

# Spoiling the Surprise: Constraints Facing Random Regulatory Inspections in Japan and the United States

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On the morning of January 26, 1998, a team of 100 officials from the Tokyo Prosecutor's Office, accompanied by national television reporters, marched through the front door of the Japanese Ministry of Finance (the "Ministry")<sup>1</sup> to make the first arrests of Ministry officials in over 50 years.<sup>2</sup> The chief of the Ministry's bank inspection office, Koichi Miyakawa, and the assistant chief of the control division, Toshimi Taniuchi, were held on suspicion of taking bribes from commercial banks in exchange for information about the dates of surprise inspections and lenient treatment of financial irregularities.<sup>3</sup> Later that week, Japanese Finance Minister Hiroshi Mitsuzuka<sup>4</sup> and Vice Finance Minister Takeshi Komura<sup>5</sup> resigned to take

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<sup>1</sup> See Jon Choy, *Ministry of Finance at Center of Whirlwind*, JEI REP., Feb. 6, 1998.

<sup>2</sup> See Shigemi Sato, *Japan's Finance Minister Quits in Bribery Scandal*, AGENCE FRANCE-PRESSE, Jan. 28, 1998.

<sup>3</sup> See Choy, *supra* note 1. Prosecutors said Miyakawa had accepted 6.2 million yen in bribes from Asahi Bank and Dai-Ichi Kangyo Bank in return for covering up his inspectors' findings of bad loans and disclosing the dates and locations of surprise bank inspections; Taniuchi was suspected of receiving 2.2 million yen in bribes from Sanwa Bank and Hokkaido Takushoku Bank. See *Arrested MOF Inspector Shelved Finding on Bad Loans*, JAPAN WKLY. MONITOR, Feb. 2, 1998.

<sup>4</sup> See Sato, *supra* note 2.

<sup>5</sup> See Miwa Suzuki, *Escalating Japanese Bribery Scandal Claims Top Finance Official*, AGENCE FRANCE-PRESSE, Jan. 29, 1998.

responsibility for the widening scandal. In all, 112 ministry officials<sup>6</sup> and six of Japan's ten leading banks<sup>7</sup> have been sanctioned for their involvement in the scandal.

The raid on the Ministry provided a dramatic prologue to the Japanese government's current initiative to reform the nation's long-troubled banking system. The full extent of the Ministry's role in exacerbating the Japanese banking crisis has only come to light with disclosures by the newly created Financial Supervision Agency. The Ministry has been forced to acknowledge that its supervisory failures permitted the banking system to hide approximately \$1 trillion in bad loans, with some analysts estimating that the actual figure is closer to \$2 trillion.<sup>8</sup>

The Japanese experience suggests the more general difficulty of designing surprise inspection programs to enforce industrial regulations. Random, unannounced inspections present unique problems relating to deterrence, corruption, and due process, each requiring a careful balancing of interests. This Article surveys these problems with reference to the Japanese banking system as well as various American regulatory contexts, and provides an analytical framework for evaluating and improving strategies for enforcing regulations and fighting corruption. The main finding is that any effective law enforcement scheme based on surprise inspections must be supported by specific anti-corruption sanctions. An additional finding is that recently adopted self-regulation programs and proposed reforms to the extent that they link the probability of future inspections to past compliance have some troublesome aspects.

This Article is organized as follows. Part I presents a rational actor model of legal compliance under an enforcement regime based on random inspections and identifies two classes of reforms that can be applied in combination to improve aggregate compliance. Part II introduces the problem of corrupt tip-offs into the model and argues that exogenous reforms are necessary to combat corruption. Part III surveys the use of random administrative inspections in the United States, reviews the approaches taken by four such programs to improve compliance and fight corruption, and describes the various constraints under which they must operate. Part IV conducts a similar analysis of banking regulation and reform in Japan.

This Article does not attempt to provide a complete survey of bank regulation in Japan or the United States. The more modest aim is to present case studies of various random inspection programs, thereby obtaining a systems analysis of the constraints facing reformers at Japan's Financial Supervision Agency. However, to the extent that Japan's recent financial

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<sup>6</sup> See *Japan's Financial Supervision Agency to Start Work on Monday*, Agence France-Presse, June 21, 1998, available in Westlaw, 1998 WL 2306174.

<sup>7</sup> See *More Japanese Banks Linked to Bribery*, IRISH TIMES, Feb. 17, 1998.

<sup>8</sup> See Tony Boyd, *Rescue May Not Save All Shaky Financial Players*, AUSTL. FIN. REV., Oct. 16, 1998, at 50.

reform initiative thus far has targeted the constraints that led to the 1998 raid, the analysis provides a basis for guarded optimism and suggests the complexity of the reform task ahead.

### I. DETERRENCE: FIRST- AND SECOND-ORDER REFORMS

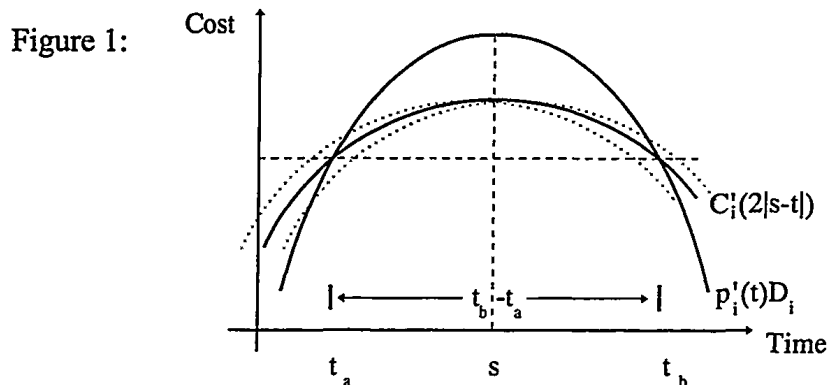
Surprise inspections encourage compliance through deterrence by assuring a positive probability that noncompliance will be sanctioned. Suppose that each business covered by a regulatory inspection program behaves as a private consumer, whose behavior is indifferent to the behavior of other businesses. A business will choose to comply with the regulation if the cost of compliance is less than the expected cost of sanctions.<sup>9</sup> Where there is a *culture of compliance* in which the marginal costs of compliance are rapidly decreasing, extended periods of compliance may be achieved. The following analysis considers how best to maximize the aggregate duration of compliance, assuming that is the goal of regulatory enforcement.

Let  $C_i(r)$  represent the cost to the  $i$ -th business of compliance over a continuous time interval of duration  $r$ . Let  $p_i(t)$  be the probability that business  $i$  is inspected at time  $t$ . Assume that  $C_i$  and  $p_i$  are twice continuously differentiable. Let  $D_i$  be the expected penalty to business  $i$ , given that it is inspected at a time when it is not in compliance.

The first-order condition for business  $i$  is  $p_i'(t) D_i = C_i'(r)$ . Thus, the business will minimize its total costs by choosing to comply over a collection of minimal time intervals  $[t_a, t_b]$ , for which

$$C_i'(t_b - t_a) = p_i'(t_a) D_i = p_i'(t_b) D_i$$

and  $p_i''(t_a) D_i \geq C_i''(t_b - t_a)$ ,  $p_i''(t_b) D_i \leq C_i''(t_b - t_a)$ . Figure 1 illustrates that each interval  $[t_a, t_b]$  is found by choosing the parameter  $s$  so that the graph of the function  $C_i'(2|s-t|)$  intersects the graph of  $p_i'(t) D_i$  at two points with equal ordinates.



<sup>9</sup>The cost of noncompliance also includes moral costs. These are not considered here, but may be accounted for by interpreting  $C_i(r)$  to be the net cost of compliance less any moral costs of noncompliance.

Since compliance over an  $x+y$  time interval can be achieved by concatenating intervals of duration  $x$  and  $y$ , we have  $C_i(x+y) \leq C_i(x) + C_i(y)$  for all  $x, y \geq 0$ . The inequality is very likely to be strict, because of economies of scale in long-term compliance. Thus, without loss of generality, we can assume that the functions  $C_i$  are sublinear (*i.e.*,  $C_i'' \leq 0$  everywhere).

This analysis identifies two systematic approaches to improving aggregate compliance. First, the cost of sanctions relative to the cost of compliance can be increased by: (a) increasing the penalty  $D_i$ ; (b) increasing the overall probability of inspections  $p_i'$ ; or (c) reducing the cost of compliance  $C_i'$ . Second, the duration of the compliance periods can be made more sensitive to changes in the relative cost of sanctions by: (a) reducing the variation in the probability of inspections  $|p_i''|$ ; (b) increasing the time economies of compliance  $|C_i''|$ ; or (c) explicitly targeting businesses with relatively high compliance costs.

These sets of approaches shall be referred to as *first-* and *second-order reforms*, respectively. First-order reforms are constrained by constitutional and statutory limits on searches and sanctions, enforcement resources, and the positive objectives of the regulation. When first-order reforms are in place, however, second-order reforms may supplement enforcement efforts by reinforcing a culture of compliance. This taxonomy of reforms will be informative in reviewing American and Japanese regulatory practices in parts III and IV, respectively.

## II. THE DIFFICULTY OF FIGHTING CORRUPTION

The purpose of surprise inspections is to enhance law enforcement efforts by increasing the likelihood that violations will be detected.<sup>10</sup> Consider now the case where an official provides business  $i$  with reliable information that the only inspections during time interval  $[t_M, t_N]$  will take place during time interval  $[t_m, t_n]$ , with  $t_M \leq t_m \leq t_n \leq t_N$ . Assuming Bayesian updating, the business will behave as if the expected cost of noncompliance were

$$\left\{ \begin{array}{ll} 0 & \text{for } t \notin [t_m, t_n] \\ p_i'(t) D_i R & \text{for } t \in [t_m, t_n], \text{ where} \end{array} \right.$$

$$R = \frac{p_i(t_N) - p_i(t_M)}{p_i(t_n) - p_i(t_m)}$$

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<sup>10</sup> See, e.g., *New York v. Burger*, 482 U.S. 691, 710 (1987) (finding frequent surprise inspections "crucial" to detecting stolen auto parts in junkyards because stolen cars are quickly disassembled).

Such a tip-off thus eliminates any incentive for compliance outside of the interval  $[t_m, t_n]$ , but increases the incentive for compliance within the interval  $[t_m, t_n]$ . Aggregate compliance may be improved in the case where the levels of sanctions and enforcement resources had achieved deterrence during  $[t_M, t_N]$  only on a proper subset of the interval  $[t_m, t_n]$ . Except for this narrow case, however, tip-offs impede regulatory enforcement.

Given this harm, regulators may seek to deter tip-offs by a combination of specific coercive (*i.e.*, criminal) sanctions and a reduction of the underlying economic incentives. In the typical case where  $R$  is large, the surplus created by the tip-off will be approximately equal to the minimum between the cost of compliance and the expected cost of sanctions, integrated over  $[t_M, t_m] \cup [t_n, t_N]$ . As noted in part I, any reductions in  $C_i'(r)$  will be limited by the positive objectives of the regulation. An across-the-board reduction in  $p_i'(t) D_i$  for all values of  $t$  would hamper first-order reforms, and a selective reduction in  $p_i'(t) D_i$  targeted to  $t \in [t_M, t_m] \cup [t_n, t_N]$  would impede both first- and second-order reforms.

This analysis suggests that a random inspection program cannot simultaneously maximize compliance and control corruption. Therefore, specific sanctions are necessary to deter tip-offs. Despite this, there are few statutory penalties for giving advance notice of a surprise inspection in the United States or Japan, and prosecutions under these statutes are rarer still.<sup>11</sup>

### III. RANDOM INSPECTIONS IN THE UNITED STATES

In the United States, unannounced inspections are employed by both federal and state officials in a wide range of regulatory contexts. At the federal level, unannounced inspections play a key role in the enforcement of laws and regulations in such areas as food safety,<sup>12</sup> occupational safety,<sup>13</sup> medical safety,<sup>14</sup> airport security,<sup>15</sup> child care,<sup>16</sup> environmental protection,<sup>17</sup> workplace drug testing,<sup>18</sup> manufacturing of government-licensed items,<sup>19</sup>

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<sup>11</sup> See *infra* section III.D and part IV.

<sup>12</sup> See, e.g., 7 C.F.R. § 301.78-10(c)(2) (1998) (irradiation of quarantined fruits and vegetables); 9 C.F.R. § 94.8 (1998) (processing of imported pork).

<sup>13</sup> See, e.g., Exec. Order No. 12,196, *reprinted as amended* in 5 U.S.C.A. § 7902, at 1-401(i) (West 1998) (occupational safety and health hazards); 29 C.F.R. § 1960.31(a) (1998) (same).

<sup>14</sup> See, e.g., 42 C.F.R. § 493.49(b)(2) (1998) (laboratories participating in Medicare and Medicaid).

<sup>15</sup> See 49 U.S.C.A. § 44916(b) (West 1998).

<sup>16</sup> See, e.g., 14 U.S.C.A. § 515(c) (1998) (child development services for Coast Guard employees).

<sup>17</sup> See, e.g., 40 C.F.R. § 55.8 (1998) (coastal air quality).

<sup>18</sup> See, e.g., 10 C.F.R. Pt. 26, App. A, at (m) (1998) (employees of nuclear energy facilities); 14 C.F.R. Pt. 121, App. I (1998) (Department of Transportation employees performing safety-sensitive functions); 49 C.F.R. § 40.29(l) (same); 49 C.F.R. § 199.13(a)(2) (pipeline workers); 49 C.F.R. § 219.701(b) (railroad workers).

and custody of valuable government property.<sup>20</sup> States also authorize unannounced inspections for enforcing laws and regulations governing securities trading,<sup>21</sup> health care,<sup>22</sup> environmental protection (both independently<sup>23</sup> and in cooperation with other states<sup>24</sup>), building construction,<sup>25</sup> transportation,<sup>26</sup> agriculture,<sup>27</sup> prisons,<sup>28</sup> schools,<sup>29</sup> and restaurants.<sup>30</sup> In addition, the federal government conditions certain grants on the requirement of unannounced inspections by state authorities as a means of enforcing federal policies,<sup>31</sup> and sometimes performs its own inspections to supplement and supervise state regulators.<sup>32</sup>

Despite the importance and wide applicability of random inspections in law enforcement, constitutional doctrines confine random inspections to industries where they can be conducted so frequently as to constitute a perva-

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<sup>19</sup> See, e.g., 39 C.F.R. § 501.2(c) (1998) (postage meters).

<sup>20</sup> See, e.g., 41 C.F.R. § 109-27.5105(a) (1998) (precious metals).

<sup>21</sup> See, e.g., National Association of Attorneys General, SECURITIES: ATTORNEYS GENERAL ENFORCEMENT OF BLUE SKY LAWS 25 (1980).

<sup>22</sup> See *infra* note 32. In addition to the examples cited therein, most other states authorize the unannounced inspection of health care facilities. See generally Kira Anne Larson, *Nursing Homes: Standards of Care, Sources of Potential Liability, Defenses to Suit, and Reform*, 37 *DRAKE L. REV.* 699, 720 (1988).

<sup>23</sup> See, e.g., CAL. PUB. RES. CODE § 14571.3 (West 1998) (recycling facilities); CONN. GEN. STAT. ANN. § 22a-220c(b) (West 1998) (solid waste management facilities); KAN. STAT. ANN. § 2-2456 (1996) (pesticides); KY. REV. STAT. ANN. § 217B.070(1) (same); N.C. GEN. STAT. § 106-65.30 (1997) (same).

<sup>24</sup> See, e.g., Northwest Interstate Compact on Low-Level Radioactive Waste Management, reprinted in ALASKA STAT. § 46.45.010, art. III (1998).

<sup>25</sup> See, e.g., MD. ANN. CODE art. 83B, § 6-204 (1998) (industrialized buildings); VA. CODE ANN. § 40.1-51.21 (Michie 1999) (asbestos removal); WISC. STAT. ANN. § 101.92(4) (mobile homes).

<sup>26</sup> See, e.g., CAL. PUB. UTIL. CODE § 99317.8 (West 1991) (bus-rail transfer stations); CONN. GEN. STAT. ANN. § 14-275(a) (West Supp. 1999) (school buses); MICH. COMP. LAWS ANN. § 257.1317 (West 1990) (motor vehicle service facilities); see also *New York v. Burger*, 482 U.S. 691, 698 n.11 (1987) (citing numerous state statutes providing for random inspections of automobile junkyards).

<sup>27</sup> See, e.g., DEL. CODE ANN. tit. 3, § 1303(b) (Supp. 1998) (nurseries); OKLA. STAT. ANN. tit. 2, § 9-206 (West Supp. 2000) (animal feeding operations).

<sup>28</sup> See, e.g., KY. REV. STAT. ANN. § 197.510(29) (Michie 1998); 61 PA. CONS. STAT. ANN. § 407.4 (West 1999), TEX. GOV'T CODE ANN. § 511.009(a)(15) (West 1998); VA. CODE ANN. § 53.1-68 (Michie 1998).

<sup>29</sup> See, e.g., HAW. REV. STAT. § 302A-1502 (Supp. 1997) (school facilities); IND. CODE ANN. § 12-17.2-5-16 (West 1994) (child care facilities); VA. CODE ANN. § 22.1-323(C) (Michie 1997) (schools for students with disabilities).

<sup>30</sup> See, e.g., IDAHO CODE § 39-1605(1) (1998).

<sup>31</sup> See, e.g., 42 U.S.C.A. § 300x-26(b)(2)(A) (West 1998) (sale of tobacco to minors); 45 C.F.R. § 96.123(a)(5) (1998) (same); 45 C.F.R. § 96.130(d)(1) (1998) (same).

<sup>32</sup> See John Braithwaite, *The Nursing Home Industry*, 18 *CRIME & JUST.* 11, 22 (1993) (noting that the HCFA "runs 'look-behind' inspections to check that the state governments are doing their jobs").

sive regulatory presence. The Fourth Amendment effectively imposes a lower (but not upper) limit on the frequency of random inspections, and requires that programs operate under neutral procedures that constrain the discretion of the inspectors.<sup>33</sup> The excessive fines clause of the Eighth Amendment prohibits the imposition of disproportionate civil sanctions.<sup>34</sup> Together, these doctrines require effective deterrence to be based upon the substantial likelihood of punishment, rather than solely upon the severity of punishment.

Within this constitutional setting, regulatory programs must also cope with limited resources for deterring noncompliance, as well as the potential for bureaucratic corruption. Certain observed modifications in the implementation of random inspection programs may be understood as second-best approaches to regulatory enforcement under conditions of low deterrent capability<sup>35</sup> and/or high incentives for corruption.<sup>36</sup>

#### A. Warrantless Searches and the Fourth Amendment

Most random inspections are conducted without warrants,<sup>37</sup> and thus operate within a limited range of exceptions to the general Fourth Amendment requirement of a search warrant based on probable cause.<sup>38</sup> The constitutional permissibility of warrantless searches is governed by a line of U.S. Supreme Court cases that elaborate the meaning of “unreasonable searches and seizures”<sup>39</sup> by “balanc[ing] the need to search against the invasion which the search entails.”<sup>40</sup>

While an exception to the Fourth Amendment requirement of a warrant may be justified on balance<sup>41</sup> in cases of emergencies<sup>42</sup> or “special needs” concerning public safety and health,<sup>43</sup> warrantless searches will more typi-

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<sup>33</sup> See *infra* section III.A.

<sup>34</sup> See *infra* section III.B.

<sup>35</sup> See *infra* section III.C.

<sup>36</sup> See *infra* section III.D.

<sup>37</sup> A notable exception are Occupational Safety and Health Act inspections, for which warrants are required (but probable cause is not). See *infra* text accompanying notes 85 - 89.

<sup>38</sup> See *Camara v. Municipal Court of San Francisco*, 387 U.S. 523, 528-29 (1967).

<sup>39</sup> The Fourth Amendment states:

The right of the people to be secure in their persons, houses, papers, and effects, against unreasonable searches and seizures, shall not be violated, and no Warrants shall issue, but upon probable cause, supported by Oath or affirmation, and particularly describing the place to be searched, and the persons or things to be seized.

U.S. CONST. amend. IV.

<sup>40</sup> *Camara*, 387 U.S. at 537.

<sup>41</sup> See *Skinner v. Railway Labor Executives' Ass'n.*, 489 U.S. 602 (1989).

<sup>42</sup> See *Michigan v. Tyler*, 436 U.S. 499 (1978) (holding that fire inspectors' search of a store for arson evidence immediately after dousing a fire was constitutional, but police detectives' subsequent search was not).

<sup>43</sup> See *Camara*, 387 U.S. at 539 (citing *North American Cold Storage Co. v. Chicago*, 211 U.S. 306 (1908) (seizure of allegedly unfit food); *Jacobson v. Massachusetts*, 197 U.S. 11

cally fall into the “pervasive regulation” exception to the Fourth Amendment. Since the *Colonnade*<sup>44</sup> and *Biswell*<sup>45</sup> decisions in the early 1970s, the Supreme Court has held that businesses that are “pervasively regulated”<sup>46</sup> have a diminished expectation of privacy under a theory of implied consent.<sup>47</sup> “In the context of a regulatory inspection system of business premises that is carefully limited in time, place, and scope, the legality of the search depends not on consent but on the authority of a valid statute.”<sup>48</sup> In such closely regulated industries, warrantless searches are not categorically unconstitutional, but may be permitted subject to a balancing of law enforcement and privacy interests. A warrantless search will survive Fourth Amendment scrutiny if it: (1) advances important government interests,<sup>49</sup> (2) is necessary to achieve effective law enforcement;<sup>50</sup> and (3) poses only a limited threat to the business’s justifiable expectations of privacy.<sup>51</sup>

In *Dewey*,<sup>52</sup> the Court reformulated the *Colonnade-Biswell* analysis as a two-part test focusing on the pervasiveness of the government presence:

[A] warrant may not be constitutionally required when Congress has reasonably determined that warrantless searches are necessary to further a regulatory scheme and the federal regulatory presence is sufficiently comprehensive and defined that the owner of commercial property cannot help but be aware that his property will be subject to periodic inspections undertaken for specific purposes.<sup>53</sup>

In effect, *Dewey* established that the first two *Biswell* balancing factors are to be left to the reasonable determination of Congress. More importantly, the ruling elevated the last, subjective, factor to a threshold test for the “pervasive regulation” exception, holding that an industry will be found to be “pervasively regulated” only if inspections are so frequent that the business owner reasonably should expect inspections “from time to time.”<sup>54</sup>

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(1905) (compulsory smallpox vaccination); *Compagnie Francaise de Navigation a Vapeur v. Louisiana State Bd. of Health*, 186 U.S. 380 (1902) (quarantine).

<sup>44</sup> *Colonnade Catering Corp. v. United States*, 397 U.S. 72 (1970).

<sup>45</sup> *United States v. Biswell*, 406 U.S. 311 (1972).

<sup>46</sup> *Id.* at 316; see also *Colonnade*, 397 U.S. at 77 (holding that probable cause is not required in industries that have been “long subject to close supervision and inspection”).

<sup>47</sup> See Jack M. Kress & Carole D. Iannelli, *Administrative Search and Seizure: Whither the Warrant?* 31 VILL. L. REV. 705, 725 (1986) (citing *Biswell* as establishing “implied consent” test).

<sup>48</sup> *Biswell*, 406 U.S. at 315.

<sup>49</sup> See *id.* at 315.

<sup>50</sup> See *id.* at 316.

<sup>51</sup> See *id.*

<sup>52</sup> *Donovan v. Dewey*, 452 U.S. 594 (1981).

<sup>53</sup> *Id.* at 600.

<sup>54</sup> See *id.* at 599 (“warrantless inspections of commercial property may be constitutionally objectionable if their occurrence is so random, infrequent, or unpredictable that the owner, for all practical purposes, has no real expectation that his property will from time to time be inspected by government officials”).



The Court subsequently clarified in *Burger*<sup>55</sup> that limits on the frequency of inspections need not be specified in the authorizing statute,<sup>56</sup> so long as the statute simultaneously constrains official discretion over the timing of the inspections and informs the regulated businesses of these constraints.<sup>57</sup> Thus, a statute authorizing random inspections would provide notice that would be “a constitutionally adequate substitute for a warrant”<sup>58</sup> by specifying limits on the time, place, and scope of inspections.<sup>59</sup>

Notably, the *Burger* analysis focuses on the design of the program of inspections, rather than on the justifications for any particular inspection.<sup>60</sup> A random inspection program may raise Fourth Amendment concerns by depriving the business owner of the predictability and regularity that would have been assured by the requirement of probable cause.<sup>61</sup> Lower courts have acknowledged the potential for abuse of official discretion in such programs by requiring strict adherence to both the coverage<sup>62</sup> and timing<sup>63</sup> provisions of the regulatory schemes.

*Dewey* has been read to require further that a random inspection program must be accompanied by neutral guidelines governing the selection of targets.<sup>64</sup> Where, however, an administrative plan satisfies the threshold constitutional requirement that it contain neutral restrictions on official discretion,<sup>65</sup> random selection procedures -- even those targeting businesses

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<sup>55</sup>New York v. Burger, 482 U.S. 691 (1987).

<sup>56</sup>See *id.* at 711 n.21.

<sup>57</sup>“The statute informs the operator of a vehicle dismantling business that inspections will be made on a regular basis. Thus, the vehicle dismantler knows that the inspections to which he is subject do not constitute discretionary acts by a government official but are conducted pursuant to statute.... [T]he “time, place and scope” of the inspection is limited to place appropriate restraints upon the discretion of the inspecting officers. The officers are allowed to conduct an inspection only “during [the] regular and usual business hours.”

See *id.* at 711 (citations omitted).

<sup>58</sup>*Id.* at 703 (quoting *Dewey*, 452 U.S. at 603).

<sup>59</sup>See *id.* at 711-12.

<sup>60</sup>See *Serpas v. Schmidt*, 827 F.2d 23, 34 (7th Cir. 1987) (Eschbach, J., dissenting).

<sup>61</sup>See *Dewey*, 452 U.S. at 599-600.

<sup>62</sup>See *United States v. Seslar*, 996 F.2d 1058, 1062 (10th Cir. 1993) (close regulation of commercial trucking industry did not authorize random stops of trucks in general).

<sup>63</sup>See *In re Hensley Adco Bucket Division*, No. 4-81-34-M, 1981 WL 40358, at \*3 (N.D. Tex. May 15, 1981) (denying inspection warrant where procedures for deciding the number and order of random inspections in a given year were not disclosed).

<sup>64</sup>See *State v. Campbell*, 875 P.2d 1010, 1014 (Kan. Ct. App. 1994) (quoting *Donovan*, 452 U.S. at 598 - 99.) (random stops of motor vehicles by state troopers).

<sup>65</sup>See *Brown v. Texas*, 443 U.S. 47 (1979) (“[T]he Fourth Amendment requires that ... the seizure be carried out pursuant to a plan embodying explicit, neutral limitations on the conduct of individual officers.”); *Marshall v. Barlow’s, Inc.*, 436 U.S. 307, 323 (1978) (“A warrant ... provide[s] assurances from a neutral officer that the inspection is reasonable under the Constitution, is authorized by statute, and is pursuant to an administrative plan containing specific neutral criteria.”); *Delaware v. Prouse*, 440 U.S. 648, 662 (1979) (“[R]egulatory inspections unaccompanied by any quantum of individualized, articulable

with high compliance costs -- are regarded as neutral and presumed to comport with the Fourth Amendment.<sup>66</sup> The Fourth Amendment thus leaves a wide scope for the implementation of random inspection procedures that are predictable, neutral and reasonable.

### B. Excessive Fines and the Eighth Amendment

An enforcement strategy based on random inspections must take into account that any penalties for noncompliance will be limited -- if not by statute, then by the excessive fines clause of the Eighth Amendment.<sup>67</sup> The constitutional requirement that any civil penalty serving a deterrent purpose must be proportional to the gravity of the offense,<sup>68</sup> when combined with limited enforcement resources and fixed regulatory objectives, may preclude first-order reforms.

The Supreme Court has only recently interpreted the excessive fines clause,<sup>69</sup> but it is already clear that it covers both criminal and civil penalties payable to the government that have a deterrent purpose. While the scope of the clause is limited to "only those fines directly imposed by, and payable to, the government,"<sup>70</sup> it includes in all sanctions that "serv[e] in part to punish."<sup>71</sup> A sanction will be regarded as a punishment, and therefore be subject to scrutiny under the excessive fines clause,<sup>72</sup> if it "cannot

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suspicion must be undertaken pursuant to previously specified 'neutral criteria'." (citing *Barlow's, Inc.*, 436 U.S. 307).

<sup>66</sup>See *Chicago Aluminum Castings Co., Inc. v. Donovan*, 535 F. Supp. 392, 397 (N.D. Ill. 1981) ("Inspection of plants in a given industry on a random basis pursuant to an administrative [OSHA] plan containing specific neutral criteria such as that presented here, comports with the Fourth Amendment."), *In re Peterson Builders, Inc.*, 525 F. Supp. 642, 645 (E.D. Wisc. 1981) (same). OSHA targets industries having a high "hazard rating" for more frequent inspections. See *infra* text accompanying note 91.

Courts have reviewed the random number tables used to select specific businesses for inspections to ensure that the program is neutral and applied in "a reasonable and nondiscriminatory fashion," but have concluded that such scrutiny is not required for a program to pass constitutional muster. See *Donovan v. Athenian Marble Corp.*, 535 F. Supp. 176, 180 (W.D. Okla. 1982). See *id.*; cf. *In re Athenian Marble Corp.*, No. 81-0795-BT, 1981 WL 40360, at \*2, \*4 (W.D. Okla. July 21, 1981) (finding random number tables for OSHA inspections privileged from discovery under 29 U.S.C. § 666(f)).

<sup>67</sup>The Eighth Amendment provides that "excessive bail shall not be required, nor excessive fines imposed, nor cruel and unusual punishments inflicted." U.S. CONST. amend. VIII.

<sup>68</sup>See *Austin v. United States*, 509 U.S. 602, 610 (1993).

<sup>69</sup>See *Browning-Ferris Indus. of Vt., Inc. v. Kelco Disposal, Inc.*, 492 U.S. 257, 262 (1989) ("[T]his Court has never considered an application of the Excessive Fines Clause."); *Austin*, 509 U.S. at 606 ("We have had occasion to consider this Clause only once before [in *Browning-Ferris*].").

<sup>70</sup>*Browning-Ferris Indus. of Vt., Inc.*, 492 U.S. at 268.

<sup>71</sup>*Austin*, 509 U.S. at 610.

<sup>72</sup>*Id.* at 622 - 23 (remanding to district court for scrutiny); *United States v. Ursery*, 518 U.S. 267, 285 - 90 (1996) (declining to conduct excessiveness analysis at preliminary stage of determining whether sanction constituted punishment).

fairly be said solely to serve a remedial purpose, but rather can only be explained as also serving either retributive or deterrent purposes.”<sup>73</sup> Assuming that the theory of deterrence ascribed by the Court to random inspections in various contexts<sup>74</sup> applies generally to regulatory programs that use random inspections, the Court should proceed to determine whether the fines are excessive within the meaning of the clause.

Although there is as yet no bright-line rule for evaluating a civil penalty for excessiveness,<sup>75</sup> the Eighth Amendment has generally been read to prohibit punishments that are disproportionate to the offense committed. As the Court held in *Solem v. Helm*:<sup>76</sup>

In sum, a court’s proportionality analysis under the Eighth Amendment should be guided by objective criteria, including: (i) the gravity of the offense and the harshness of the penalty; (ii) the sentences imposed on other criminals in the same jurisdiction; and (iii) the sentences imposed for commission of the same crime in other jurisdictions.<sup>77</sup>

Notably, the excessiveness analysis does not consider a low probability of detection and punishment to be a factor weighing in favor of severe punishment. The finding of a deterrent purpose is relevant to deciding whether a sanction should be analyzed under the excessive fines clause, but is not germane to the analysis itself.

The Eighth Amendment thus imposes independent constraints on the penalties that can be imposed under a random inspection program. This implies that an enforcement strategy cannot be based solely on high punitive fines, but must also include an effective program of frequent inspections that maximize the expected cost of sanctions and support a culture of compliance.

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<sup>73</sup> *Austin*, 509 U.S. at 610 (citing *United States v. Halper*, 490 U.S. 435, 448 (1989)).

<sup>74</sup> See *Vernonia Sch. Dist. 47J v. Acton*, 515 U.S. 646, 661 (1995) (finding that important governmental concern in “[d]eterring drug use by our Nation’s schoolchildren” supported random drug testing of high school athletes); *United States v. Villamonte-Marquez*, 462 U.S. 579, 592-93 (1983) (finding substantial governmental interest supported random boat searches “in waters where the need to deter or apprehend smugglers is great”); *Delaware v. Prouse*, 440 U.S. 648, 660 (1979) (imputing a deterrent purpose to a random traffic stop program, but finding the program not “sufficiently productive to qualify as a reasonable law enforcement practice under the Fourth Amendment”); *United States v. Biswell*, 406 U.S. 311, 316 (1972) (“[I]f inspection is to be effective and serve as a credible deterrent, unannounced, even frequent, inspections are essential.”); see also *Almeida-Sanchez v. United States*, 413 U.S. 266, 293 (1973) (White, J., dissenting) (noting that random spot checks of automobiles by Border Patrol were necessary to “maintaining any kind of credible deterrent”).

<sup>75</sup> See Margaret Meriwether Cordray, *Contempt Sanctions and the Excessive Fines Clause*, 76 N.C. L. REV. 407, 457 (1998).

<sup>76</sup> 463 U.S. 277 (1983).

<sup>77</sup> *Id.* at 291.

### C. Case Examples of Random Inspection Programs

The effectiveness of random inspection programs is constrained not only by constitutional doctrines, but by agency resources. Agencies that enforce regulations by threatening penalties are especially vulnerable to budget cutbacks because they cannot turn to alternative sources of support, such as user fees.

#### 1. OSHA

Attempts to enforce the Occupational Safety and Health Act<sup>78</sup> by the Occupational Safety and Health Administration in the Department of Labor provide a paradigmatic example of these difficulties. In 1996, then-Secretary of Labor Robert Reich observed that “random, surprise inspections remain one of OSHA’s most effective enforcement tools in the prevention of injuries, illnesses and fatalities.”<sup>79</sup> Nevertheless, the shortage of enforcement resources available to OSHA is longstanding and widely acknowledged,<sup>80</sup> and has had the practical effect of limiting the frequency of surprise inspections by the agency.

From its beginning, OSHA’s inspectorate has been staffed at less than a quarter of that needed to meet the minimal goal of one inspection per year of employers in high-risk industries and one inspection per decade of employers in low-risk industries.<sup>81</sup> Today, OSHA has fewer employees than it

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<sup>78</sup> 29 U.S.C.A. §§ 651-78 (West 1999). Workplace safety regulations are necessary because workers have inadequate information and bargaining power with respect to the risks they assume on the job. See Sidney A. Shapiro, *Substantive Reform, Judicial Review, and Agency Resources: OSHA as a Case Study*, 49 ADMIN. L. REV. 645, 648 (1997).

<sup>79</sup> *Labor-HHS Budget Impasse: Hearings Before the Subcomm. on Labor, Health and Human Services, and Education of the Senate Comm. on Appropriations*, 104th Cong., 1st Sess. (testimony of Robert B. Reich, Secretary of Labor), available in Westlaw, 1996 WL 93450, at \*21-23 (Mar. 5, 1996).

<sup>80</sup> In 1995, an administrative law judge refused to find the agency responsible for policing workplace violence, noting that such a responsibility “would most surely tax OSHA’s limited resources in ways difficult to control.” See *Secretary of Labor v. Megawest Financial, Inc.*, 17 O.S.H. Cas. (BNA) 1337, 1338 (1995).

Other commentators have observed that OSHA has been so “feckless and beleaguered” that the agency itself is deterred from vigorous enforcement of workplace regulations “for fear that Congress will massively reduce its funding and authority.” See Marc Linder, *Smart Women, Stupid Shoes, and Cynical Employers: The Unlawfulness and Adverse Health Consequences of Sexually Discriminatory Workplace Footwear Requirements for Female Employees*, 22 J. CORP. L. 295, 327 (1997); see also Nick Smith, *Restoration of Congressional Authority and Responsibility over the Regulatory Process*, 33 HARV. J. LEGIS. 323, 327 (1996) (“instructions [in conference reports] put [agency regulators] on notice to comply or face possible future retaliation (e.g., funding cuts or explicit denials of funds for certain purposes)”).

<sup>81</sup> Rothstein, *OSHA After Ten Years: A Review and Some Proposed Reforms*, 34 VAND. L. REV. 71, 94-95 (1981).

had during its first year of operation,<sup>82</sup> and its inspection programs have only become more inadequate. Only one out of twenty-five job sites within OSHA's jurisdiction has ever been visited by an OSHA inspector.<sup>83</sup> The budget crises of recent years have only exacerbated the problem. During the second 1996 government shutdown, OSHA delayed more than 1,440 random safety inspections.<sup>84</sup>

The early failure to develop OSHA into a pervasive regulatory regime also resulted in a constitutional obstacle to enforcement efforts. In *Marshall v. Barlow's*,<sup>85</sup> the Supreme Court found that OSHA regulations were not sufficiently pervasive to fall under the *Colonnade-Biswell* exception.<sup>86</sup> This finding left the Court free to hold that warrants must be secured prior to a surprise OSHA inspection,<sup>87</sup> despite its finding that probable cause was not in issue<sup>88</sup> and despite the Secretary of Labor's objection that the warrant requirement would destroy the element of surprise and unduly strain an already beleaguered inspection system.<sup>89</sup>

As sections III.A and III.B of this article have emphasized, both the effectiveness and constitutionality of regulatory enforcement require that random inspections be frequent and pervasive. By decimating the frequency of inspections, OSHA's underfunding is, in Reich's words, "tantamount to repealing" the labor safety laws.<sup>90</sup>

The agency has done its best to cope. The structure of OSHA's safety inspection program represents a flexible response to severe financial constraints. The agency's national office assigns each industry a "hazard rating value," and provides each area office with lists of industry workplaces within its region.<sup>91</sup> Using a random number table, the area office then selects the projected number of sites to be inspected during the fiscal year.<sup>92</sup>

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<sup>82</sup> See Shapiro, *supra* note 78, at 647.

<sup>83</sup> THOMAS O. MCGARITY & SIDNEY A. SHAPIRO, *THE FAILED PROMISE OF THE OCCUPATIONAL SAFETY AND HEALTH ADMINISTRATION* 212 (1993).

<sup>84</sup> See *Job Safety Inspections Again Deferred During Continuing Government Shutdown*, DAILY LAB. REP. (BNA-DLR) No. 2, at A6 (Jan. 3, 1996).

<sup>85</sup> *Marshall v. Barlow's*, 436 U.S. 307 (1978).

<sup>86</sup> See *id.* at 321.

<sup>87</sup> See *id.* at 325.

<sup>88</sup> See *id.* at 320.

<sup>89</sup> See *id.* at 316.

<sup>90</sup> During the House Appropriations Committee hearings on the 1996 budget impasse, Reich testified:

Simply put, the House-passed cuts would gut the enforcement of workplace protection laws. For example, they will harm our agencies' ability to conduct random, surprise enforcement measures, which provide a deterrent to employers who would otherwise try to cut their costs by endangering their workers's safety, working them beyond legal hours, paying them less than the minimum wage or flouting other minimum workplace standards.

Reich, *supra* note 79, at \*18.

<sup>91</sup> See *Donovan v. Athenian Marble Corp.*, 535 F. Supp. 176, 179 (W.D. OK. 1982).

<sup>92</sup> See *id.*

The selected sites are grouped into one or more "cycles," each containing at least ten sites.<sup>93</sup> The inspections within each cycle may be conducted in any order that uses resources efficiently, but all inspections in a cycle must be completed (with only limited exceptions) before the next cycle is begun.<sup>94</sup>

Underfunding of OSHA's inspection program, combined with low statutory limits on civil penalties,<sup>95</sup> create a tension between the first-order goal of increasing the probability of inspections and the second-order goal of reducing variation in the probability of inspections. The structure of the inspection program reflects what might be best characterized as an optimistic attempt to reconcile these two goals under adverse conditions. The minimum of ten sites per cycle encourages all area offices to maximize the frequency of inspections given the available resources. Each area office, however, may choose a different number of cycles according to the relative importance of making the probability of inspections more uniform. In those few regions and industries where OSHA inspections provide adequate deterrence, area offices are free to direct their resources toward second-order reforms.

## 2. Nursing Homes

A contrasting area of regulation is the regulation of nursing homes and other health care facilities, where frequent inspections are required by both federal and state law.<sup>96</sup> Largely in response to strong pressure from con-

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<sup>93</sup> See *id.*

<sup>94</sup> See *id.*

<sup>95</sup> While the cost of compliance with OSHA standards can run into the hundreds of millions of dollars, *see, e.g.*, *American Textile Mfrs. Inst. v. Donovan*, 452 U.S. 490, 527 n.44 (1981), the maximum civil penalty provided by the Act for the violation of a standard is \$70,000. *See* 29 U.S.C.A. § 666(a) (West 1998). Although this limit is considerably higher than the original \$10,000 maximum, *see* Omnibus Budget Reconciliation Act, Pub. L. No. 101-508, § 3101(2) (1990), these penalties cannot be expected to deter violations where compliance costs are high. As one commentator explains:

OSHA could theoretically be empowered to increase fines progressively against a recalcitrant employer until adequate compliance is finally achieved. Given the staggering costs associated with some health and safety measures, however, the size of such fines would have to be exceedingly large....

Massive civil fines in this context are [politically] unattractive.... Huge civil fines would take money directly away from corporate violators hence increasing the cost of the OSHA Act to industry while doing nothing to benefit workers directly.

Note, *A Proposal to Restructure Sanctions Under the Occupational Safety and Health Act*, 91 YALE L.J. 1446, 1459, 1473 & n.63 (1982).

<sup>96</sup> See generally Braithwaite, *supra* note 32, at 21-27 (1993); Kira Anne Larson, Note, *Nursing Homes: Standards of Care, Sources of Potential Liability, Defenses to Suit, and Reform*, 37 DRAKE L. REV. 699, 720-21 (1988). Larson criticizes the level of federal funding for nursing home inspections, citing a 1979 article, but notes that after the reforms of the 1980s, "the future looks brighter for nursing home residents." *See id.* (citing Butler, *Assuring the Quality of Care and Life in Nursing Homes: The Dilemma of Enforcement*, 57 N.C. L. REV. 1317 (1979)).

sumer groups, unprecedented resources are now dedicated to the inspection of federally funded health care facilities.<sup>97</sup> A 1993 survey of nursing home inspections in twenty-four states found strong institutional support for first- and second-order reform; *i.e.*, frequent, regular inspections, a high probability of detecting noncompliance, and flexible, adequate sanctions:

Not only is the consistent frequency of inspection much more impressive than in other areas of regulation, the intensity of the scrutiny is far more fine-grained than for occupational health and safety, environmental, food, or pharmaceuticals inspectors in any country we know.<sup>98</sup>

Under the threat of sanctions that may include administrative penalties, suspension of new admissions, license revocation, and criminal prosecution, compliance is achieved 90 percent of the time without formal enforcement actions.<sup>99</sup> Deterrence in these cases, is "implicit and real."<sup>100</sup> "[T]he United States has tougher nursing home enforcement than any country we know; stronger than in Australia, and much stronger than in England or Japan."<sup>101</sup>

### 3. *The FCC and Industry Self-Regulation*

Lying somewhere between the unhappy state of OSHA enforcement and the promised land of nursing home regulation are the new and largely uncharted territories of industry self-regulation.<sup>102</sup> While a full assessment of self-regulation is beyond the scope of this Article,<sup>103</sup> the rational actor model raises a fundamental criticism of certain self-regulatory regimes.

The Federal Communications Commission has adopted an Alternative Broadcast Inspection Program under which stations are subject to inspection by state broadcast associations. When a station passes an inspection conducted under the program, the association notifies the FCC, which then exempts the station from random inspections by the local FCC field office for a period of two or three years.<sup>104</sup>

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<sup>97</sup> See Braithwaite, *supra* note 32, at 26-27 (describing the Reagan administration as a "period of unparalleled regulatory growth" in the health care industry, and noting "substantial further growth under President Bush").

<sup>98</sup> *Id.* at 22.

<sup>99</sup> See *id.* at 23-24.

<sup>100</sup> *Id.* at 29.

<sup>101</sup> *Id.* at 24-25.

<sup>102</sup> The term "self-regulation" here refers to the delegation of powers to implement federal laws or regulations by the federal government to a non-governmental organization, typically consisting of regulated entities and their representatives. See Douglas C. Michael, *Federal Agency Use of Audited Self-Regulation as a Regulatory Technique*, 47 ADMIN. L. REV. 171, 175-76 (1995).

<sup>103</sup> For an excellent review and assessment, see *id.*

<sup>104</sup> See Notice of Public Information Collections Being Reviewed by the Federal Communications Commission, 61 Fed. Reg. 6006, 6007 (1996).

One claimed advantage of self-regulation is that it reduces the cost of compliance and thereby fosters a culture of compliance.<sup>105</sup> The FCC's experiment with self-regulation, however, cannot be defended on these grounds. If there is a legitimate justification for the exemptions, it is that exempted stations will tend to be firms for which compliance costs are relatively low, and the FCC will compensate for any losses in compliance due to the exemptions by accelerating random inspections of the non-exempted stations. More commonly, however, self-regulation programs in the United States are developed in the context of budget cutbacks, where the lost inspections are viewed as cost savings<sup>106</sup> rather than as opportunities for targeting stations with high compliance costs.

Viewed from the cost-saving perspective, the Alternative Broadcast Inspection Program cannot be said to foster a culture of compliance. To claim this is to make the category error of counting a reduction (to zero!) in the probability of random inspections as a reduction in the cost of compliance. Instead, the two- to three-year exemption from programmed FCC inspections effectively eliminates the expected cost of sanctions during this period, increases the variation in the probability of inspections, and results in lower aggregate compliance unless the marginal cost of two years of compliance for all exempted firms is zero.<sup>107</sup> Even the most sanguine proponents of self-regulation would find it difficult to claim such time economies. In general, linking the probability of surprise inspections to past compliance<sup>108</sup> is a clumsy and risky way to create a culture of compliance.

#### 4. Banks

In the United States, banks are subject to regulation by the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of Thrift Supervision, and various state agencies. In the 1970s and 1980s, the federal bank regulation system did not effectively marshal limited resources to achieve maximum

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<sup>105</sup> See *Michael, supra* note 102, at 183-84 (“[I]ncentives [for compliance] are increased not because the regulated entity is now suddenly more willing to comply but because compliance has become easier (less costly) and has been recognized as consistent with and not impairing or opposing the entity’s goals.”).

<sup>106</sup> See *Michael, supra* note 102, at 184.

<sup>107</sup> The Florida Association of Broadcasters further assures that they “will not notify the FCC of your station’s participation in the Alternative Inspection Program until the contract inspector has signed off on the station.” See *The FAB/FCC Alternative Inspection Program*, (visited March 16, 1998) <<http://www.fab.org/fccaip.htm>>. This confidentiality effectively prevents the FCC from taking any steps before the inspection to compensate for the elimination of the cost of noncompliance after the inspection.

<sup>108</sup> For another example, see TEX. GOV’T CODE ANN. § 511.009(a)(15) (West 1997) (providing that announced and unannounced inspections of each jail will be based in part on its history of compliance).



compliance. Although each of the federal agencies determined its own policy for inspection frequency, all of them sought to tie frequency to past compliance.<sup>109</sup> At the same time, the agencies failed to respond to resource constraints by targeting banks with high compliance costs. For example, an understaffed FDIC in 1988 inspected 75 percent of the healthy banks in its jurisdiction, but fewer than half of the problem banks.<sup>110</sup>

Section 111 of the Federal Deposit Insurance Corporation Improvement Act of 1991<sup>111</sup> has brought greater uniformity to the inspection regime and reduced the correlation between compliance and inspection frequency. Specifically, the statute requires that each agency conduct a full-scope on-site examination of each insured depository institution that it supervises at least once every 12 months.<sup>112</sup> Small insured banks that are well-managed well-capitalized, and have not experienced a change in control during the previous 12 months, are permitted to be examined once every 18 months.<sup>113</sup> Certain government-controlled banks are exempted from these requirements.<sup>114</sup> By standardizing and improving confidence in the agencies' inspection schedules while allowing the agencies to target banks with high compliance costs,<sup>115</sup> the 1991 act has significantly strengthened the federal bank regulation system.

#### D. Anti-Corruption Provisions

Most statutory random inspection programs do not provide specific sanctions for tipping-off targets. At the federal level, the two exceptions are

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<sup>109</sup>In the 1970s, the agencies conducted examinations of sound banks every 12 to 18 months and more frequent examinations of unsound banks. See FEDERAL REGULATION OF BANKING 54-55 (1981). With respect to sound banks, the OCC set different inspection frequencies depending on the size of the bank's assets, while the FDIC and Federal Reserve Board varied their inspection frequencies in coordination with state regulators. *Id.* In the 1980s, the OCC dropped its policy requiring examinations at specified intervals in favor of a case-by-case approach. Hearing Before the Subcomm. on Commerce, Consumer, and Monetary Affairs of the House Comm. on Government Operations, 100th Cong., 1st Sess. 418 (1987).

<sup>110</sup>H.R. REP. NO. 100-1088, at 63 (1988).

<sup>111</sup>12 U.S.C. 1820(d).

<sup>112</sup>*Id.*

<sup>113</sup>12 U.S.C. 1820(d)(4).

<sup>114</sup>12 U.S.C. 1820(d)(5).

<sup>115</sup>As the agencies recently noted in promulgating regulations under section 111:

The Agencies have determined that ... [the statutory framework] is generally consistent with the safety and soundness of insured depository institutions assuming the absence of other risk factors. A longer examination schedule permits the Agencies to focus their resources on the segments of the banking and thrift industry that present the most immediate supervisory concern, while concomitantly reducing the regulatory burden on smaller, well-run institutions that do not pose an equivalent level of supervisory concerns.

Expanded Examination Cycle for Certain Small Insured Institutions, 62 Fed. Reg. 6449, 6451 (1997).

OSHA and the corresponding mine safety and health statute, MSHA.<sup>116</sup> The OSHA and MSHA statutes both provide that giving advance notice of a surprise inspection is a crime punishable by six months' imprisonment and/or a \$1,000 fine.<sup>117</sup> However, even in these cases, however, the legislative intent does not seem to have been to deter corruption. Instead, from the beginning, Congress regarded the prohibition against giving advance notice of a surprise inspection as an integral part of the protections provided by the statutes.<sup>118</sup> However, consistent with the demise of OSHA's other good intentions,<sup>119</sup> these crimes have never been prosecuted.<sup>120</sup> Given the low incentives for corrupt tip-offs about OSHA inspections,<sup>121</sup> more vigilant enforcement of these laws does not appear to have been warranted.

At the state level, specific sanctions for the disclosure of unannounced regulatory inspections have been enacted only in the context of health care facilities.<sup>122</sup> Punishments range from a five-day suspension<sup>123</sup> to a felony conviction,<sup>124</sup> and may vary according to the rank of the official involved.<sup>125</sup> It is unclear to what extent tip-offs are a problem or how vigorously these provisions are enforced.<sup>126</sup> In any case, however, the appearance of such

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<sup>116</sup>30 U.S.C.A. §§ 801-962 (West 1998).

<sup>117</sup>29 U.S.C.A. § 666(f) (West 1998); 30 U.S.C.A. § 820(e) (West 1998).

<sup>118</sup>See 29 U.S.C.A. § 651(b)(10) (West 1998) (stating that one of the Act's purposes is "to assure so far as possible every working man and woman in the Nation safe and healthful working conditions and to preserve our human resources ... by providing an effective enforcement program which shall include a prohibition against giving advance notice of any inspection").

<sup>119</sup>See *supra* text accompanying notes 78 - 95.

<sup>120</sup>See Barbra Marcus et al., *Employment-Related Crimes*, 34 AM. CRIM. L. REV. 457, 459 (1997).

<sup>121</sup>The analysis in part II *supra* shows, *inter alia*, that where penalties for noncompliance are negligible, incentives for corruption will be low. See *supra* note 95 (describing OSHA's low penalties for noncompliance).

<sup>122</sup>See, e.g., D.C. CODE ANN. § 32-1309(d)(1) (1997) (health care residence facilities); FLA. STAT. ANN. § 400.19(3) (West 1997) (nursing homes); IOWA CODE ANN. § 135C.16(1) (West 1997) (health care facilities); MINN. STAT. ANN. § 144A.10(2) (West 1997) (nursing homes); NEB. REV. STAT. § 71-6024 (1996) (nursing homes); N.Y. PUB. HEALTH LAW § 2803(1)(a) (McKinney 1997) (hospitals); N.Y. SOC. SERV. LAW § 461-a(2)(a)(2) (McKinney 1997) (adult care facilities); TEX. HEALTH & SAFETY CODE ANN. § 241.052 (West 1997) (end-stage renal disease facilities); TEX. HEALTH & SAFETY CODE ANN. § 242.045 (West 1997) (nursing homes); TEX. HEALTH & SAFETY CODE ANN. § 252.042 (West 1997) (facilities for the mentally retarded); WIS. STAT. ANN. § 50.03(2)(c) (West 1998) (nursing homes).

<sup>123</sup>See FLA. STAT. ANN. § 400.19(3) (West 1997); N.Y. PUB. HEALTH LAW § 2803(1)(a) (McKinney 1997); N.Y. SOC. SERV. LAW § 461-a(2)(a)(2) (McKinney 1997); WIS. STAT. ANN. § 50.03(2)(c) (West 1998).

<sup>124</sup>See TEX. HEALTH & SAFETY CODE ANN. § 242.045 (West 1997).

<sup>125</sup>See NEB. REV. STAT. § 71-6024 (1996) (providing that any director or deputy director who gives advance notice of an inspection shall be subject to \$5,000 fine).

<sup>126</sup>A search of Westlaw, ALLCASES database, found no reported case referring to any of the prohibitions against disclosure of unannounced inspections cited in note 122 *supra*.

explicit anti-corruption measures exclusively in the health care context attests to the vitality of the underlying regulatory regime.<sup>127</sup>

#### IV. RANDOM INSPECTIONS AND BANKING REGULATION IN JAPAN

At the time of the Ministry scandal, Japanese banks, including their foreign branches, were supervised by two institutions, the Ministry and the Bank of Japan, which conducted three distinct types of bank inspections.<sup>128</sup> First, the Banking Bureau of the Ministry conducted highly detailed surprise inspections directed to ensuring that the bank ran soundly.<sup>129</sup> Second, the Bank of Japan conducted less exacting scheduled examinations aimed at maintaining the soundness of the financial system<sup>130</sup> and protecting its contractual agreements with institutional accountholders.<sup>131</sup> Finally, the International Finance Bureau of the Ministry conducted examinations to supervise the foreign exchange operations of banks.<sup>132</sup> The Banking Bureau's inspection program is most germane to the subject of this Article.

Article 25 of the Banking Law of 1981, entitled "Spot Inspection,"<sup>133</sup> authorized the Ministry to inspect all bank facilities and offices whenever "necessary in order to secure the healthy and suitable operations of the business of the bank."<sup>134</sup> The Banking Bureau aimed to inspect each bank at least once every three years,<sup>135</sup> but the frequency of these surprise inspections was subject to numerous pressures and various circumstances.

The chief constraint on the frequency of inspections has been the size of the bank inspection staff.<sup>136</sup> Overall, Japan's financial inspection officials number about 1,000, only about one-eighth of those in the United States,<sup>137</sup> and their competence has been called into question.<sup>138</sup> Since

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Of course, the imposition of a sanction is unlikely to go to trial because of the size of the punishment involved is generally small.

<sup>127</sup> See *supra* text accompanying notes 96 - 101.

<sup>128</sup> See Marilyn B. Cane & David A. Barclay, *Competitive Inequality: American Banking in the International Arena*, 13 B.C. INT'L & COMP. L. REV. 273, 295-96 (1990).

<sup>129</sup> See Bill Shaw & John R. Rowlett, *Reforming the U.S. Banking System: Lessons from Abroad*, 19 N.C. J. INT'L L. & COM. REG. 91, 107 (1993).

<sup>130</sup> See *id.*

<sup>131</sup> See MAXIMILIAN J. B. HALL, BANKING REGULATION AND SUPERVISION 149 (1993) (citing Nihon Ginko Ho [Bank of Japan Law], Law No. 67 of 1942, arts. 42-44).

<sup>132</sup> See Cane, *supra* note 128, at 295-96.

<sup>133</sup> See *id.* at 295 n.162.

<sup>134</sup> Ginko Ho (Banking Law), Law No. 59 of 1981, art. 25 [hereinafter Banking Law].

<sup>135</sup> See HALL, *supra* note 131, at 169 n.81; see also Cane, *supra* note 128, at 295 (every two or three years); *Arrested MOF Inspector Shelved Finding on Bad Loans*, JAPAN WKLY. MONITOR, Feb. 2, 1998 (every three or four years).

<sup>136</sup> See HALL, *supra* note 131, at 169 nn.80-81.

<sup>137</sup> See *FSA Plans to Strengthen Staff by 200-300 in FY 1999*, JAPAN WKLY. MONITOR, Aug. 17, 1998.

1988, scarce regulatory resources have been rationalized by varying the frequency and intensity of inspections according to banks' net worth ratios, asset quality, management control systems, profitability, liquidity,<sup>139</sup> location, and size.<sup>140</sup> These resources and policies have in turn been subject to political tides in the wake of highly publicized financial scandals, most notably in 1991,<sup>141</sup> when the target inspection cycle for city banks was reduced from 41 to 36 months.<sup>142</sup> A final factor influencing the frequency of inspections was the coordination of scheduling between the Ministry and the Bank of Japan so that each bank is inspected annually.<sup>143</sup>

In contrast to the situation in the United States,<sup>144</sup> Japan's Constitution imposes no practical constraints on random inspection programs. The Showa Constitution generally prohibits warrantless searches,<sup>145</sup> but there are many exceptions to this doctrine,<sup>146</sup> and the Japanese High Court in at least one case has allowed a warrantless search after balancing the extent of the invasion against the importance of the evidence at trial.<sup>147</sup> Further, there is no explicit constitutional prohibition against excessive fines.<sup>148</sup> There-

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<sup>138</sup> See Jathon Sapsford, *Japan's Most Powerful Banks are Viewed as Rescuers*, WALL ST. J., Aug. 27, 1998, at A10 (quoting economist Richard Koo's assessment that only 200 Japanese bank inspectors "are considered any good"); *Rookies Run Rule Over Banks*, FINANCIAL TIMES, July 24, 1998, at 15.

<sup>139</sup> See Hall, *supra* note 131, at 151.

<sup>140</sup> See *id.* at 169 n.81.

<sup>141</sup> See Colin P.A. Jones, *Japanese Banking Reform: A Legal Analysis of Recent Developments*, 3 DUKE J. COMP. & INT'L L. 387, 432-33 (1993) (identifying 1991 banking scandals as impetus for Financial System Reform Act).

<sup>142</sup> See HALL, *supra* note 131, at 169 n.81.

<sup>143</sup> See *id.* at 149 - 150.

<sup>144</sup> See *supra* sections III.A and III.B.

<sup>145</sup> Article 35 of the Showa Constitution states:

The right of all persons to be secure in their homes, papers and effects against entries, searches and seizures shall not be impaired except upon warrant issued for adequate cause and particularly describing the place to be searched and things to be seized, or except as provided by Article 33.

Each search or seizure shall be made upon separate warrant by a competent judicial officer.

KENPO, art. 35.

<sup>146</sup> See, e.g., Banking Law, *supra* note 134, art. 25 (allowing Minister of Finance, "when he deems it necessary in order to secure the healthy and suitable operations of the business of the bank," to conduct bank inspections); Industrial Safety and Health Law, Law No. 57 of 1972, art. 91 (authorizing Labour Standards Inspectors, "where they deem it necessary in order to enforce this Law," to inspect workplaces and confiscate equipment without compensation); see also Rajendra Ramlogan, *The Human Rights Revolution in Japan: A Story of New Wine in Old Wine Skins?*, 8 EMORY INT'L L. REV. 127, 160 (1994) ("[A]lthough the Showa Constitution seems to provide protection against unauthorized searches and seizures, the law has stretched the exceptions to an almost unbelievable extent.").

<sup>147</sup> See *id.* at 159 & n.110 (citing Judgment of Dec. 26, 1983, Sapporo Kosai (High Court), 1111 Hanji 143, 144-46 (Japan)).

<sup>148</sup> One commentator has suggested that punitive fines, when coupled with criminal penalties, may fall within the double jeopardy prohibition of Article 39. See Mitsuo Matsuhita, *The Structural Impediments Initiative: An Example of Bilateral Trade Negotiation*, 12

fore, the structure of the Banking Bureau's spot inspection program is constrained by resources, not by constitutional doctrine.

In principle, the structure of the Banking Bureau's spot inspection program represented a fairly sound approach to enforcement using limited resources. The Bureau's policies were directed to maximizing the overall frequency of inspections while also targeting its scrutiny at those banks that were most likely to have high compliance costs. (Coordinating inspection schedules with the Bank of Japan created perturbations in the bureau's inspection probability distributions, but this second-order effect was not a cause for great concern.) Even more significantly, the Bureau's capacity for imposing sanctions was potentially so high as to be coercive.<sup>149</sup> A further source of potential deterrent capability was the informal system of administrative guidance that accompanies the Ministry's multiple regulatory and managerial roles.<sup>150</sup>

This picture changed drastically, however, when corruption came into view. The Ministry's wide-ranging and potentially conflicting roles gave it "the largest authority and strongest power in Japan."<sup>151</sup> Vagueness in Japan's banking laws further strengthened the Ministry's hand. As one commentator has noted, the "lack of transparency [in the banking statutes] compels companies to develop close relationships with ministries and agen-

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MICH. J. INT'L L. 436, 448 & n.33 (1991). Article 39 of the Showa Constitution states, "No person shall be held criminally liable for an act which was lawful at the time it was committed, or of which he has been acquitted, nor shall he be placed in double jeopardy." KENPO, art. 39.

The Constitution also prohibits "[t]he infliction of torture by any public officer and cruel punishment," KENPO, art. 36, but the courts have rarely applied this doctrine even in cases of extensive physical and psychological abuse, let alone monetary penalties. See Ramlogan, *supra* note 146, at 181-82.

<sup>149</sup>Under the Banking Law of 1981, the Ministry of Finance had the power to revoke banks' licenses for violation of any law, articles of incorporation, or ministry regulations, see Banking Law, *supra* note 134, at art. 27; to suspend the bank's business or freeze its assets when it deems necessary, see *id.* at art. 26; and to approve a wide variety of banking decisions including the opening and closing of branches and reductions in the level of capital held below a certain minimum, see HALL, *supra* note 131, at 149. The Banking Law provided civil and criminal penalties of up to three million yen and three years imprisonment for violation of the ministry's licensing and examination requirements. See Banking Law, arts. 61-66.

<sup>150</sup>See Cane & Barclay, *supra* note 128, at 289:

[T]rue regulatory power over Japanese banks resides in the MOF. The Banking Law of 1927 grants the MOF such broad supervisory powers that its responsibilities have been likened to "those of the Treasury, Internal Revenue Service, Securities and Exchange Commission, state banking commissions and policy-making responsibilities of the FRB." Within this broad grant of power, the MOF has considerable discretion to tailor its regulations and policies to the needs of individual banks in return for their voluntary cooperation with MOF directives. This regulatory style is called *gyosei-shido*, or administrative guidance.

<sup>151</sup>The ministry sets Japan's budget and economic policy, intervenes on foreign exchange markets, grants business licenses, and issues advice to industry that is generally followed. See Suzuki, *supra* note 5.

cies in order to know whether their activities comply with current interpretations of the laws on the books."<sup>152</sup> As the analysis in part II shows, however, the very potency of the Ministry's discretionary enforcement power created a powerful incentive for corruption that would be difficult to resist even in an arm's-length relationship. In fact, the tip-offs occurred in a web of close social relationships among bank officials and Bureau inspectors,<sup>153</sup> an environment rich in opportunities for collusion and poor in safeguards of accountability.

The unusually intense public furor in the wake of the scandal led to a pledge by Japan's major banks to abolish their MOF-*tan*, or "ministry handler," system, in which bank officials had been specifically assigned to cultivate social relationships with ministry officials.<sup>154</sup> More urgent economic and political pressures, however, initially distracted the ruling Liberal Democratic Party from large-scale banking reforms.<sup>155</sup> The incoming Finance Minister Hikaru Matsunaga immediately ruled out a full breakup of the Ministry and offered no programs to prevent future corruption in the banking industry.<sup>156</sup>

Elections in July 1998, however, led to the resignation of Prime Minister Ryutaro Hashimoto in favor of Keizo Obuchi, who took office pledging to reform Japan's banks and to take the country out of recession.<sup>157</sup> At about the same time, Japan's new Financial Supervisory Agency took over the Banking Bureau's inspection program and most of its staff, under the direction of Masaharu Hino, a public prosecutor and banking industry outsider.<sup>158</sup> The agency marked Obuchi's first day in office by ordering penalties for eight banks involved in the bribery scandals.<sup>159</sup> Despite having just 165 inspectors, many of them inexperienced,<sup>160</sup> the agency also conducted inspections of all of Japan's major commercial banks between

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<sup>152</sup> See *id.*

<sup>153</sup> See *infra* note 154 and accompanying text (describing the MOF-*tan* ("ministry handler") system).

<sup>154</sup> See *More Japanese Banks Linked to Bribery*, *supra* note 7. Choy, *supra* note 1, describes the MOF-*tan* system:

Banks and other financial and non-financial firms admit to having special groups of employees whose only job is to develop and maintain friendly relations with relevant ministry functionaries.... [T]he relationship-building usually takes place outside regular business hours in the form of dinners or, sometimes, golfing weekends, trips and other leisure activities. These lengthy affairs are supposed to provide the time to develop close personal ties and to discuss issues in depth. Critics now say that they also serve as a convenient channel to curry favor with key bureaucrats.

<sup>155</sup> See *id.*

<sup>156</sup> See Landers, on file with author.

<sup>157</sup> See Nayan Chanda, *Surges of Depression*, FAR E. ECON. REV., Dec. 31, 1998, at 22.

<sup>158</sup> See *Rookies Run Rule Over Banks*, *supra* note 138.

<sup>159</sup> See *Japan's New Watchdog Bites the Banks*, FINANCIAL TIMES, Aug. 1, 1998, at 3.

<sup>160</sup> See *New Japan Bank Watchdog Faces Herculean Task*, L.A. TIMES, July 19, 1998, at A1.

July and October 1998.<sup>161</sup> When the audits revealed that the Long-Term Credit Bank of Japan and Nippon Credit Bank were insolvent, the FSA exercised its power to nationalize them.<sup>162</sup> Bolstering the agency's authority over the remaining banks is an attractive carrot in the form of a \$260 billion line of credit the government has made available to banks that convince the regulators they are committed to reform.<sup>163</sup> The agency has also been willing to use a large stick -- the threat of license revocation -- in support of its new inspection practices.<sup>164</sup> The FSA's staff of inspectors is growing rapidly and is expected to have more than 1,000 in the year 2000.<sup>165</sup> If the FSA maintains this focus on confronting corruption and challenging resource constraints, Japan's random bank inspection program is likely to become the highly effective regulatory tool it was designed to be.<sup>166</sup>

Japan's lawmakers can assist the reform efforts at the FSA in two ways. First, specific provisions are needed to combat corruption in the random inspection program. The agency's August crackdown and the Japanese legislature's proposal of a code of ethics for civil servants<sup>167</sup> are a good start, but direct prohibitions against tip-offs, backed by coercive sanctions, need to be built into the inspection program's framework and vigorously enforced. Second, institutional support for the close informal relationships that breed corruption should be dismantled. In addition to the banks' move to abolish the MOF-*tan* system,<sup>168</sup> the legislature should clarify the banking laws to reduce agency discretion and resulting opportunities for collusion.

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<sup>161</sup> See *Top 17 Banks' Bad Loans Worth 49 Tril. Yen in March: FSA*, JAPAN WKLY. MONITOR, Dec. 28, 1998.

<sup>162</sup> See *Gov't to Nationalize Troubled LTCB*, JAPAN WKLY. MONITOR, Oct. 26, 1998; Robert Whyman, *Japanese Bank Nationalised to Shore Up Sector*, TIMES OF LONDON, Dec. 14, 1998, at 41.

<sup>163</sup> See Jathon Sapsford, *Funding Depends on Cleanup Plans*, WALL ST. J., Feb. 8, 1999, at A17.

<sup>164</sup> The FSA's draft bank inspection manual states that any bank that fails to follow the agency's risk management framework will have its license revoked. See *FSA Preparing Tough Bank Inspection Manual*, JAPAN WKLY. MONITOR, Dec. 7, 1998.

<sup>165</sup> See *Japan Aims to Double Bank-Inspector Ranks*, ASIAN WALL ST. J., Dec. 1, 1998, at 4.

<sup>166</sup> Tellingly, inspections at Credit Suisse First Boston and Sumitomo Bank in January and February 1999 were unannounced and unexpected, and agency directors were planning to continue the practice of secrecy and surprise. See *Japan Watchdog Inspects Credit Suisse First Boston Office*, ASIA PULSE, Jan. 21, 1999; *FSA Completes Sumitomo Bank Market Risk Management Inspection*, AFX NEWS, March 2, 1999.

<sup>167</sup> See Barbara Wanner, *Financial Scandals Renew Focus on Bureaucratic Power*, JEI REP., Mar. 6, 1998.

<sup>168</sup> Major banks have also instituted a ban on entertaining government officials or executives of public corporations. See *id.*

## V. CONCLUSION

Given the United States' apparent lack of experience with large-scale corruption involving tip-offs of surprise inspections, the recent Japanese banking scandal may be the most instructive case study available for understanding the problem and considering solutions. Part II of this Article presented the theoretical case for specific anti-corruption sanctions to accompany random inspection programs. The Japanese experience described in Part IV can provide further empirical support for such sanctions, provided that American regulators are as willing to learn from Japan's difficulties as they have been to offer advice.<sup>169</sup>

Corruption is not as prevalent in practice as theory predicts. The decision of whether or not to accept a bribe in return for advance disclosure of a random inspection is not based solely on a weighing of the available rents against the expected penalties. Observed penalties for tip-offs are too rare and too small<sup>170</sup> to be explained by a pure deterrence theory. Similarly, compliance in practice is often more common than theory predicts. Despite this, the theoretical analysis presented in this Article should be taken seriously for the concerns it raises and the reforms it suggests.<sup>171</sup>

This gap between theory and practice provides some play in the joints of reform proposals. For example, it seems reasonable to view Japan's bank rating system<sup>172</sup> as a positive reform measure designed to rationalize limited inspectorate staff, even if it is unclear whether the first-order pre-

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<sup>169</sup> See *MOF to Hire Foreign Experts*, ASAHI SHIMBUN, Feb. 7, 1998 (reporting that the Ministry of Finance had invited advisors from the Office of the Comptroller of the Currency and the Federal Reserve Board); Jathon Sapsford, *Japan's Bank Overhaul Lacks Crucial Details*, WALL ST. J., Sept. 21, 1998 (noting that U.S. government officials "have given unusually detailed public advice to Japan on the shape of its bank reforms").

<sup>170</sup> See *supra* section III.D.

<sup>171</sup> As Braithwaite writes in the nursing home context:

[C]ompliance arises more from a desire to go along with authoritative requests to comply with the law or authoritative suggestions to act in a professionally responsible way than from any rational weighing of the costs and benefits of compliance.... Voluntary compliance is underwritten by deterrence, but not in a way that often leads the [regulated business] to calculate about the actual levels and probabilities of deterrent threats. Because of this, even when these actual levels and probabilities are zero, orchestration of an appearance that they are nonzero will often be enough to do the job.... Needless to say, however, such state authority is a fragile accomplishment and therefore hardly a basis for sound regulatory policy.

Braithwaite, *supra* note 32, at 29-30. See also Wayne B. Gray & John T. Scholz, *Does Regulatory Enforcement Work? A Panel Analysis of OSHA Enforcement*, 27 LAW & SOC'Y REV. 177, 178 (1993) (noting that empirical studies of OSHA enforcement suggest that "[t]he complexity of perceptual processes that intervene between the threat or experience of legal sanctions and illegal actions may weaken the link between enforcement activities and deterrence."); see generally JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES chs. 14, 19, 21-23 (Daniel Kahneman et al., eds, 1982) (describing human biases in calculation of probabilities from experience).

<sup>172</sup> See *supra* text accompanying notes 139 - 140.



condition of adequate deterrence has been met. On the other hand, the departure from the rational actor model also allows that policy changes may have a signaling function. The Alternative Broadcast Inspection Program may be interpreted as a vote of confidence in self-regulation or, perversely, as a license to violate the law after the initial inspection.

As Japan's banking regulators are learning, random inspections present unique and complex problems of law and policy reform under tight constitutional, fiscal, prudential, and political constraints. This Article is an invitation to the task of solving them.

