



Prioritizing Process: How Poor Process Contributes to Compliance Failures


Professor Nicola Faith Sharpe
University of Illinois College of Law
May 4, 2018



 UNIVERSITY OF ILLINOIS AT URBANA-CHAMPAIGN


Today

- Volkswagen Emissions Scandal
- Volkswagen's Governance Structure
- Process Oriented Approach (POA)
- Volkswagen's Poor Process
- Prioritizing Process
- Questions and Discussion

 UNIVERSITY OF ILLINOIS AT URBANA-CHAMPAIGN

Staggering Statistics

- 11 million vehicles
- \$30 billion in fines and buybacks
- 48 hours
- 6 executives
- 7 years in prison
- 3 years

 UNIVERSITY OF ILLINOIS AT URBANA-CHAMPAIGN

Timeline

- 2005**: Focus on Diesel Cars in the US, but EPA poses a barrier
- 2007**: Abandoned pollution control technology & hired Winterkorn
- 2011**: VW technician warned of illegal practice
- 2012**: Ursula Piech appointed to the Supervisory Board
- 2013**: WVU test on-road VW diesel emissions and finds abnormal results
- 9/18/15**: EPA issues Notice of Violation To VW
- 9/15-11/15**: VW admits to installing defeat devices

UNIVERSITY OF ILLINOIS AT URBANA-CHAMPAIGN

How Did VW Do It?

- Volkswagen, Porsche, and Audi Models
- 2009-2016
- 2.0L and 3.0L diesel engines
- Puts children, elderly, and those with respiratory diseased at risk

THE VEHICLES EMIT UP TO **40 TIMES** THE LEGAL LEVELS OF NOx

which can cause emphysema, bronchitis, and other respiratory diseases.

Source: Watts & Laxenburg
<https://www.wattsflux.com/consumer/protection/volkswagen-defeat-device/>

UNIVERSITY OF ILLINOIS AT URBANA-CHAMPAIGN

How Volkswagen's defeat device works

SWITCH OF SOFTWARE

Software in the cars electronic control module (ECM) determines when the car is being driven (i.e. highway, road, testing) by analyzing a series of factors.

FACTORS ANALYSED

- Position of steering
- Speed
- Duration of engine operation
- Barometric pressure

MODE OF THE VEHICLE?

| BEING TESTED | NORMAL OPERATION |
|---|--|
| Mode switches to "dyno calibration" as software recognizes vehicle is taking emission test. | Mode switches to "road calibration" as software recognizes vehicle is in normal operation. |
| RESULT EPA compliant emission levels produced. | RESULT Effectiveness of emission control system reduced, increasing nitrogen oxide levels to 20 to 40 times above standards. |

Source: U.S. Environmental Protection Agency
 7/16/15, 12/16/15 © VWUSA

UNIVERSITY OF ILLINOIS AT URBANA-CHAMPAIGN

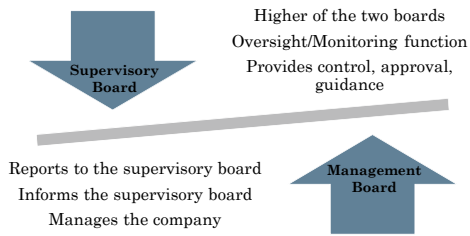
Today

- Volkswagen Emissions Scandal
- Volkswagen's Governance Structure
- Process Oriented Approach (POA)
- Volkswagen's Poor Process
- Prioritizing Process
- Questions and Discussion



UNIVERSITY OF ILLINOIS AT URBANA-CHAMPAIGN

German Dual Board Structure



UNIVERSITY OF ILLINOIS AT URBANA-CHAMPAIGN

Deutscher Corporate Governance Kodex (DCGK)

- **Standards of independence**
 - Non-independent if a supervisory board member has a conflict of interest
 - Limits the number of former management board members to two
- **Volkswagen lacked independence**
 - Porsche and Piech members have significant influence over the supervisory board
 - State of Saxony holds two seats
 - Qatar holdings has two seats
 - Guaranteed jobs for over half of the supervisory board



UNIVERSITY OF ILLINOIS AT URBANA-CHAMPAIGN

VW's Risk Management System

- Funneled through Management Board
- Management Board decides whether to inform the Supervisory Board



UNIVERSITY OF ILLINOIS AT URBANA-CHAMPAIGN

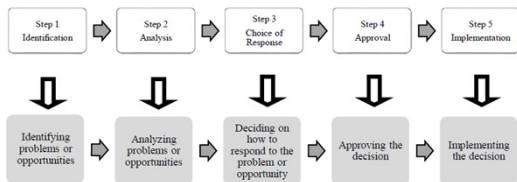
Today

- Volkswagen Emissions Scandal
- Volkswagen's Governance Structure
- **Process Oriented Approach (POA)**
- Volkswagen's Poor Process
- Prioritizing Process
- Questions and Discussion



UNIVERSITY OF ILLINOIS AT URBANA-CHAMPAIGN

Process Oriented Approach



UNIVERSITY OF ILLINOIS AT URBANA-CHAMPAIGN

Necessary Tools

- Time
- Information
- Knowledge



UNIVERSITY OF ILLINOIS AT URBANA-CHAMPAIGN

Today

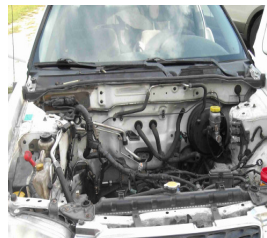
- Volkswagen Emissions Scandal
- Volkswagen's Governance Structure
- Process Oriented Approach (POA)
- Volkswagen's Poor Process
- Prioritizing Process
- Questions and Discussion



UNIVERSITY OF ILLINOIS AT URBANA-CHAMPAIGN

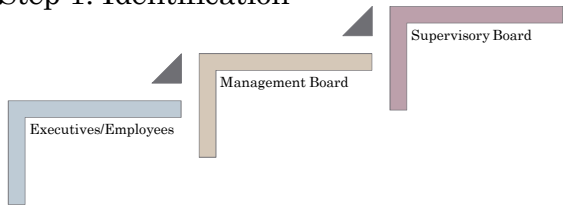
Cosmetic Independence

- **Time**
 - 5 to 6 meetings per year between 2008 and 2015
- **Information**
 - Lacked complete information
 - Engineers were insulated in designing the diesel products
 - Disseminated to executives but not the board
 - Autocratic leadership
- **Knowledge**
 - Lacked firm specific knowledge
 - Limited technical knowledge



UNIVERSITY OF ILLINOIS AT URBANA-CHAMPAIGN

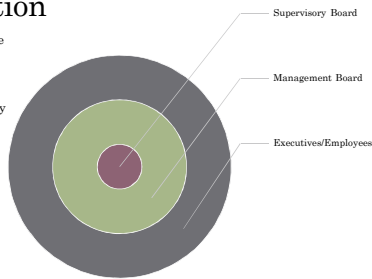
Step 1: Identification



UNIVERSITY OF ILLINOIS AT URBANA-CHAMPAIGN

Step 1: Identification

- Executives and employees determine the information the Management Board received
- Management Board further filters the information passed on to the Supervisory Board
- These gatekeepers create the outer boundaries of the problems the Supervisory Board can identify
- Gatekeeper limitations include her:
 - Biases
 - Expertise
 - Goals



UNIVERSITY OF ILLINOIS AT URBANA-CHAMPAIGN

Diesel Success Goals

- In 2009 Volkswagen rolled out "clean diesel in America"
- In 2011, Volkswagen "continued to write the success story of diesel engines in other areas"
- Executives' motivation to obscure or highlight a problem



UNIVERSITY OF ILLINOIS AT URBANA-CHAMPAIGN

Step 2: Analysis

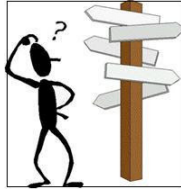
- German courts require that Supervisory Board members – individually and as a group – carry out “independent risk analysis.”
 - More complex transactions require more analysis
- Supervisory Board passively accepted the Management Board’s proposals
- Failure to verify



UNIVERSITY OF ILLINOIS AT URBANA-CHAMPAIGN

Step 3: Choice of Response

- Decision to cheat was made over a decade before
- Organizational structure allowed culpable individuals to insulate themselves
- Management knew, but did not inform the Supervisory Board.



UNIVERSITY OF ILLINOIS AT URBANA-CHAMPAIGN

Step 4: Approval

- Supervisory Board blindly approved Management Board’s proposals
- Supervisory Board was more of a pawn than a monitor
- Supervisory Board composition made approval pro forma



UNIVERSITY OF ILLINOIS AT URBANA-CHAMPAIGN

Improvements

- Culture of Compliance
- Transparency
- Constructive Conflict
 - Devil's Advocate
- Independent Information Gathering Channels
 - Corporate Ombudsperson
- Open Communication Channels Between Silos
 - Open Electronic Access to Information
- Technical Experts on the Board
- A Seat at the Table for Compliance Professionals



UNIVERSITY OF ILLINOIS AT URBANA-CHAMPAIGN

Today

- Volkswagen Emissions Scandal
- Volkswagen's Governance Structure
- Process Oriented Approach (POA)
- Volkswagen's Poor Process
- Prioritizing Process
- Questions and Discussion



UNIVERSITY OF ILLINOIS AT URBANA-CHAMPAIGN

Questions



UNIVERSITY OF ILLINOIS AT URBANA-CHAMPAIGN



Volkswagen Law

- Fails the test for codetermination
- Lacks independence
- Volkswagen's Poor Process
- Prioritizing Process

The University of Illinois at Urbana-Champaign logo is in the bottom left corner.
