

**ENFORCING ETHICS:
NEW STRATEGIES FOR TACKLING CREATIVE COMPLIANCE**

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Abstract

This paper looks at the interweaving of law and ethics in the regulatory aspirations and enforcement strategies of the post-Enron era. What constitutes compliance is being increasingly recognised as problematic, with a growing intolerance of mere technical or 'creative compliance', and growing demand for what might be thought of as 'ethical compliance'. The paper examines and assesses the strategies being brought into play to foster and enforce ethical compliance, looking not only at the initiatives of regulatory authorities but at new developments in the corporate accountability agenda of civil society.

Capital market governance is impeded not only by non-compliance but by my own particular bugbear, creative compliance. Creative compliance refers to the use of technical legal work to manage the legal packaging, structuring and definition of practices and transactions, such that they can claim to fall on the right side of the boundary between lawfulness and illegality. It is essentially the practice of using the letter of the law to defeat its spirit, and to do so with impunity. Practices that might be illegal, indeed criminal, if legally structured in one way, are legally repackaged and claimed to be lawful, or at least 'not illegal'. The word 'claimed' is important, since these structures might depend on questionable or aggressive interpretations of law or facts, on 'bullish' approaches or on 'sailing close to the wind', as it was put to me in interviews with lawyers, bankers and regulators. They might be found 'legally ineffective' if challenged but even then are expected to act as 'fraud insurance' because they are based on disputed technical legal argument rather than on non-disclosure or outright breaches of law.

I have argued elsewhere that creative compliance cannot be tackled through law alone. Underlying it are two factors: law, which provides the material for creative compliers to work on, and the way law is received. Ultimately creative compliance depends on a mindset in which to comply with the letter but defeat the spirit of the law is deemed clever and legitimate. To tackle creative compliance one must challenge that culture of legitimacy, and to do that means moving from a positivist vision of law as a technical task, to one where compliance also involves compliance with the spirit of the law. It means a shift from technical to what might be thought of as ethical compliance. Is this a mere abstract academic aspiration? Perhaps but there are developments taking place in practice which might be seen as pursuing, fostering, and, indeed, enforcing just such a shift in standards. This paper explores the strategies being brought into play, looking not only at the initiatives of regulatory authorities but at new developments in the corporate accountability agenda of civil society.

I Regulatory developments: the US

The Enron Effect: Raising awareness of creative compliance

Enron has played a key role in recent regulatory developments in the US – and for that matter elsewhere. The trials of Enron personnel themselves focussed not on creative compliance but on outright fraud – indeed often on illegalities incidental to or consequential to accounting rather than the accounting techniques themselves. The reason was simple and understandable enough. The objective was to set an example and to get senior executives behind bars. That needed fraud charges, and fraud charges simple

enough to stick. The danger of this however was that it missed an opportunity to tackle in a high profile case the pervasive practice of creative compliance.

Enron may have engaged in outright breach of the law but it was also heavily into creative compliance. At the heart of its creative accounting was the practice of ‘off balance sheet (OBS) financing’, through the use of ‘special purpose entities’ (SPEs). This is discussed at greater length elsewhere,¹ but essentially with SPEs a company can set up a separate company or partnership, the SPE, which it controls but which does not need to be included in its accounts. Hence the concept of OBS: the finances of the SPE are off the main company’s balance sheet. SPEs were originally conceived to separate them from the liabilities and assets of the parent company. This could, for example, enhance the credit rating for the ‘special purpose’ for which the entity had been set up. SPEs can also be used, however, to keep ‘bad news’ – debts, losses and risky ventures - out of the parent’s accounts. SPEs were set up by Enron – and all the other companies using SPEs in this way - on the basis that it could be argued they met a ‘3%’ criterion set out in a letter from the SEC. This was in relation to a specific situation and never intended as a ‘bright line rule’ (Bratton 2004), though that was exactly how business and accountants applied it.

It is a technique of creative compliance to search for anything that can be construed as an authoritative rule, construct structures that comply with it in form but use it in unintended or unanticipated ways, then point to the rule to claim to be merely complying with what the authorities expressly required. Such practices are routine and widespread, and not only in the US. Parallel practices have been pervasive in the UK (McBarnet and Whelan 1999), and they have been described by David Tweedie, formerly

¹ McBarnet in O’Brien 2005, *British Journal of Criminology* 2006

Chair of the UK's Accounting Standards Board, and currently Chair of the International Accounting Standards Board, as fundamentally undermining the whole purpose of accounting.

Enron's SPEs were used in complex ways to construct paper profits and assets that could feed back into Enron to further artificially enhance – to an enormous degree – its financial reports. They were not, as has been sometimes suggested, 'hidden'. Their existence was disclosed as legally required, in the notes to the accounts. Their disclosure has been described as 'impenetrable' (Partnoy 2002), or 'obtuse' (Powers 2002), but that is also perfectly normal corporate practice. Enron also made massive use of derivatives, taking advantage of 'the regulatory black holes' there (Partnoy 2002), and used the opportunities in 'mark-to-market' accounting, where managers forecast future earnings, to be astonishingly optimistic in its valuations. For example in accounting for its deal with Blockbuster to provide entertainment via broadband, it included in its 2001 accounts profits of \$110 million even though it had not yet solved (and never did) the technical problems in making the delivery (Coffee 2006a). The consequence was enormously inflated performance, high share values, otherwise unsustainable credit ratings and huge recompense for executives in both performance related pay and share options.

But Enron was not alone. Exploiting SPEs, derivatives and valuation opportunities has been pervasive practice, and the consequence has been routine distortion of accounts and misleading of the market. Enron brought home the damage such practices do. 'American equity holders awoke in 2002 to realise they no longer could trust corporate financial reports. Their doubts extended beyond Enron and the

Arthur Andersen firm to a large set of companies with reputations for aggressive accounting.²

A whole range of Congressional investigations followed the collapse of Enron. Much of the outrage expressed in these investigations and in media comment focuses quite explicitly not just on the issue of fraud but on the revelation that practices claimed to be perfectly legal could still mislead and distort the market. Even the prosecutors in the Enron trials talk of ‘fraud *and* accounting hocus pocus’, ‘funny accounting’, ‘arcane accounting’ or ‘aggressive accounting’ - practices they are implicitly distinguishing from out and out fraud. Harvey Pitt, SEC Chairman of the time, talked not just of fraud but of ‘gaming the system’ (Pitt 2002). Comments at Congressional investigations drove this point home repeatedly: ‘The real scandal here may be from not what is illegal, but what is totally permissible. If the GAAP allow the bookkeeping shenanigans that have been reported in the press then we should all go into the derivative business. It seems that all too often the name of the corporate game is to conceal the true financial situation of the company while doing the minimum amount of disclosure to avoid legal exposure.’ (US Senate 2002, Senator Fred Thompson). There was anger too at legal argument legitimising practices contrary to common sense: ‘all these smart attorneys...can’t figure it out, but the lay person on the street can.’ (US House of Representatives 2002, Stupak)

For Congress, the media and the general public, part of the outrage of Enron lay simply in the fact that the market was fundamentally misled on Enron’s financial status by its use of off-balance sheet accounting devices, whether criminal or arguably not illegal, and the issues this raised for the reliability of financial reporting in general. As two congressional representatives put it: ‘Off the books transactions were purposefully

² Bratton (2004)

designed to mislead shareholders about Enron's precarious financial profits.' (US House of Representatives 2002, Greenwood). Or again: the 'broader issues are capital systems and transparency in accounting.' (US House of Representatives 2002, Deutsch).

Outrage and disbelief also permeate the reaction to the revelation that Enron could use the different rules of tax and accounting to simultaneously report huge profits in its SEC returns and claim tax losses, and huge refunds, in its tax returns. From 1995 to 2000 Enron reported \$1.8 billion in profits. How much tax did it pay? None. In fact it received \$381 million in rebates. (Klinger and Sklar 2002) Nor was Enron alone. Citizens for Tax Justice (2002) reported 41 major companies paying 'less than zero' in at least one year in the period 1996-98. They reported a total of \$25.8 billion profits in their financial accounts, but rather than paying tax, they received \$3.2 billion in rebates. The *New York Times* (2006 5 February) observed: 'Imagine a company that makes a practice of keeping two sets of accounts. One version is revealed to the public through periodic Securities and Exchange Commission filings and public announcements. The other is never made public and conveys a markedly different picture. Does it sound scandalous? Actually it's common practice. It isn't as if companies are breaking the law....'

Enron did not just draw attention to corporate fraud. It drew attention, despite the limited focus of the actual Enron trials, to the problem of technical or creative compliance, and acted as a catalyst for demands for change.

The Enron effect : licence for stronger regulation and enforcement

The state's focus on fraud had one important consequence in relation to the control of creative compliance. It provided good reason for far more suspicion of claims

that structures and devices successfully circumvent legal rules. Enron has given regulators a licence for investigation even in the face of that classic pillar of creative compliance, endorsement by professionals and respected financial advisers. Schemes may not in fact be clever but simply criminal, not devious but deviant. And that may be the case regardless of how impressive and apparently reputable the claimants are, or how heavily the claim is endorsed by professional opinion or respected financial advisers, who may also have been manipulated, or indeed complicit.

Examples of this emerged in my early ‘creative compliance’ research (McBarnet 1992). There were instances of what one interviewee referred to as ‘the sensitive bit’ in a chain of legal structuring, where what was done was not in fact lawful at all. There was an element buried in the complex structuring which, were it noticed, would invalidate the claim to the overall product being ‘perfectly legal’. The authors, however, did not intend it to be noticed. This practice relies not on creative legal argument which can be openly presented, win or lose, but on non-disclosure. It is not creative compliance. It is unlawful behaviour posing as creative compliance, and indeed trying to pass itself off as creative compliance. At the time of the research I wondered just how much of a ‘dark figure’ of *abuse* of the law might be lurking under the image of clever *use* of the law.

Enron, and its aftermath have demonstrated the routine incorporation of hidden deals and illegalities in what might on the surface appear to be simply complex legal structures. It has exposed numerous examples of the ‘sensitive bit’ that invalidates the legal claim to the accounting or tax treatment claimed. This is underlined by the wider investigations prompted by Enron, going beyond accounting to tax, and beyond Enron itself, with, for example, the pursuit of KPMG over ‘abusive tax shelters’ (US Senate

2003; Braithwaite 2005). Here a leading accounting firm was portrayed as constructing and marketing what were presented as ‘perfectly legal’ tax avoidance deals which, however, when investigated, were alleged to contain elements which depended not on taking clever advantage of legal loopholes but simply on hiding what was going on, ‘having good optics... [or] not leaving a road map... These are not just a mere contortion of the law... these are contortions of fact. These are lying, deceiving, and concealing true facts and really trying to be taxed on hypothetical transactions that never took place.’ (US Senate 2003, former KPMG employee). Enron and the further investigations it sparked off demonstrated that what poses as clever use of law may turn out, if investigated, to be merely non-compliance.

Many leading professional and financial firms have been closely implicated in Enron, and in the wider investigations that followed it. Several leading banks, J P Morgan Chase, Citigroup, Merrill Lynch, among others, were directly involved and legally pursued. Their complicity was heavily criticised, with banks and advisers informed that ‘you can’t turn a blind eye to the consequences of your actions – if you know or have reason to know that you are helping a company mislead its investors, you are in violation of securities law.’ (SEC 2003). KPMG has had most of the publicity on the ‘abusive tax shelters’ issue, but Ernst & Young and Price Waterhouse were also pursued. Nor have lawyers come out well (Rhode and Paton 2002).

One consequence of this erosion of trust is that regulators have been given a licence (for a while at least) to take a more suspicious approach to the endorsement and involvement of ‘reputable firms’, to be more interventionary and to engage in stronger enforcement – not least against those ‘reputable firms’ themselves. In the strategy of

deferred prosecution settlements in particular they used that licence to go beyond the control of fraud and non-compliance to challenge creative compliance.

Enforcement strategies in Deferred Prosecutions

In a number of key cases related to and following on from Enron - notably the cases against the *firm* of Merrill Lynch (as opposed to specific Merrill Lynch executives prosecuted for their part in the Barges deal), the Canadian Imperial Bank of Commerce, another participant in Enron deals, and KPMG, pursued in knock on investigations into tax shelters - the state adopted a strategy of deferred prosecution agreements rather than outright prosecution. These deals set up a prosecution but defer it in return for a range of obligations being undertaken by the firm. So long as the terms of the agreement are complied with, after a specified time the prosecution is dropped.

This strategy has been criticised as letting big firms off the hook (Corporate Crime Reporter 2005) and, certainly, after the demise of Arthur Andersen, there were pressures on competition grounds, and indeed in terms of jobs and economic benefits, not to destroy more accountancy firms . But the agreements negotiated, or imposed, also demonstrate significant leverage exerted by the prosecutors to set up new constraints on the firms in question. Typically the firm is required to admit guilt and to pay significant sums in fines, restitution and disgorgement of fees. But the terms have also included governance constraints that go well beyond narrow issues of fraud prevention, and have potential implications for creative compliance.

Though some of the terms imposed suggest the usual closing of the stable door syndrome where the very specific problems demonstrated in a particular case are addressed – such as a prohibition on undocumented agreements at Merrill Lynch – there are also wider-reaching demands that affect the practices within the firms and stretch restrictions out to routine creative compliance practices rather than just fraud. One common requirement is to set up committees comprising senior executives (‘Head of Group or experienced designee’) from all the ‘disciplines’ in the firm, to review and approve transactions, with the need for agreement of all Heads before a transaction structure is approved. This review obligation extends, for example in the Merrill Lynch agreement, to ‘all complex structured finance transactions effected by a third party with Merrill Lynch’ (US Department of Justice 2003). The concerns of Congress and the press are echoed in the prohibition from engagement in any transaction intended to ‘achieve a misleading earnings, revenue or balance sheet effect’ – note the use of ‘misleading’ rather than just ‘fraudulent’. There is also a demand that in assessing these structures, there should be a shift of focus from technical compliance to a concern with the ‘objectives’ of the structuring, objectives that are characteristic of routine creative compliance in ‘normal’ transaction work.

There is an express requirement too to take into account not just legal risk but ‘reputational risk’, extending the gamut of control beyond potential fraud and civil liability to what is simply not approved, and to pay attention to both ‘illegal and unethical’ elements’; ‘elevated standards’ beyond specific legal obligations are required; and there is a significant focus on the setting up of ‘effective’ and monitored compliance and ethics programmes (US Department of Justice 2005).

Tackling creative compliance: wider strategies

This focus on ethics not just law is important. One of the consequences of Enron has been to put ethics, culture and the spirit of the law on the corporate, professional and regulatory agenda. As we have seen, while the Enron cases tended to focus narrowly on fraud, the Senate investigations into Enron provided a stage for much wider revelations of and judgements on business ethics. There was concern about the pervasiveness of unethical practices and about the systemic nature of practices which distorted the market, whether treated as lawful or not. The same message has been communicated in speeches by key regulatory players (Pitt 2002; Donaldson 2004). The argument of Lay and Skilling, that they were engaging in normal business practice, may have been employed as a defence against charges of fraud, but ironically it only exacerbates the awareness of 'gaming the system' as routine and pervasive. There is increasing use in regulatory circles of the language of a 'corrupt corporate culture' (Wray 2005), and calls from the SEC for change not just in corporate law but in corporate culture and ethics (Gadziala 2005). Stephen Cutler (2004), SEC Director of Enforcement, has ascribed securities laws violations to both individual failings *and* 'deficient' corporate culture. Indeed part of the state's response has been to try to foster changes in corporate culture through a new emphasis on corporate compliance and ethics programmes, in an approach that has been

seen both by academics and regulators as a vision of corporate governance as ‘corporate conscience’.

The Sarbanes-Oxley Act imposes a minimalist requirement of Codes of Ethics for CEOs and CFOs, but other developments take this further. The US Sentencing Commission’s (2004) Guidelines encourage adoption of company wide Codes of Ethics and Compliance by making this a mitigating factor in future sentences. Importantly, evidence of code *implementation* and a *culture* of integrity is increasingly required. The Guidelines require companies to ‘promote an organisational culture that encourages ethical conduct and a commitment to compliance with the law’, with ‘high level personnel’ responsible for ensuring the programme is effective. They must embed their message in the corporate culture via repeated communication and ‘effective training’, and through appropriate incentives and disciplinary measures. The SEC, and major stock exchanges all now require not just codes of conduct but effective implementation procedures, and a culture of compliance must, says the SEC, be instilled ‘from the top down’ (Gadziala 2005), an approach reflected too in the deferred prosecution terms requiring approvals from joint heads. This direct involvement of those at the top of organisations makes it harder to distinguish the organisation from ‘rogue traders’, or the individual from the culture.

Of course calling for a new ethical culture and a commitment to compliance does not of itself challenge *creative* compliance, even in aspiration. To do that would mean calling for a new approach to compliance itself that focussed on a need for compliance with the spirit and not just the letter of the law. However, regulatory discourse is now setting standards for companies and professionals that go beyond mere literal compliance

to compliance with the spirit of the law, to 'ethical compliance'. SEC chairman, Donaldson (2005), has pressed the importance of investors being able 'to see for themselves that companies are living up to their obligations and embracing the spirit underpinning all securities laws', 'beyond just conforming to the letter'. His predecessor Pitt (2002) has driven home to lawyers that 'Helping a company satisfy literal legal prescriptions, even if doing so is contrary to what those legal prescriptions were intended to accomplish, doesn't satisfy a corporate lawyer's duties.'

Some companies are indeed undertaking, in either their Sarbanes-Oxley required code of ethics or in their general corporate codes of conduct, to abide not just by the letter but by the spirit of the law. This is an area currently under research, but our pilot work on the top 50 corporations in the Fortune 500 found almost half, 24 of the 50, commit themselves expressly in their current codes of conduct to compliance with the spirit of law, 18 committing to the spirit of the law in general, and another 6 committing to compliance with spirit in the context of core areas of law. In the UK, some 23 companies in the FTSE 100 commit to the spirit of the law in general, 9 in general, 14 in specific areas.

All this, of course, is evidence of rhetoric rather than practice, and even compliance with the spirit of the law can be creative and circumventory (McBarnet and Whelan 1999). In any case, in an environment where the issue is erosion of trust, and where even the letter of the law has been routinely flouted, what value can be set on pleas for a new ethics or on voluntary commitments to compliance with the spirit of the law? Is there also a policy of enforcing a wider ethical standard?

The deferred prosecution agreements operate at least for a time under the continuing threat of prosecution if they are not carried through. Nor is their impact confined to the specific businesses involved in them. Rather these agreements provide guidance on what regulators will look for in assessing whether companies' new compliance and ethics programmes meet regulatory standards of 'effectiveness'. Likewise regulatory pronouncements on ethical and reputational risk, and on compliance with the spirit of the law are being taken on board as criteria for setting up 'state of the art ethics and compliance programs' (Mirvis et al 2005). The new commitment to 'spirit of the law' compliance in corporate codes is not happy chance.

The SEC reports it is putting its aspirations into practice, looking beyond procedures to culture in its examinations (Gadziala 2005), the Sentencing Guidelines hold out carrot *and* stick, while the Department of Justice has declared its intention to take 'unethical' as well as 'illegal' conduct into account in its enforcement: 'A company's history of repeated unethical conduct followed by an employee's criminal act might well be viewed quite differently from the same criminal conduct coming instead on the heels of a long history of responsible ethical conduct' (www.metrocorp.counsel.com March 2006, interview with Wray).

II Regulatory developments: the UK

There are clear parallels with this regulatory drive for a new standard of compliance, more akin to 'ethical compliance', in countries other than the US. In the UK, for example, though the context and regulatory history are different from the US, making

for differences in approach, emphasis and language, there is nonetheless also a clear drive in the same direction.

UK regulation did not need Enron to raise awareness of either white collar crime or creative compliance, the UK having had its own crises. UK regulators had diagnosed and begun to tackle the issue of creative compliance in accounting and corporate governance long before Enron, in the late 1980s and 1990s, using the strategy of a shift from rules (which facilitate claims to technical compliance) to principles, in the format of regulations. The Accounting standards Board was a particular leader in this strategy under chairman David Tweedie (Now IASB chair), while the Financial Services Authority (FSA) also brought in an approach based on principles to financial services regulation, and especially from the late 1990s the Inland Revenue (now HMRC) was following through on earlier judicial attacks on creative compliance in the form of tax avoidance.

Enron, however, helped licence a new focus on corporate ethics and corporate cultures including attitude to law and compliance. Patricia Hewitt, for example, as Secretary for Trade and Industry talked post Enron of the issues of corporate governance *and* 'loose ethics'. Dan Waters criticised a 'legalistic approach' to rules and compliance suggesting it would lead to 'our very own Enron experience' (FSA, 2006 Vp3). Margaret Cole of the FSA describes herself in a 2007 speech as being disturbed to 'still see a blind spot when it comes to associating market misconduct with financial crime. Some people, it seems, don't believe that market manipulation, market abuse and insider dealing is as serious an issue as fraud. There is still a way to go in bringing about a cultural shift in this area.'

Recent developments have seen increased focus on changing corporate culture, increased emphasis on ethics and more overt calls for compliance with the spirit of the law. The language used is both that of ethics and of ‘responsibility’, a reflection of the stronger development of the Corporate Social Responsibility movement in the UK and Europe, of which more later. There is a shift of focus, as in the US, to holding senior personnel responsible. [FSA, HMRC] There is an enhanced emphasis (as in the US’s deferred prosecutions agreements) on the need for companies to take account of reputation risk, including ethical risk. And there is more overt focus on the application of regulations – the responsibility of the regulated - rather than just on the format of regulations, as in the regulators’ earlier shift to principles. Rather than concentrating on how regulators deliver regulations, more attention is being paid at last to how the regulated receive regulations, how they apply and comply with them, and ethics or responsibility is the language being brought to bear in how that should be done. Tweedie, for example, calls for companies to apply accounting principles (notes 8) ‘responsibly and with integrity’, an approach endorsed by the DTI and Treasury (2003 V7). Margaret Cole of the FSA observes the dual nature of responsibility and its ethical aspect: ‘Although we [regulators] have a statutory responsibility, we consider that there is a moral responsibility on market participants to work proactively to preserve the integrity of the markets.’ These developments can be seen in all of the three core agencies of UK corporate regulation – the ASB, FSA and HMRC.

Regulatory standards are being described increasingly as not just legal but ethical. The FSA in 2002 overtly described its principles, its ‘high level standards’ as ‘based on ethical values’. The ASB has also underlined the ethical nature of its principles by

republishing a paper influential twenty five years ago on the meaning of the principle of ‘true and fair’ accounting – a standard which the new president of ICAS describes as related to ‘societal perception of truth and fairness, which is ultimately a matter of ethics and morality’.³ A drive for ‘ethical’ or ‘responsible’ compliance as opposed to technical, ‘arguably perfectly legal’ compliance is also expressly on the agenda. In 2002 the FSA issued a discussion paper on ‘An ethical framework for financial services’, expressly criticising mere compliance with the letter of the law and a mindset that asks ‘“show me where it says we can’t...?”’ rather than “how can we improve our standards and conduct our business with integrity”. It called for a value based corporate culture, concerned among other things with compliance with the spirit not just the letter of the law. Overt calls for compliance not just with the letter but also with the spirit of the law have also been made by the OECD. In its Guidelines for Multinational enterprises, in the particular context of tax and referring directly to the impact of Enron, it calls for companies to ‘make every effort to act in accordance with both the letter and the spirit of laws and regulations’ p27.

In terms of enforcing ethics, the FSA has noted its determination to enforce its ethical principles even if a rule as such has not been broken, pointing to two major cases in 2006. There are also parallels with US mitigation strategy in the FSA’s policy ‘in deciding on the appropriate regulatory outcome’ that its approach to ‘firms that consistently behave well .. can and should be different to those where we do not see that behaviour’. There will be a ‘regulatory dividend for good behaviour’.⁴ In 2006 Her Majesty’s Revenue and Customs (HMRC), the enforcers of tax law, issued a consultation

³ Isobel Sharp of Deloitte, as reported in the Financial Times 1 March 2007

⁴ Cole V tax etc 7

paper on which they addressed the issue of encouraging corporate cultures of compliance by taking compliance history into account when dealing with ‘apparent compliance failure’ and in penalty mitigation. The kind of compliance they have in mind is ‘responsible compliance’. They are exploring ‘whether there could be a way of helping businesses to demonstrate “corporate responsibility” in company reports or other business plans by giving some visible evidence of ‘responsible compliance’ .⁵

III Wider developments

This reference to ‘corporate responsibility’ brings us to another set of relevant developments – the extra-legal social and market forces demanding a new standard of ‘ethical’ or ‘responsible’ compliance. Whatever their aspirations regulators may in fact have difficulty in enforcing ethics. There has been something of a backlash in the US against strong regulation and specifically s404 on grounds of national competitiveness. There may be resistance too to calls for ‘ethical compliance’ on the basis of the rule of law, arguments that these demands involve too much subjectivity and retrospectivity and too much power to the enforcers. There have been such criticisms of the US deferred prosecution agreements. The UK’s principle based regimes in the ASB and FSA, as well as anti-tax avoidance strategies have all come in for such critique - though the social climate can change, and can change partly because of crises like Enron and partly because of a shift in societal expectations. In the UK there is currently evidence of a shift in societal expectations of business behaviour and business ethics, being expressed in part in the movement for CSR. What is more, the CSR movement is not only providing a

⁵ V2

backdrop for regulatory enforcement of ethics but is itself beginning to use market forces to force ethical compliance onto the corporate agenda.

It is difficult to open a newspaper these days without coming across some reference to Corporate Social Responsibility (CSR). As the ready resort to acronym suggests, it is a term that has entered into routine usage in debates both about business and within business. Post Enron, and in a world in which the role of business in human rights and the environment is a matter of standard debate, the social and ethical responsibilities of business have become key issues, and CSR has become a much talked about element in corporate governance in its widest sense.

CSR essentially involves a shift in the focus of corporate responsibility from profit maximisation for shareholders within the obligations of law⁶ to responsibility to a broader range of *stakeholders*, including communal concerns such as protection of the environment, and accountability on ethical as well as legal obligations. Typically CSR policies involve a commitment by corporations, usually expressed in their Statements of Business Principles or corporate-specific Codes of Conduct, to enhanced concern for the environment, human rights, fairness to suppliers and customers, and opposition to bribery and corruption, with the range of issues involved constantly expanding. Importantly, for our concerns here, after Enron, CSR is also regarded as not only involving social and environmental issues but as going to the heart of core business operations such as accounting and even tax policies, and has become an issue for corporate governance in the narrower sense of the term. The language of business ethics is also frequently brought into play, with environmental and social impact seen as part of a new business ethics. The

⁶ M Friedman , 'The Social Responsibility of Business is to Increase its Profits' *New York Times Magazine*, 13 September 1970

trend to a shift of language in business from CSR to simply CR, 'Corporate Responsibility', reflects this. CSR has indeed become something of a portmanteau concept, which incorporates a broad sweep of concerns from saving the planet to demanding ethics in business dealings.

CSR is generally presented by business and governments alike as voluntary. In reality this is a little misleading. The 'voluntary' adoption of CSR policies by business has received a very firm push from external social and market forces. From the start, 'voluntary' CSR has been socially and economically driven. NGO campaigns, ethical trading initiatives, SRI or socially responsible investment and a range of other social, market (and increasingly legal) factors have put the pressure on for a new approach to corporate responsibility in big business.

CSR is a new point of pressure for ethical compliance. Indeed business has, in the very way it presents its adoption of CSR policies, laid itself open to this pressure. The voluntary image is encapsulated in the idea of CSR as 'what companies are going to do beyond mere compliance with the law',⁷ the notion of going 'beyond legal compliance' being key to the image of *social* responsibility. That view of CSR, however, assumes a baseline of compliance that is in fact problematic, not only because of the significant amount of non-compliance that takes place in business, but because of the routine practice of creative compliance. In some contexts this would be, and has been, seen as not only legitimate but admirably astute. But in the context of a new business environment in which companies are keen to present themselves as socially responsible, the practice of creative compliance may raise some uncomfortable questions.

⁷ BT Social Report 1999

For companies holding themselves out as going beyond mere compliance, is compliance with a strict literal interpretation of the law enough? Is meeting the letter of the law while deliberately frustrating its spirit *responsible* compliance? Are the *consequences* of creative compliance socially responsible? Is it socially responsible to use legal creativity to escape intended controls, obviate employment rights or circumvent health and safety protections? Is aggressive tax avoidance socially responsible? Is there not a certain irony in companies taking credit in their CSR reports for contributing to community schools or hospitals at the same time as using every arguable form of legal creativity to avoid paying the tax that might have funded them from the public purse? Nor is it just social welfare that is impeded by creative compliance but the functioning of capital markets themselves, though of course failure in the market has social effects too for investors, creditors, employees and pensioners. Is it socially responsible or ethical to use, in any context, legal arguments that ‘sail close to the wind’ to circumvent legal control?

Such questions imply a misfit between CSR claims and compliance practices, and indicate potential for CSR to become a source of leverage in getting companies to reassess their attitudes to law and compliance. As I have argued elsewhere, though CSR is generally presented as going beyond legal obligations, it may be that business could best ‘demonstrate a new attitude to corporate social responsibility not so much by *surpassing* law’s requirements, but by meeting those requirements *in spirit* at last.’⁸

Creative compliance on the CSR agenda

⁸ McBarnet ‘After Enron: corporate governance, creative compliance and the uses of Corporate Social Responsibility’, in J O’Brien (ed), *Governing the Corporation*, John Wiley, 2005, 205-222

The issue of compliance is beginning to appear on the CSR agenda as a result of growing interest among NGOs, consultancies and investment funds, particularly in relation to tax avoidance – tax avoidance indeed being seen increasingly as an issue of corporate governance. New dedicated NGOs have emerged, using classic strategies of naming and shaming campaigns. The Tax Justice Network (TJN), an international non-governmental organisation launched in the UK in 2003, has taken a key role in stirring up publicity and provoking responses. While its interests extend more widely to poverty in developing countries and the role in that of tax lobbying, evasion, corruption, and international tax competition, TJN has also embraced the issue of tax avoidance and CSR. The Davos World Economic Forum (WEF) in January 2005, was seized by NGOs⁹ with a CSR agenda, as an opportunity to make Corporate Social *Irresponsibility* awards, and tax avoidance joined more conventional CSR issues as one of the award categories. The two NGOs organising the ceremony described it as a reminder ‘to members of the WEF and other large corporate groups that the public expects them to be responsible stewards of the environment; insists on their respect for human rights and labour rights; and does not tolerate tax avoidance.’¹⁰ The Tax Justice Network nominated the ‘winner’ on tax avoidance, accountancy firm KPMG, for its marketing of ‘abusive’ tax avoidance schemes, s revealed in the post Enron US Senate investigations.¹¹

Not far behind NGOs have been consultancies advising a rethink of attitudes to tax in particular and in some cases to compliance more generally. Ironically, given its brush with infamy over ‘abusive’ tax avoidance, or indeed because of it, KPMG has taken a

⁹ The Berne Declaration and Pro-Natura-Friends of the Earth Switzerland.

¹⁰ www.publiceye@evb.ch, 20 January 2005

¹¹ *Tax Justice Focus*, newsletter of Tax Justice network, spring 2005 vol 1 no 1, re US exposees

lead role here. In its 2004 paper, 'Tax in the Boardroom', it acknowledges tax strategy now carries reputational risk, due not only to changing governmental attitudes but to the role of the CSR movement. Tax planning is seen as key in this. Corporate tax planning, KPMG notes, can range from the 'social duty' end of the spectrum to the 'shareholder duty' end. While conventionally corporate duty was seen to fall on the shareholder duty end of the spectrum, requiring minimisation of tax by all legal means, KPMG warn that the balance may be less clear now because of reputational damage and the risk that poses – despite the legality of the techniques involved - to long term shareholder value:

Boards should recognise, when overseeing the design and monitoring of tax strategies and policies , that contemporary debates about governance, corporate social responsibility and ethics mean that even legal tax-minimisation activity can generate reputational liabilities that can destroy shareholder value.¹²

Investment organisations have entered into the debate, with Henderson Global Investors producing an influential report based on a survey of the Chairmen of FTSE 350 companies. This was explicitly presented as a response to the fact that tax, including what some view as 'inappropriate tax avoidance' is coming under greater scrutiny and that commentators are suggesting that 'approaches to tax should be seen as a matter of corporate social responsibility'.¹³ Conferences, workshops and internet debates on the subject are also springing up in rapid succession. In a multiplicity of ways, tax avoidance has emerged as an issue for the Corporate Social Responsibility agenda, and as an ethical rather than just a legal concern.

¹² KPMG Tax in the Boardroom 2004, p8

¹³ Henderson Global Investors *Tax, risk and corporate governance*, Feb 2005

To some managers, and indeed lawyers, this is entirely inappropriate, there being, in traditional legal thinking, no place for ethical judgement in tax law. But CSR is, as business, keeps telling us, beyond law, and it is in the courts of public opinion rather than the courts of law that business practice is being judged. Creative compliance in areas such as tax avoidance may pass the test of legality but fail on the test of social responsibility.

In the UK, the tax authorities have expressly brought the language of CSR into their discussions of tax avoidance, and developed initiatives to get ‘Tax on the Boardroom Agenda’. The OECD too sees tax avoidance as firmly on the agenda of the “corporate social responsibility” movement. ‘Tax is where environment was ten years ago.’¹⁴

It is not surprising that tax avoidance has caught the eye of critics geared to CSR. In terms of its consequences it is clearly a social welfare issue. It is also of course a challenge for business in that it goes to the heart of the issue of profit maximization and provides a real test of whether companies adopting CSR policies embed them throughout the organisation – including the core departments of tax and accounting – seeing them as relevant to financial and legal issues as well as the more established agenda of environment, human rights et al.

Though tax avoidance has particularly caught the CSR imagination, there are indications that a more general concern with creative compliance as a CSR and reputational risk could also evolve. Part of the tax debate and of wider relevance for legal compliance more generally is the increasing discussion in CSR debate of compliance with the spirit of the law. A report by BiTC, Insight Investment and FTSE looked more

¹⁴ Jeffrey Owens, OECD, quoted by Vanessa Houlder, *Financial Times*, 22 November 2004

generally to the issue of compliance with the spirit and not just the letter of the law, as did Sustainability's report on tax.¹⁵

The issue of legal compliance and of what it means to comply with the law *responsibly* does seem to be entering the CSR agenda. Bringing CSR ideas to the issue of legal compliance raises the threshold on what is required for business's legal behaviour to be deemed legitimate. Regulators may find it difficult to enforce the spirit of the law or ethical compliance. Courts of law may be unwilling or find it difficult to hold companies to legal account for what is arguably technically lawful behaviour - although every now and then they do just that, with 'new approaches' which 'lift the corporate veil', look through form to substance, or reinterpret how transaction forms are read, and changing social demands might encourage this. But courts of public opinion, markets and investors can set their own standards for what they hold to be legitimate, and they may set the bar higher than what is 'arguably technically legal', viewing even legal compliance through the lens of what is ethically acceptable or socially responsible. And then it is market forces rather than the law that are brought to bear in enforcing ethics.

In adopting CSR policies and holding themselves accountable to standards beyond legal compliance, companies may not have anticipated CSR reaching from calls for social responsibility on such issues as environmental concerns to calls for social responsibility in relation to legal compliance itself. But CSR has its own momentum, and the potential is there for the market to exercise judgment, and flex its muscles, in the arena of legal compliance too.

All the usual provisos, the limits of market and social forces, of course apply.¹⁶ Nonetheless there is potential in CSR as a force not just for ethical behaviour on the part

¹⁵ BITC, Insight Investment, FTSE *Rewarding Virtue*, November 2005

of business but for ethical compliance with the law, putting pressure on business to review its attitude to law and compliance, shifting the threshold of social responsibility and ethical legitimacy from compliance with the letter of the law to compliance with its spirit and so, potentially, enhancing regulatory effectiveness.

CSR is a much stronger and more developed force in the UK and Europe than in the US. Yet interestingly overt connections are being drawn in the US between regulation, ethics and corporate responsibility in the wider European sense. A conference initiated by the influential Conference Board in the US, is currently addressing the issue of integrating corporate responsibility, ethics and compliance, recognising that the European concept of business ethics typically encompasses a broader concept of corporate responsibility and exploring the drivers for convergence in the US.

CSR is also feeding back into regulatory strategy. By making risk a key part of directors' obligations and including reputational risk regulators are essentially backing market and civil society sanctions with legal obligation. Indeed although CSR is generally presented as a voluntary commitment on the part of business, it is increasingly not only undertaken under the pressure of market forces and civil society demands but in response to new legal obligations too, sometimes subtle and indirect, sometimes initiated by private rather than state parties, but legal obligations nonetheless. (McBarnet, Voiculescu and Campbell 2007) And regulatory and market pressures interrelate: the more the regulators raise the issue the more the market – as Henderson Global Investors emphasise - sees risk in ignoring it.

¹⁶ For more detail on the market forces being brought to bear and for critical assessment see McBarnet ch 1 in McBarnet, Voiculescu and Campbell *The new corporate accountability: CSR and the law*, Cambridge UP, 2007

Conclusion

For an academic interested in the idea of ethical or responsible compliance there are then some intriguing developments taking place suggesting a new pressure for ethical compliance both from regulatory and from social and market sources. All have limitations, all are benefiting to some extent from the Enron effect and the pendulum may swing again. However if our concern is with challenging the legitimacy of creative compliance, debate on what standard of compliance is legally, socially and ethically acceptable, as well as the emergence of a rhetoric of regulatory ethics and ethical compliance, matters in itself. Current developments are creating an environment in which it is much more difficult for business executives and their advisers to see it as indisputably legitimate to 'game the system'. Since the key attraction of creative compliance is precisely that it can claim to be legitimate, just challenging that legitimacy is itself a strategy worth pursuing.