, may inspire mainstream adjudication in secular courts and expand the possibilities which are available to judges when confronting legal conflicts. When parties agree to promote certain values and policies, judges should be authorized to respect such choices and to incorporate into the law considerations which go beyond the rules, while not violating general principles of the rule of law. In time, such developments may acquire their own general characteristics and may function as open code systems to inform new disputants in new circumstances.

CONCLUSION

Our paper has argued for a new role for court arbitration judges deciding cases by compromise, based on the parties' consent. We suggested that this mode of judicial dispute resolution can overcome some basic limitations of legal rules and legal decision making. It can promote more precise justice, overcome the indeterminacy of rules and facts, promote social justice, enhance equity and combine new considerations into judges' discretion. With more regulated forms of court arbitration by compromise and the explicit consent of the parties, the legal system may become much more pluralistic and nuanced when responding to the complexity of legal cases.

Considering the fact that most cases settle and do not reach a final formal decision based on law, and that only a small part of them is resolved through ADR, judges have a significant role in the settling of legal disputes. Although their role has changed dramatically in the past few decades, its new nature has not brought about a corresponding shift in legal thought, and has remained largely unexplored. Our paper contributes to a new conceptualization, hopefully followed by new regulation, of the judges' role in cases of consent of the parties to court arbitration compromise verdicts. Such consent makes possible an interesting mixture of authority and consent, legal rules and social complexity, autonomy and community, old and new.

⁸⁴ *Id.* at 224-25.