What Compliance Lessons Can We Learn from Volkswagen’s Diesel Emissions Scandal?

A look at the car manufacturer’s recent diesel emissions scandal from a compliance perspective—or, what not to do if you should ever find yourself, your company, or a client in a similar situation.
Anatomy of a Scandal

In mid-2016, Volkswagen (VW), a multinational automotive manufacturing company headquartered in Wolfsburg, Germany, executed the first in a series of settlements with the U.S. Environmental Protection Agency (EPA)—joined by the California Air Resources Board (CARB) by and through the State of California—to resolve a civil environmental enforcement action brought in connection with alleged violations of U.S. Clean Air Act mobile source emissions regulations for diesel vehicles. Though the alleged violations occurred over a number of years, the enforcement action first became public in September 2015 when EPA issued a notice of violation to VW accusing the company of utilizing “defeat devices” to bypass, defeat, or render inoperative diesel emission control systems during normal driving conditions.2

It was later revealed that VW engineers had developed engine control software that enabled its diesel vehicles to detect when they were being subjected to emissions testing. The software analyzed various drivetrain data, including steering wheel position, vehicle speed, engine parameters, and atmospheric data to recognize testing conditions. During testing, the software would fully activate the vehicle’s diesel emissions control systems to ensure the vehicle could safely pass required emissions testing. During normal everyday driving, however, the software would bypass and/or partially or fully deactivate the vehicle’s diesel emissions control systems to improve engine performance.2

By the spring of 2018, VW had completed three partial civil enforcement action settlements with EPA. All told, these settlements involved nearly 600,000 vehicles from the model-years 2009 through 2016.2 Separately, the U.S. Department of Justice pursued criminal enforcement actions against VW and several of the company’s employees—with one middle level engineer recently sentenced to 7 years in federal prison.3 The total financial impact to VW in terms of civil penalties, vehicle buy-backs, recalls, and retrofits is at or near US$30 billion. EPAs September 2015 notice of violation led to VW’s stock (VLKAY) price dropping by 30 percent almost immediately.3 The company simultaneously lost almost US$20 billion in market capitalization (much of which has been recovered, as of this writing). Meanwhile, reputational damage to the VW, Audi, and Porsche brands (including loss of “goodwill”) is unquantifiable.

On its face, the VW diesel scandal is a Clean Air Act mobile source emissions enforcement case with far-reaching implications for the future of both mobile source compliance and the continued viability of consumer diesel vehicles themselves. At its core, however, the scandal is a cautionary tale about intentional violations of environmental laws and regulations, a high-level corporate cover-up, deceiving and misleading regulators and, ultimately, what not to do at almost every step if you (heaven forbid...) should ever find yourself, your company, or a client in a similar situation.

Caught in a Cascade of Lies

VW’s troubles ultimately sprang from an all-in U.S. sales strategy that began in 2006 tied to “clean diesel” vehicles that apparently ran headlong into the unfortunate reality that VW had no idea how to manufacture a “clean diesel” vehicle.3 Shortly after the sales campaign was kicked-off, a senior VW official was filmed in 2007 complaining that compliance with CARB’s diesel regulations was “impossible”.4 This perceived impossibility led not long thereafter to VW engineers refining and ultimately implementing a defeat device that had first been used by Audi in Europe only a few years earlier.1 In the following years, VW, Audi, and Porsche officials all became aware of the use of defeat devices in their vehicles to varying degrees. It appears that none of them took decisive action to investigate and/or stop the non-compliance.

The beginning of the end came in the spring of 2014 when researchers from West Virginia University presented and later published a study containing the results of real-world emissions tests that they had conducted on several diesel vehicles, including a BMW sports utility vehicle and two VW cars. While the BMW’s emissions were compliant in both laboratory and on-road tests, the VW cars were compliant only under laboratory testing conditions (on a dynamometer), while emitting 15 to 35 times the allowable limit of nitrogen oxides (NOx) in on-road driving conditions.5

The details of VWs internal response at this point are not entirely clear. What is clear is that CARB and EPA regulators were not told about the presence of the defeat devices until late summer 2015. In the interim, VW promised regulators that software patches installed through vehicle recalls would fix the diesel emissions problems (even though VW likely knew this to be untrue).3 Ultimately, a VW engineer admitted to CARB in August 2015 that the company had been using defeat devices. Another VW engineer confessed in writing in early September 2015.3 EPAs notice of violation was issued soon after.

Post-Mortem

VW’s senior leadership had the ability to dramatically alter the company’s outcome in this matter (for the better) up to and until the point where more junior VW representatives admitted wrongdoing to the State of California in 2015. Once a whistleblower comes forward (assuming the
whistleblower has sufficient knowledge and is telling some version of the “truth”), a regulated entity’s ability to control the narrative of non-compliance is largely lost. VW lost its ability to control the narrative by continuing to hide the truth about the existence of defeat devices from CARB until it was too late.

There is some suggestion that outside legal counsel may have given VW a false sense of security by delivering an unintentionally misleading “reasonable worst case” scenario for VW to base its decisions on. Looking at the legal precedent allegedly relied upon by VW’s outside counsel (a US$100 million fuel efficiency case against Hyundai and Kia settled in 2014), the magnitude of the noncompliance, elements of intent, and lack of candor with regulators on VW’s part suggest a vastly different and arguably incomparable fact pattern.

It is impossible for us to know exactly what legal advice VW received (Thank you, attorney-client privilege...), but it is interesting to speculate whether VW’s internal response would have been different if outside legal counsel had simply said “there is no analog for this, it’s uncharted territory” or “here’s the worst thing we found, given our different facts, we could easily be facing penalties ten times greater (i.e., US$1 billion plus).”

VW appears to have conducted several different cost of compliance analyses (either formally or informally) beginning as early as 2006. It seems at one point VW’s decision was to not disclose the defeat devices because the economic damage of a continued CARB hold on the incoming 2016 model-year was seen as being too costly (given that a hold in California would simultaneously result in several other large states also banning sales pending California approval).

There are numerous compliance and corporate cultural issues to unpack here—not the least of which is that explicitly weighing and discussing the economic impact of compliance versus the economic benefits of noncompliance could be the evidentiary thread that leads the government to convert a “simple” administrative or civil enforcement case into a much more serious criminal investigation. Involving legal counsel in any such discussions is critical as it establishes the “attorney-client privilege,” which can protect certain communications involving legal advice from disclosure in an enforcement action or litigation. The benefit of establishing attorney-client privilege early in an investigation is that, while the privilege cannot prevent the release of “facts,” it can protect the often erroneous opinions and speculation that dominate the beginning stages of investigations when little is truly known.

**Lessons Learned**

Noncompliance is never easy to deal with no matter the magnitude. Mistakes that lead to noncompliance are made frequently in good faith. Intentional noncompliance is less common. Regardless of what initially led to an instance of noncompliance, the situation cannot be made better by doubling-down on deception or by trying to lead regulators away from facts. This is especially true given that facts are increasingly harder to hide in a digital world where e-mails, text messages, PowerPoint presentations, and voicemails are invariably stored-away for posterity’s sake.

Hindsight is 20/20, but VW’s financial outcome could have been improved (and its reputational damage lessened) if the following steps had been followed once it became clear VW’s senior leadership had the ability to dramatically alter the company’s outcome in this matter (for the better) .... VW lost its ability to control the narrative by continuing to hide the truth about the existence of defeat devices until it was too late.
internally that the company was intentionally violating diesel emissions standards by using defeat devices:

1. An internal “watchdog” function (e.g., compliance, an ombudsperson, an ethics hotline, or legal counsel) should have immediately been alerted to the possible noncompliance;
2. A full-bodied internal investigation led by outside legal counsel under attorney-client privilege should have been commissioned;
3. Those leading the compliance investigation should have been given full and complete access to everyone involved at all levels in an effort to bring all relevant facts to light;
4. When outside counsel was engaged, VW should have ensured that they were allowed to know everything, especially to the extent VW was seeking guidance on worst case scenario outcomes;
5. VW’s internal investigation should have sought out both the contributing causes and the root causes that allowed the defeat devices and ensuing cover-up to come into being;
6. VW should have developed meaningful internal corrective actions, including employee discipline, new or revised internal compliance policies, programs, and/or administrative controls—along with proposed external corrective actions (subject to regulatory approval), such as recalls, software updates, buy-backs, or some combination of the above to present to regulators as a “turn-key” package to resolve a potential enforcement action; and
7. In a timely manner (once all facts were known, the root cause investigation was complete, and a package of corrective actions was developed), VW should have carefully approached both EPA and CARB with a “best light” factual account of what happened—along with the company’s proposed remedies.

While it is impossible to know whether successful implementation of any or all of the above steps would have materially altered VW’s outcome for the better, it is highly likely that a carefully controlled disclosure to EPA and the State of California would have been preferable to two separate whistleblowers coming forward. While VW could do nothing in 2015 to change what had happened from 2006 through 2014, the company could have dramatically altered its optics by coming forward and doing the right thing prior to being forced to do so by regulators.

References

1. Note: The terms “Volkswagen” and “VW” refer collectively to Volkswagen AG, Audi AG, Dr. Ing. h.c. F. Porsche AG, Volkswagen Group of America, Inc., Volkswagen Group of America Chattanooga Operations, LLC, and Porsche Cars North America, Inc.
4. See https://www.youtube.com/watch?v=rThmune955g.
5. West Virginia University performed its research under contract with the International Council on Clean Transportation. The final report is available online at: https://www.theicct.org/sites/default/files/publications/WVU_LDDV_in-use_ICC_T_Report_Final_may2014.pdf.
8. Note: Facts themselves cannot be kept secret simply because a client relays them to an attorney. What a client did or did not do in any given matter cannot be protected from discovery by the privilege. Internal discussions regarding the why’s and how’s of something that was done can be protected to some extent by involving an attorney and invoking attorney-client privilege.
9. Note: The preference for outside legal counsel (vs. in-house legal counsel) is based on a body of case law that questions the width and breadth of the attorney-client privilege when it is established solely through in-house legal counsel. These cases argue that the attorney-client privilege is meant only to protect and encourage the free flow of legal advice, whereas in-house legal counsel often find themselves in the dual roles of both legal and business advisor. Any guidance provided while an in-house attorney is functioning as a business advisor is not entitled to the protection from disclosure afforded by the attorney-client privilege.

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