Testimony of Michael Palmer, J.D., Ph.D.
Before the Senate Committee on Government Operations
Concerning Senate Bill 8

Montpelier, January 19, 2017

Madam Chairwoman, Senators Collamore, Ayer, Clarkson, and Pearson, ladies and gentlemen. Good afternoon.

My name is Mike Palmer. I am honored to have been asked to testify at today's hearing on Senate Bill 8.

My Background and Experience

I am the president of Ethics By Design, which I founded in 2007, and also the founder of Win Before Trial, a legal risk management company, both based in Middlebury. I have been an attorney since 1980, first with Jenner & Block in Chicago and then as head of my own firm in Middlebury, which I closed in 2007 to do consulting full time.

Before receiving my law degree from Georgetown in 1980, I was a teaching fellow at the Free University of Berlin, Germany, where I was graduated with an M.A. and a Ph.D. My field of study was broad, but I sum it up as a concentration in social ethics.

I have taught practical and professional ethics at Middlebury College, Champlain College, and the UVM Grossman School of Business.

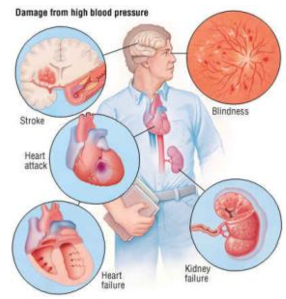
In addition to numerous articles, I have published three books on ethics: *The Morally Responsible College*, *Professional Ethics for Managers,* and *Complying with the Ethics Mandates of the Federal Acquisition Regulation.*

I have provided consulting services for a Big 4 accounting firm and other organizations, and developed ethics program proposals for a large city government and for other government entities.

I have also been a speaker on ethics at national and international conferences, including the Society of Corporate Compliance and Ethics, the Association of Chamber of Commerce Executive Directors, the National Contract Management Association, the Institute of Internal Auditors, and the American Bar Association.

High Blood Pressure

I have high blood pressure. It's likely some of you do too.



Essential hypertension and hypertensive renal disease are among the 15 leading causes of death in the U.S. (65(4) National Vital Statistics Reports, "Deaths: Final Data for 2014" (June 30, 2016).

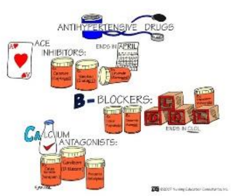
"About 69% of people who have a first heart attack, 77% who have a first stroke, and 74% who have congestive heart failure have blood pressure higher than 140/90 mm Hg." Statistical Fact Sheet, High Blood Pressure, American Heart Association.

President Franklin D. Roosevelt likely died from untreated hypertension.

You can't see high blood pressure. Generally, there are no symptoms until it's too late.

But you can do something about it.

You can check to see whether you have it.



If you have it, medicine can help you get it under control.

Because I routinely go in for a medical exam, my primary care physician was able to spot my hypertension and prescribe medicine that keeps it within the 120/75 range.

Many Ethical Problems are Like Hypertension—Out of Sight

According to the Association of Certified Fraud Examiners, the average organization—including government entities—loses about 5% of its topline income to fraud and theft every year. Vermont spends over $5 billion every year. If you do the math, that means we could be losing around $250 million every year to fraud, theft, corruption, and other misconduct.

Wow! How could that be? Wouldn't we see all that fraud and theft going on? Wouldn't it be obvious, like a flood or drought?

Well, no. Most of the fraud, theft, and other misconduct is like hypertension or sub-clinical inflammation or other killer diseases that go unnoticed until it's too late. Like the mass of icebergs, such misconduct is below the water line, out of sight.

The Association of Certified Fraud Examiners issues a Report to the Nations every two years based on surveys of organizations in various countries, including the United States.

Industry/Scheme	Banking and Financial Services	Government and Public Administration
Cases	368	229
Billing	9.5%	25.3%
Cash Larceny	11.1%	7.9%
Cash on Hand	17.9%	10.5%
Check Tampering	9.5%	9.2%
Corruption	37.5%	38.4%
Expense Reimbursements	5.4%	15.7%
Financial Statement Fraud	12.0%	7.9%
Non-Cash	10.6%	14.8%
Payroll	3.8%	13.5%
Register Disbursements	2.7%	1.7%
Skimming	6.8%	14.0%

Less Risk More R

2016 Report to the Nations 36

According to the 2016 report, government and public administration have the second highest incidence level of fraud and theft, exceeded only by the banking and finance industry.

25.3% of the cases relate to billing, essentially false claims.

38.4% are connected to corruption.

Expense reimbursement and financial statement fraud together account for another 23.6% of the losses.

A study by the U.S. Chamber of Commerce concluded that 30% of all business failures are the result of employee fraud or theft. One of my clients was part of that statistic. The trusted bookkeeper of another of my legal clients client stole over $700,000 by writing herself a check every month for 6½ years. All under the radar, like hypertension.

Like most frauds of this type, the bookkeeper's embezzlement was discovered by accident. Most ethical misconduct—in government and elsewhere—floats under the water line like the bulk of an iceberg.

There is a reason why the third plea of the Lord's Prayer reads "lead us not into temptation." Vermont is not immune from human frailty.

The Cost of Untreated Ethics Problems

If the estimate of the Association of Certified Fraud Examiners applies to Vermont—and there is no reason to think it doesn't—Vermont loses around $250 million every year to fraud and theft. That's over $31,000 per state employee.

The spate of recent embezzlement cases in Irasville, Weybridge, and other towns around the state provides anecdotal evidence that we have a problem. (*See* Mike Donoghue, "Vermont: A State of Thievery," Burlington Free Press (January 1, 2015).

But even if the losses are only 1% of revenue, that's $50 million. If it's not more than 1/10th of 1%, it's still $5 million. Out the window. Poof! Money that is not going to repair bridges or employ teachers or provide better police protection or faster court decisions or—drum roll please—reduce taxes.

To illustrate how these hidden costs occur, suppose Vermont employees submit an average of 10,000 travel and expense reimbursement statements every year with an average claim of $500. And suppose half of those claims are inflated by 15%, meaning they falsely claim they paid for a taxi ride or a meal or some other expense that did not happen. That would be a loss of $750,000 in the aggregate.

Or suppose the State pays an average of 15% more than necessary as a result of sole-source contracts totaling $100 million. That's $15 million needlessly down the drain.

We are collecting millions of dollars in taxes that we are allowing to be stolen merely because we have neglected to put an effective ethics program in place.

Vermont Has Almost No Ethics Infrastructure in Place

For several years, The Center for Public Integrity, in partnership with Global Integrity, has conducted a comprehensive assessment of state government accountability and transparency. The project uses extensive research by reporters in each state to grade and rank the states **based on existing laws** and analysis of how well they are implemented.

This is a carefully researched report with a comprehensive explanation of each of 13 categories.

In 2015, Vermont got an **overall grade of D-**:

1.	Public Access to Information	F
2.	Political Financing	B
3.	Electoral Oversight	D-
4.	Executive Accountability	F
5.	Legislative Accountability	F
6.	Judicial Accountability	F
7.	State Budget Processes	A
8.	State Civil Service Management	F
9.	Procurement	C-
10.	Internal Auditing	C-

11. Lobbying Disclosure	C-
12. Ethics Enforcement Agencies	F
13. State Pension Fund Management	D-

Vermont ranks 50th of all states on the Ethics Enforcement Agencies category.

The Center for Public Integrity explained its rating on this category as follows:

> Vermont is one of eight states with no "commission dealing with ethics or government transparency," according to the National Conference of State Legislatures. The nonpartisan (but not nonideological) Campaign for Vermont also found no "professional ethics enforcement agency." The NCSL report mentions the Secretary of State's office and the Senate Judiciary Committee. But the Senate's rules (http://legislature.vermont.gov/assets/All-Senate-Documents/Senate-Rules.pdf) say nothing about upholding ethical standards. The Secretary of State's office administers campaign finance and lobbying, but no more. There is an Executive Branch code of ethics, but its scope is limited, and it creates no enforcement entity. There is a nine-member Judicial Conduct Board which hears and investigates complaints against judges, and has the power to reprimand or suspend them, though only the Legislature can remove them from office. But the Judicial Conduct Board has no full-time personnel. Its chair is a lawyer in private practice. It has no staff (the current chair's secretary in his law office serves as the board's entire staff). It responds to complaints, but does not monitor. Lawyers do not refer to it as an ethics agency, and on balance, it would not seem to qualify as one. In 2015, the House of Representatives created an "Ethics Panel" appointed by the Rules Committee "to receive and investigate complaints of alleged ethical violations made against members of the House," and possibly "recommend" disciplinary action. The panel is not considered a House committee, and is not listed as one. The Senate has no comparable entity. By and large, when it comes to government ethics and openness, Vermont relies more on personal relationships and trust than on institutions.

What Does it Mean to Put an Effective Ethics Program in Place?

The standard model for ethics and compliance programs articulated by the Federal Sentencing Guidelines Commission has 7 elements:[1]

1. Written standards of conduct and policies and procedures (including a code of conduct)
2. Designation of a chief compliance officer and other appropriate bodies
3. Effective education and training
4. Audits and evaluation techniques to monitor compliance
5. Reporting processes and procedures for complaints
6. Appropriate disciplinary mechanisms
7. Investigation and remediation of systemic problems

A large body of programs, resources, and experience has been built up around these elements. Vermont does not need to create all of this on its own.

An effective ethics program requires dedicated leadership at the highest levels. If the Governor and his cabinet and the legislative leadership do not buy in, an ethics program will largely be little more than words on paper.

In addition to the standard framework developed by the United States Sentencing Commission, government ethics programs need to include ethics requirements both for procurement officers and for contracting organizations.

> "There is no kind of dishonesty into which otherwise good people more easily and frequently fall than that of defrauding the government."
> Benjamin Franklin

As I mentioned at the outset, I wrote a book on the *Ethics Mandates of the Federal Acquisition Regulation*. The FAR is a weighty tome that regulates every facet of doing business with the Federal Government. In 2010, our own Peter Welch introduced legislation requiring a revision in the FAR that now requires anyone who knows about fraud anywhere in the supply chain to report that information. The FAR also requires every contracting entity to be ethical and those companies with contracts in excess of $5 million to have an effective ethics program in place.

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[1] Adapted from Debbie Troklus and Emma Wollschlager Schwartz, "Essential Elements of an Effective Ethics and Compliance Program," in *The Complete Compliance and Ethics Manal 2016* (Society of Corporate Compliance and Ethics, 2016).

As Benjamin Franklin said, "There is no kind of dishonesty into which otherwise good people more easily and frequently fall than that of defrauding the government."

The FAR identifies and expressly prohibits several kinds of improper business practices, including gratuities to government personnel (not even a cup of coffee), anti-trust violations, contingent fees paid to middlemen who solicit or obtain government contracts, buying-in, subcontractor kickbacks, contracts with government employees, and false claims. Buying in is the practice of submitting a bid below expected costs to win the contract with the expectation of increasing the contract amount after it has been awarded. False claims includes the failure to return payments in excess of the amount owed to the contractor.

There is no reason to suppose that Vermont is immune from these and other improper business practices. At the moment, we have no way of detecting, monitoring, reporting, or sanctioning them when they occur.

Effective Ethics Programs Save Money and Improve Effectiveness

In the context of writing anti-harassment training programs, I conducted a study of the financial costs of harassment, bullying, and abuse in organizations—a major issue in organizational ethics. Apart from the direct costs of lawsuits and damage awards, average rates of harassment in organizations lead to high turnover, absenteeism, lower employee engagement, lower productivity, higher health care premiums, a smaller pool of potential employees, and diverted management time. In 2003, economist Dr. Fraeda Klein concluded that the cost of inappropriate/unfair treatment of employees in the average Fortune 500 company was $919 per employee per year—in 2003 dollars.[2] In Vermont that would translate into over $8 million of embedded, unnecessary, and preventable costs.

In addition to the studies by the Association of Certified Fraud Examiners I cited earlier, other studies have shown that effective ethics programs save organizations significant amounts of money and improve organizational efficiency and effectiveness.[3]

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[2] Freada Klein, Estimating the Cost of Unfair Treatment to a Typical Fortune 500 Company (The Level the Playing Field Institute).

[3] See, e.g., "2016 Ethics and Compliance Hotline Benchmark," NAVEX Global (2016); Maurice E. Stucke, "In Search of Effective Ethics & Compliance Programs," 39 *The Journal of Corporation Law* 769 (2014); Matthew J. Kiernan, *Investing in a Sustainable World: Why Green is the New Color of Money on Wall Street* (New York: Amacom, 2009); Simon Webley and Kerry Hamilton, "How Does Business Ethics Pay: An Exploratory Look at the Ways Through Which Doing Business Ethically is Being Translated Into Corporate Financial Performance," *Institute of Business Ethics*, London (2004); James K. Harter, Frank L. Schmidt, and Corey L. M. Keyes, "Well-Being in the Workplace and its Relationship to Business Outcomes: A Review of the Gallop Studies," in C.L. Keyes & J. Haidt (eds.), *Flourishing: The Positive Person and the Good Life* 217-218 (Washington DC: American Psychological Association, 2002); Jeff Huther and Anwar Shah, *Anti-corruption Programs and Policies: A Framework for Evaluation* (World Bank, 2000); John M. Stevens, H. Kevin Steensma, David A. Harrison, and Philip L. Cochran, "Symbolic or Substantive

An Ounce of Prevention is Surprisingly Cheap

Neglecting to put an ethics program in place is like driving a car without an oil filter. You may think you're doing just fine, but sooner or later the repair and replacement costs far exceed the prevention costs.

Not only would an effective ethics program help Vermont save a good chunk of the money we currently lose to fraud, theft, and corruption by putting an oil filter in place. But it would also be surprisingly inexpensive to do so.

Several top-flight ethics and compliance firms provide services at low cost with proven effectiveness. For example, Navex Global could administer a whistleblower hotline and an incident management system for roughly $20,000 per year with a one-time setup fee of $28,350.

More importantly, Vermont has an abundance of experienced ethics and compliance officers and other professionals who could help write an effective code of conduct for state employees and officials at little or no cost to the State. Every state college and university as well as regional hospitals employees has an ethics and compliance officer, some of whom have no other responsibilities. Several private corporations have ethics specialists who would volunteer their time if asked. And Senior Judge William Sessions, the former chair of the U.S. Sentencing Commission, which wrote the standards for ethics programs I listed earlier, would undoubtedly contribute his expertise as well.

But even if it costs $150,000 to set up an ethics commission, that would likely be the most cost-effective expenditure in the state budget.

A Word About the Basics

It is impossible in the short time available to discuss everything that an effective ethics program involves or to fully explain why it makes financial sense to put one in place. But before I close, I want to make three points that are fundamental.

Document? The Influence of Ethics Codes on Financial Executives' Decisions," 26 Strategic Management Journal 181 (2005); Golin Harris, "Doing Well by Doing Good 2005: The Trajectory of Corporate Citizenship in American Business;" Moses L. Pava and Joshua Krausz, Corporate Responsibility & Financial Performance: the Paradox of Social Cost (Westport, CN: Quorum Books, 1995); Pascual Berrone, Jordi Surroca, Josep A. Tribo, "Corporate Ethical Identity as a Determinant of Firm Performance: A Test of the Mediating Role of Stakeholder Satisfaction," 76 Journal of Business Ethics 35-53 (2007); Gary Weaver and Linda Trevino, "Compliance and Values Oriented Ethics Programs: Influences on Employees' Attitudes and Behavior," 9(2) Business Ethics Quarterly 315 (1999); Curtis Verschoor, "A Study of the Link Between a Corporation's Financial Performance and Its Commitment to Ethics," 17 Journal of Business Ethics 1509-1516 (1998); Sandra A. Waddock and Samuel B. Graves, "The Corporate Social Performance-Financial Performance Link," 18(4) Strategic Management Journal 303 (1997); Institute for Business Ethics, "Does Business Ethics Pay?—Revisited," (2007).

First, the guide for all efforts to regulate the conduct of people exercising power on behalf of others—which includes all legislators, executive officials, and most State employees—is the law of fiduciary duty. The fiduciary duty has two parts: The duty of care; and the duty of loyalty.

When Senate Bill 8 addresses conflict of interest issues, it is focusing on one aspect of the duty of loyalty. But the duty of loyalty encompasses much more than the avoidance of conflicts of interest. Simply put, the duty of loyalty requires that the legislator, executive, or State employee always put the interests of the people of the State of Vermont ahead of their own interests. They may never—never—use their position of power or authority to further their own interests, whether by hiring a relative because she is a relative, by padding an expense account, by awarding a contract to curry favor for later employment, by drafting legislation to benefit a specific business, or by giving in to any of the other temptations people in power experience.

That is the general principle that should govern specific rules in Senate Bill 8 and in its implementation.

Second, I approach government ethics and anti-corruption programs as an instance of risk management. Our sense of moral outrage over misconduct sometimes leads us to approach the problem as an attempt to make people be good, either by wagging fingers at them or by otherwise appealing to their sense of morality. A risk management approach, in contrast, designs interventions based on statistical probabilities. We know, for example, that 40-50% of people will cheat in small ways if given the opportunity to do so. The risk management approach says: Remove the opportunity. Increase the probability of getting caught. Discipline those who are detected.

Third, ethical responsibility needs to be seamlessly integrated into the culture of state government at all levels. This requires leadership and followership. With the right policies and programs in place, Vermont will reap significant, measurable benefits.

Thank you for your attention.

Mike Palmer

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