TO COLUMBIA WORKSHOP PARTICIPANTS:

Attached you will find the theoretical sections of an article that provides an economic analysis of structural reform mandates imposed on firms subject to potential conviction for corporate crimes. The theoretical analysis is 3/4s of the full article. The full article will include both a theoretical and empirical section.

We are taking the opportunity provided by Victor Goldberg’s invitation to present this article this fall to present the theoretical section, even though we have not completed the empirical section, because we wanted the benefit of your comments at this stage. I included one preliminary empirical result that I will discuss during the workshop.

Yours,

Jennifer Arlen
CORPORATE GOVERNANCE REGULATION THROUGH NON-PROSECUTION

Jennifer Arlen and Marcel Kahan*

Abstract

This article examines prosecutors’ use of pretrial diversion agreements to exercise quasi-regulatory authority over firms with detected wrongdoing through the use of pretrial diversion agreement to require firms to alter the compliance programs, internal governance, and to accept additional external oversight. While various economic justifications have been given for such mandates, including corporate asset insufficiency, we find that these mandates are justifiable in only one situation: when serious agency cost problems afflict corporate policing. This justification not only restricts when mandates should be imposed but also the type of mandates that should be imposed. Specifically, we find that DPA mandates must be targeted a policing agency costs. Thus, generally mandates should incorporate provisions shifting responsibility over policing to actors not afflicted by policing agency costs (internal or external). By contrast, DPAs should not mandate generic compliance programs or corporate governance reforms that do not address policing agency costs.

I. INTRODUCTION

Over the last decade, corporate criminal enforcement in the U.S. has undergone a dramatic transformation. Today, prosecutors not only impose monetary sanctions, but regularly exert broad, quasi-regulatory authority over firms that avoid conviction through Deferred and Non-Prosecution Agreements (for simplicity, we will refer to both types of agreement as DPAs).¹

DPAs are agreements entered into between prosecutors and firms potentially eligible for indictment under which prosecutors agree not to indict (or to proceed to trial) if the firm agrees to and satisfies certain conditions. Under a NPA, the prosecutor agrees not to file a charging document in return for the firm agreeing to certain conditions. NPAs are expressed in the form of a letter, often not filed in court. Brandon L. Garrett, Structural Reform Prosecution, 93 VA. L. REV. 853, 928 (2007); Lawrence D. Finder, Ryan D. McConnell, & Scott L. Mitchell, Betting the Corporation: Compliance or Defiance? Compliance Programs in the Context of Deferred and Non-Prosecution Agreements: Corporate Pre-trial Agreement UDPAte – 2008, 28 CORP. COUNS. REV. 1, 2–4 (2009).

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¹ With a DPA, the prosecutor files a criminal charge (or criminal information) but defers prosecution if the firm agrees to and satisfies certain conditions. Under a NPA, the prosecutor agrees not to file a charging document in return for the firm agreeing to certain conditions. NPAs are expressed in the form of a letter, often not filed in court. Brandon L. Garrett, Structural Reform Prosecution, 93 VA. L. REV. 853, 928 (2007); Lawrence D. Finder, Ryan D. McConnell, & Scott L. Mitchell, Betting the Corporation: Compliance or Defiance? Compliance Programs in the Context of Deferred and Non-Prosecution Agreements: Corporate Pre-trial Agreement UDPAte – 2008, 28 CORP. COUNS. REV. 1, 2–4 (2009).
against) the firm in return for the firm agreeing to a variety of conditions. These conditions include standard enforcement terms, such as requiring the firm to cooperate in an investigation or to pay monetary sanctions. But they also contain more novel mandates designed to achieve forward-looking, quasi-regulatory aims. These mandates may require firms to adopt corporate compliance programs with specific features, change their internal reporting structure, modify certain business practices, or hire a prosecutor-approved corporate monitor.\(^2\) Moreover, while the prosecutor agrees not to prosecute if the firm complies with these mandates, the firm agrees not to contest that it committed the initial offense. Thus, if a firm is found to have violated a mandate imposed by a DPA or NPA, it risks prosecution – and faces almost certain conviction – and heightened sanctions for the initial offense.\(^3\)

These DPA-mandates fundamentally alter the liability structure of corporate criminal law. Traditionally, firms were held criminally liable for all crimes committed by their employees in the scope of employment, even if the firm had implemented an effective compliance program or otherwise tried to prevent the crime. More recently, firms faced a de facto liability regime of duty-based liability as a result of U.S. Department of Justice (DOJ) non-prosecution policy which enabled firms to avoid conviction or indictment if they took certain actions to assist federal enforcement efforts, including adopting an effective compliance program, self-reporting detected wrongdoing and cooperating with federal authorities’ efforts to obtain evidence of the crime and identify the wrongdoers. We refer to these corporate activities as “policing” measures. We will refer to a regime that imposes liability only if the firm commits a substantive violation (as opposed to a failure to adopt the requisite compliance measures) as “harm-contingent” and a regime where liability is contingent (or enhanced) if a firm fails to satisfy the requisite policing duties as “duty-based.” Thus, the initial de facto regime is both harm-contingent and duty-based.

The use of DPAs to mandate internal reforms alters this regime in two ways. First, DPA-policing mandates require firms to adopt policing measures that differ from those generally imposed on firms ex ante, for example through duty-based liability. Some require a different, and stricter, compliance program that those generally required by similar firms not subject to a DPA. Others mandate changes in the internal responsibility over the firm’s compliance program or require enhanced external oversight of compliance. Accordingly, DPA that impose mandates that differ from the

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\(^2\) These mandated compliance programs differ from the compliance programs that firms generally adopt voluntarily. See infra note. They also often differ from the compliance program sufficient to satisfy the requirements of an “effective compliance program” as defined by the Organizational Sentencing Guidelines.

duties that are generally applicable \textit{ex ante}, thus create duties that are both firm-specific and crime-contingent. Second, a mere violation of these “ex post” compliance duties, without the commission of (another) substantive violation by a firm agent, exposes the firm to liability. Put differently, once a firm has entered into a DPA, its liability for violating its policing duties is no longer harm-contingent. Accordingly, through DPA mandates, prosecutors can become firm-specific, quasi-regulators.\textsuperscript{4} They impose specific duties on a subset of firms with alleged wrongdoing; they enforce compliance with these duties through sanctions for a mere failure to adopt the specified compliance measure, even if the firm commits no further substantive violation; and they do all of this without any effective guidance from the Department of Justice,\textsuperscript{5} without any apparent coordination across districts, and often without much expertise about the industry in which the firm operates and the wrongdoing it was charged with.

Unsurprisingly, this usurpation of regulatory authority and the manner in which is exercised has given rise to charges of prosecutorial abuse of discretion in imposing mandates\textsuperscript{6} and calls for greater DOJ guidance to prosecutors in the use of these mandates. Yet existing analysis has not yet addressed the most fundamental questions raised by this innovation. When, if ever, is it justifiable to impose crime-contingent mandates enforced by quasi-regulatory (non-crime-contingent) liability on firms with detected wrongdoing? And, which types of crime-contingent mandates plausible enhance social welfare?

This Article examines the economic justifications for the imposition of crime-contingent policing duties (e.g., compliance program reform, monitors, and other internal reforms) through DPAs. We begin with the standard economic analysis of corporate criminal liability which shows, first, that in order to optimally deter corporate crime, corporate liability must induce firms to adopt optimal compliance programs, self-report, and cooperate (hereinafter “policing measures”), and that the state can achieve all of these goals by adopting a duty-based composite liability regime that relies entirely on monetary sanctions.\textsuperscript{7} Specifically, the corporate liability regime must impose ex


\textsuperscript{5} Accord Garrett, \textit{ supra} note 1, at 893(“[N]o DOJ guidelines define what remedies prosecutors should seek when they negotiate structural reform agreements.”). By contrast, the DOJ has issued guidance on a variety of other issues relating to corporate prosecutions, including (1) whether to impose extraordinary restitution, (2) when to seek a waiver of the attorney-client privilege, and (3) the decision to impose a corporate monitor. \textit{See infra} note 127 (discussing these guidelines); \textit{infra} note.

\textsuperscript{6} \textit{See infra} notes 56 and (discussing examples of prosecutorial abuse of discretion in this area).

ante policing duties on all firms; these duties are enforced by subjecting firms with
detected wrongdoing to substantially higher (often criminal) sanctions if the firm failed
to take the requisite policing measures (harm-contingent duty-based sanctions) than if it
did not.\textsuperscript{8} Such a duty-based liability regime can, if the liability standards and sanctions
are set at the optimal levels,\textsuperscript{9} generally both achieve optimal deterrence of substantive
violations and create optimal incentives to adopt policing measures.\textsuperscript{10} This analysis
thus implies that there is no justification for using DPAs to impose firm-specific crime-
contingent policing duties absent a specific reason for concluding that an optimal duty-
based corporate liability regime would not be effective.

We identify three sets of circumstances where enforcement authorities cannot
rely on such a composite corporate liability regime to induce optimal corporate
policing. First, when the firm does not have sufficient assets to pay the optimal
monetary sanction (corporate asset insufficiency).\textsuperscript{11} Second, when management has
private reasons not to adopt optimal policing measures (policing agency costs). Third,
when special features may make heightened duties optimal for a particular subset of
firms.\textsuperscript{12} Nevertheless, we find that these circumstances do not all justify the imposition
of DPA mandates. DPA mandates are only justified if they are superior to other
mechanisms for supplementing duty-based corporate liability: in particular, to ex ante
regulation. We find that only policing agency costs provide a plausible rationale for
imposing duties through DPAs. By contrast, regulation is generally superior to DPA-
mandates for addressing asset insufficiency and the need for heightened duties.

Our conclusion that DPA-imposed mandates can be justified when needed to
redress policing agency cost, in turn, has implications for the proper use and scope of
these mandates. First, DPA mandates should be used only when there are reasons to
believe that management failed to ensure effective corporate compliance for private

\textsuperscript{8} As is explained in Section I, firms which comply with all of their policing duties generally
should still be held liable (either civilly or through monetary sanctions imposed through a DPA) (harm-
contingent, non duty-based sanctions) in order to ensure that firms with optimal policing have optimal
incentives to take other measures to deter wrongdoing (i.e., prevention). Arlen & Kraakman, supra note
7.

\textsuperscript{9} If the liability standard and sanctions are not optimal, the proper response is of course to modify
the liability standard and the sanctions ex ante, rather than through ex post mandates. Although note that
optimal liability standards and sanctions do not imply that firms will never commit crimes and always
adopt the required policing measures.

\textsuperscript{10} Arlen & Kraakman, supra note 7 (showing that duty-based composite liability can achieve all
the deterrence goals of corporate enforcement including inducing optimal corporate policing, prevention,
and activity levels).

\textsuperscript{11} Cf. Khanna & Dickinson, supra note 3 (suggesting that asset insufficiency would justify
corporate monitors, a type of harm-contingent duty).

\textsuperscript{12} The economic justifications for mandates do not include a core justification often used by
prosecutors: the concern that convicting the firm would trigger collateral sanctions that would ruin the
firm. See infra Section II.A.
benefit.13 Second, to be effective, DPAs mandates must be designed to addressing policing agency costs, and cannot simply impose standard policing duties and rely on the deterrent effect of ex post corporate sanctions imposed to induce compliance with any mandates.14 Instead, DPA-mandates must be designed to reduce policing agency costs. This generally is best accomplished by imposing meta-policing duties which shift responsibility for corporate compliance, and access to immediate information about corporate violations, to actors less affected by agency costs. In some cases, this can be achieved through mandates enhancing the authority (and information access) of particular outside directors. In others, external oversight is needed. Thus, DPAs should not impose mandates that either to no more than alter the structure of a firm’s compliance program in ways that unlikely to mute policing agency costs or that reduce general agency costs without addressing those affecting corporate policing. Third, DPA mandates should not impose requirements that shareholders can impose, and monitor compliance with.

Finally, we examine the actual practice regarding DPA mandates to determine whether prosecutors are imposing mandates that are plausible justified by optimal deterrence. [This section is to be completed]

This Article proceeds as follows. Part II discusses the optimal structure of corporate liability and the actual practice, including the use of DPAs. Part III compares DPA mandates with two more common liability regimes – duty based, harm-contingent liability and ex ante policing regulation – and discusses the reasons why these other regimes are generally preferable to DPA mandates. Part IV examines three rationales for DPA mandates – asset insufficiency, policing agency costs, and targeted heightened duties. We conclude that only policing agency costs can plausibly justify DPA mandates and derive the implications for the when such mandates should be imposed and how they should be structured. Part V examines the DPAs imposed through Main Justice from 2003-2010 in light of the analysis in Part IV and identifies needed reforms. Part VI concludes.

II. PURPOSES AND STRUCTURE OF CORPORATE CRIMINAL ENFORCEMENT

In this Part, we first present the classic economic analysis of optimal corporate monetary sanctions, focusing on liability imposed on firms whose owners are not

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13 Thus, DPA mandate are not justified merely because a firm agent committed a substantive crime and the firm had failed to take the required policing measures, even if such failure was intentional. If the expected monetary sanction on the firm is insufficient to induce optimal policing, the response should be to increase the sanction, rather than to impose an ex post policing mandate. Moreover, depending on the context, it may be socially optimal to let firms chose between taking the required policing measures and facing a lower probability of sanction and taking less measures and facing a higher probability of sanction.

14 The threat of imposing significant penalties on the corporation (borne, mostly, by its shareholders) for violating the mandates does not address the core problem that management, for private reasons, acts in manner that is not in the best interest of the corporation and its shareholders.
directly involved in day-to-day management, such as publicly held firms. An optimal corporate liability regime induce firms to deter employee wrongdoing by adopting both optimal “prevention measures”—defined as measures that reduce the benefit or increase the direct cost of crime—and optimal “policing measures,” which are measures that increase the probability that crimes are detected and individual wrongdoers’ are identified and convicted. We review the economic literature to show that the state can create optimal incentives through a composite liability regime, which holds firms liable for their employees’ crimes but dramatically lowers the sanctions imposed on firms that have taken proper policing measures (often eliminating all formal criminal sanctions) while enhancing sanctions for firms which did not take proper policing measures. We refer to such a regime as “duty-based corporate liability,” to reflect the fact that corporate sanctions depends on a firm’s compliance with prosecutor-imposed policing duties. We then show that the DOJ’s policy of not indicting, but nevertheless sanctioning, firms that self-report and cooperate is a form of duty-based corporate liability. Finally, we argue that the recent practice of using DPAs to impose policing mandates on some firms with detected wrongdoing presents a departure from duty-based corporate liability. Duty-based corporate liability involves the imposition of general policing duties imposed on all firms enforced with the threat of monetary sanctions. DPA policing mandates supplement this liability with firm-specific policing mandates, imposed on a subset of firms by individual prosecutors, and which subject firms to the threat of sanction for a mere policing failure, even in the absence of a substantive violation. Since duty-based corporate liability can create optimal incentives for both policing and preventing, this raises the question of whether and when social welfare is enhanced by allowing federal enforcers supplement duty-based liability with firm-specific policing duties enforced by sanctions imposed for breach of duty alone.

A. Economic Analysis of Corporate Criminal Liability

Individuals knowingly commit corporate crimes when they expect to derive a net benefit from doing so. Accordingly, corporate managers (and other employees) who do not own a significant percentage of a company’s stock do not commit crimes while acting on behalf of the company in order to benefit the firm and its shareholders.

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15 We focus on firms where the shareholders are not directly involved in managing the firm on a day-to-day basis, and will not have been directly involved in any corporate wrongdoing.


17 Throughout this article, corporate crime is defined as a crime committed by an employee of the firm in the scope of employment with some ostensible benefit to the firm in the short run.

18 See Arlen, supra note 16, at 194 n. 39 (discussing why corporate crime can be treated as the product of self-interested rational decisionmaking even if many street crimes are not).
Instead, they commit such crimes to obtain private benefits, including job protection and additional compensation associated with illusory or short-term corporate gains. Thus, employees (including managers) can benefit from corporate crimes even when the committing the crime does not benefit the firm, given the expected reputational and monetary sanctions to the firm associated with detection. Put differently, crimes by publicly-held firms often are an agency cost, best deterred by imposing liability directly on the individual wrongdoers.

Nevertheless, the government generally cannot optimally deter crime by employees of publicly-held corporations through individual liability alone. The sanction that can optimally be imposed on individuals is constrained by the wealth of the individual and the high social cost of imprisonment. Given these limited sanctions, enforcement authorities often would be unable to detect wrongdoing or sanction individual wrongdoers with sufficient regularity to ensure that corporate crime does not pay if required to rely entirely on their own resources.

To optimally deter crime given limits on sanctions, enforcement authorities need to increase the probability that wrongdoers are detected and sanctioned. Often, the most cost-effective way to do this is to induce firms to detect wrongdoing, investigate detected wrongs to identify the individuals responsible and obtain the evidence needed to convict them, and then self-report and cooperate (“policing measures”). Firms also can lower the net social cost of crime by adopting “prevention measures” that reduce

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19 The present analysis focuses on wrongdoing by publicly-held firms or other large firms where managers and other employees can commit crimes in pursuit of private benefits.

20 We define “corporate crimes” as those for which the firm could be criminally liable under federal law. This implies that there must be some intent to benefit the firm. Nevertheless, the net effect of the crime on the firm is negative once reputational effects or criminal liability are taken into account. See infra note 21.

21 See Cindy R. Alexander & Mark A. Cohen, Why Do Corporations Become Criminals? Ownership, Hidden Actions, and Crime as an Agency Cost, 5 J. CORP. FIN. 1 (1999) (evidence that the incidence of corporate crime by publicly-held firms is higher the lower the stock ownership of directors and senior officers is consistent with agency cost hypothesis); see also Jennifer Arlen & William Carney, Vicarious Liability for Fraud on Securities Markets: Theory and Evidence, 1992 U. ILL. L. REV. 691 (securities fraud is an agency cost arising in the shadow of a managerial last period; Mark S. Beasley, An Empirical Analysis of the Relationship Between Board of Director Composition and Financial Statement Fraud, 71 ACCT. REV. 443 (1996) (explaining that directors of firms committing audit fraud and other financial disclosure violations own proportionately less stock than directors of non-offending firms).

22 See Arlen, supra note 7. Many of the gains employees seek—such as promotions, bonuses, and avoiding termination—are one-way effects: employees can get a promotion by benefiting the firm, but generally do not expect to suffer expected losses equal to this benefit even if the wrong is detected. This can occur if the wrong is not attributed to the employee, the employee is not sanctioned, and/or the wrongdoers are managers who survive detection of the crime and are able to adjust their compensation upwards to counteract the negative effect on the firm of the crime. See Arlen, supra note 16 (discussing the issue of private benefits and showing that the government generally cannot rely on corporate liability alone to optimally deter crime by employees of publicly-held firms).

23 E.g., Arlen, supra note 16 (providing a more detailed discussion of this conclusion).

24 Alexander Dyck, Adair Morse, & Luigi Zingales, Who Blows the Whistle on Corporate Fraud?, 65 J. FIN. 2213 (2010) (providing evidence that most corporate frauds are not detected by the government).
Corporations will not undertake these measures unless they are subject to a properly-structured corporate liability regime. As one of us has shown, an optimal regime imposes liability on firms if an employee commits a substantive crime, with heightened criminal sanctions if the firm failed to take optimal policing measures. Firms with optimal policing must nevertheless face some form of monetary sanction in order to induce them to adopt optimal prevention measures. The fact that firms that police optimally nevertheless must bear sanctions implies that the sanctions imposed on firms that breach their policing duties must be very large: sufficiently large to ensure that firms face sufficiently higher expected sanctions when they do not satisfy their policing duties than when they do policing optimally, even though a failure to police reduces the probability they will be sanctioned. One way to achieve this goal is to impose civil and criminal liability on firms that do not comply with their policing duties, while exempting from formal prosecution those that do satisfy their policing duties—especially those that self-report and fully cooperate. We will refer to this regime as duty-based liability.

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25 Prevention efforts, in our parlance, make it less likely for wrongdoing to occur to start with, but do not make it more likely for wrongdoing to be detected. For example, firms can affect employees’ incentives to commit crime by altering compensation and promotion policies. They also can adopt policies that make crimes more difficult and expensive to commit.

26 Arlen & Kraakman, supra note 7.

27 Arlen & Kraakman, supra note 7; see Arlen, supra note 7.

28 Federal authorities need to use multiple levels of duty-based sanction enhancements targeted at specific types of policing because policing measures occur sequentially over time. Compliance programs are adopted ex ante, compliance audits when wrongdoing is suspected, reporting once wrongdoing is detected, and cooperation subsequent to that. Each duty-based penalty enhancement should be designed to ensure that, at each point in time, companies benefit from satisfying their future duties even if they failed to comply with their duties in earlier periods. Arlen & Kraakman, supra note 7 and Arlen, supra note 16, and summarized in Arlen, supra note 7.

30 The government needs to use duty-based liability to induce optimal policing because strict corporate liability with a fixed fine cannot induce both optimal policing using the sanction that induces optimal prevention in equilibrium. Arlen & Kraakman, supra note 7 (showing that duty-based liability can induce optimal ex ante and ex post policing whereas strict respondeat superior liability with a fixed fine cannot); Arlen, supra note 7 (same for ex ante monitoring); cf. Louis Kaplow & Steven Shavell, Optimal Law Enforcement with Self-Reporting Behavior, 102 J. Pol. ECON. 583 (1994) (showing that individuals can be induced to self-report by reducing the sanction commensurate to counteract the liability enhancing effect of self-reporting on the probability of sanction). For an in-depth discussion of the justifications for and optimal structure of corporate liability see Arlen & Kraakman, supra note 7; Arlen supra note 16.
B. Actual Corporate Criminal Enforcement

Current U.S. corporate criminal enforcement practice resembles the duty-based liability regime discussed above, at least in the case of publicly-held firms. In the U.S., corporations are subject to *de jure* strict corporate liability for crimes committed by employees in the scope of employment through the doctrine of *respondeat superior* regardless of whether they failed to police.\(^{31}\) The scope of corporate criminal liability is unusually broad and extends even to crimes committed by low-level employees,\(^{32}\) even when employees violated official corporate directives.\(^{33}\) Corporations convicted of crimes can be subject to substantial criminal sanctions (both absolutely and relative to their assets), including a criminal fine, criminal restitution, remediation, and nonmonetary criminal sanctions (such as corporate probation).\(^{34}\) They also can be subject to civil penalties and administrative sanctions,\(^{35}\) including potentially ruinous collateral penalties, such as debarment from contracting with particular federal agencies.\(^{36}\)

Although *respondeat superior* is the *de jure* standard governing corporate liability, in practice firms (especially publicly-held firms)\(^{37}\) are subject to a duty-based regime as a result of DOJ guidelines that encourage prosecutors not to indict firms that adopt certain policing measures.\(^{38}\) In practice, in determining whether to indict,

\(^{31}\) Individuals are criminally liable for crimes committed with the requisite mens rea even if they acted on behalf of the firm and were following instructions.

\(^{32}\) E.g., United States v. Dye Constr. Co., 510 F.2d 78 (10th Cir. 1975); Tex.-Okla. Express, Inc. v. United States, 429 F.2d 100 (10th Cir. 1975); Riss & Co. v. United States, 262 F.2d 245 (8th Cir. 1958); United States v. George F. Fish, Inc., 154 F.2d 798 (2d Cir. 1946).

\(^{33}\) E.g., United States v. Twentieth Century Fox Film Corp., 882 F.2d 656 (2d Cir. 1989); United States v. Hilton Hotels Corp., 467 F.2d 1000 (9th Cir. 1972), cert. denied 409 U.S. 1125 (1973) (holding that a corporation can be criminally liable for an employee’s crime committed within the scope of employment even when done against corporate orders); United States v. Ionia Mgmt. S.A., 555 F.3d 303 (2d Cir. 2009). By contrast, many other countries grant a good faith defense to firms that adopt measures to deter crime. *See generally* Sara Sun Beale & Adam G. Safwat, *What Developments in Western Europe Tell Us about American Critiques of Corporate Criminal Liability*, 8 BUFF. CRIM. L. REV. 89 (2005).

\(^{34}\) *See generally* Arlen, *supra* note 16, at Section 1 (providing evidence on criminal fines using data provided by the Sentencing Commission); *see also* Brandon Garrett, *Globalized Corporate Prosecutions*, 97 VA. L. REV. 1775 (2011) (supplementing the Commission’s data to provide evidence on convictions especially of foreign firms).

\(^{35}\) These non-fine sanctions often dwarf the criminal fine. *See* Cindy Alexander, Jennifer Arlen, & Mark Cohen, *Regulating Corporate Criminal Sanctions: Federal Guidelines and the Sentencing of Public Firms*, 42 J. L. & ECON. 393, 410 (1999) (finding that the total monetary public and private sanctions imposed on publicly-held firms following the adoption of the Organizational Sentencing Guidelines was almost three times as large as the mean criminal fine).


\(^{37}\) *See* Arlen, *supra* note 16, at Section 1 (providing theory and evidence that the de facto duty-based regime primarily applies to larger firms, with a separation of ownership and day-to-day control).

\(^{38}\) The first general guidelines were issued by then-Deputy Attorney General Eric Holder in 1999. The “Holder memo” detailed factors prosecutors should consider in deciding whether to indict a firm. Memorandum from Eric Holder, Deputy Attorney General, U.S. Dep’t of Justice, to Heads of Department Components and United States Attorneys (June 16, 1999) [hereinafter Holder Memo]. The current guidelines are contained in Principles of Federal Prosecution of Business Organizations, § 9-28.900 of the
prosecutors tend to focus on whether the firm self-reported and fully cooperated. As a result, de facto criminal liability is harm-contingent and duty-based. Firms exempted from prosecution nevertheless are subject to monetary sanctions, often substantial, imposed with by federal prosecutors (see below), or by regulatory authorities. Both features of the current system are consistent with an optimal corporate liability regime.

C. Use of DPAs to Effectuate and Alter Duty-based Corporate Liability

Since 2003, prosecutors have increasingly used pretrial diversion agreements (DPAs) to effectuate a regime of duty-based corporate liability with monetary sanctions. They also have used DPAs to supplement standard duty-based liability with a more regulatory type of intervention: policing duties imposed on select firm and enforcement through the threat of non-crime-contingent sanctions. Federal prosecutors have imposed at least 163 such agreements between 2003 through 2010.


Prosecutors tend to focus on corporate cooperation when determining whether to indict a corporation, consistent with a policy memo issued by then-Deputy Attorney General Larry Thompson stating that public welfare often is served by exempting a firm from conviction to obtain its cooperation. See Memorandum from Larry D. Thompson, Deputy Attorney General, U.S. Dep’t of Justice, to Heads of Department Components and United States Attorneys (Jan. 20, 2003) [hereinafter Thompson memo]. Nevertheless, questions remain about whether policing activities are equally effective at insulating foreign firms from criminal liability. See Garrett, supra note [43].

Prosecutors also consider the collateral consequences to innocent parties of conviction and remedial measures taken by the firm in deciding whether to defer prosecution. General Accounting Office, Preliminary Observations on the Department of Justice’s Use and Oversight of Deferred Prosecution and Non-Prosecution Agreements, GAO-09-636T (June 25, 2009).

These non-fine sanctions often dwarf the criminal fine. See Cindy Alexander, Jennifer Arlen, & Mark Cohen, Regulating Corporate Criminal Sanctions: Federal Guidelines and the Sentencing of Public Firms, 42 J. L. & ECON. 393, 410 (1999) (finding that the total monetary public and private sanctions imposed on publicly-held firms following the adoption of the Organizational Sentencing Guidelines was almost three times as large as the mean criminal fine).

Pre-trial diversion agreements were used prior to 2003, most prominently in the 1994 DPA with Prudential. Mary Jo White, Corporate Criminal Liability: What Has Gone Wrong?, 237TH ANN. INST. SEC. REG. 815, 818 (PLI Corp. Law & Practice, Course Handbook Series No. B-1517, 2005). Nevertheless, the Thompson memo was an official endorsement of these agreements and dramatically increased their use. In the entire period prior to 2002, prosecutors negotiated only 18 DPAs. See Garrett, supra note 1. By contrast, prosecutors at main justice negotiated at least 163 in the 7 years between 2003 and 2010 (Table 1). Also DPAs issued after the Thompson memo are more likely to impose firm-specific crime-contingent policing duties and monitors. See Lisa Kern Griffin, Compelled Cooperation and the New Corporate Criminal Procedure, 82 N.Y.U. L. REV. 311, 323 (2007); Spivack & Raman, supra note 3, 166–67; see also Baer, supra note 36, at 969–70.

We focus on DPAs entered into by Main Justice and the U.S. Attorney’s offices. We do not considering agreements done by the Antitrust or Environmental Divisions. For a discussion of enforcement practices of other divisions, see Daniel Skokol (antitrust); Garrett, supra note 34 (discussing federal enforcement as applied to foreign firms).
Under pretrial diversion agreements—which can take the form of a non-prosecution agreement or a deferred prosecution agreement—prosecutors agree not to proceed criminally against the firm generally to reward the firm for certain acts of good policing behavior, which generally includes by agreeing to fully cooperate with federal investigations and often includes self-reporting the crime. DPAs differ from a simple grant of amnesty because they enable prosecutors to require firms to comply with certain mandates in return for non-prosecution. Prosecutors use DPAs to enforce a firm’s commitment to cooperate with prosecutors. They also use them to impose “fines” and other monetary sanctions—sanctions the prosecutor could not impose on a firm granted amnesty from prosecution. As is shown in Table One, the fines imposed by, or enforced through, DPAs can be substantial. The imposition of substantial sanctions on firms, even if they satisfied their policing duties, is consistent with optimal duty-based liability provides that the sanctions are set at the level needed to induce optimal prevention and also are sufficiently smaller than the sanction that would be imposed on the firm if it did not comply (and got convicted of the crime) to ensure that the firm faces lower expected costs if it polices effectively.

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43 Most prosecutors focus on the firm’s willingness to cooperate, collateral consequences to innocent parties of conviction, and remedial measures taken by the firm in deciding whether to defer prosecution. Nevertheless, prosecutors do vary in the factors they consider. General Accounting Office, Preliminary Observations on the DOJ’s Use and Oversight of Deferred Prosecution and Nonprosecution Agreements, GAO-09-636T (June 25, 2009). Moreover, at least one office has granted leniency to firms that initially actively refused to cooperate. Prepared Statement by Christopher J. Christie, Former U.S. Attorney for New Jersey, given before the House... (June, 25, 2009).

44 Prosecutors also use DPAs to enforce penalties imposed by other agencies

45 Arlen & Kraakman, supra note 7; Arlen, supra note 16; but see. Andrew Weissmann, A New Approach to Corporate Criminal Liability, 44 AMER. CRIM. L. REV. 1319, 1320 (2007) (arguing that firms that engage in effective policing (e.g., compliance programs) should not be sanctioned for their employees’ crimes). To induce optimal compliance programs, this sanction must be duty-based, in that the sanction imposed on firms exempt from prosecution should be much higher if they did not adopt an effective compliance program than if they did. Arlen, supra note 7; Arlen & Kraakman, supra note 7.
Table One

Federal Criminal DPAs: Penalties Imposed

(Dollars in Millions)

<table>
<thead>
<tr>
<th>Year</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total DPAs</td>
<td>5</td>
<td>9</td>
<td>14</td>
<td>20</td>
<td>39</td>
<td>19</td>
<td>19</td>
<td>38</td>
</tr>
<tr>
<td>DOJ “Fine”(^47)</td>
<td>$28</td>
<td>$144</td>
<td>$170</td>
<td>$525</td>
<td>$304</td>
<td>$130</td>
<td>$21</td>
<td>$1,739</td>
</tr>
<tr>
<td>Mean DOJ “Fine”</td>
<td>$5.6</td>
<td>$16</td>
<td>$12</td>
<td>$26</td>
<td>$7.8</td>
<td>$6.8</td>
<td>$1.1</td>
<td>$46</td>
</tr>
<tr>
<td>Total Penalty (All)(^48)</td>
<td>$300</td>
<td>$1,043</td>
<td>$2,173</td>
<td>$3,153</td>
<td>$2,027</td>
<td>$270</td>
<td>$2,822</td>
<td>$4,648</td>
</tr>
<tr>
<td>Mean Total Penalty(^49)</td>
<td>$60</td>
<td>$116</td>
<td>$155</td>
<td>$137</td>
<td>$51</td>
<td>$14</td>
<td>$149</td>
<td>$126</td>
</tr>
</tbody>
</table>

Yet prosecutors are not simply using DPAs to enable them to effectuate a duty-based corporate liability regime. Some prosecutors are using DPAs to impose policing mandates on firms. These ex-post mandates often, but not always, go beyond the scope of generally applicable \textit{ex ante} policing standards, and thus constitute firm-specific crime-contingent policing duty.\(^50\) For example, they most DPAs require the firm to

---

\(^{46}\) We hand-collected data on DPAs and checked it against DPA datasets available through Gibson Dunn, Ethisphere, Vic Khanna, and Brandon Garrett. Garrett’s dataset includes a few that we did not include here where the DPA was listed but the agreement was not attached and we could not confirm it independently. Garrett’s data incorporates a list of DPAs obtained from the U.S. Government Accountability Office. We excluded those that we could not confirm because we determined that one of these agreements was a civil settlement agreement, and not a DPA. The following list of agreements are excluded here: Facility Group (2010), M.A. Angelides (2010), Cosmetic Laboratories of America (2010), McSha Properties (2009), Frosty Treats (2009), Unum (2008), Levad (2008), RFK Institute (2008), Holy Spirit Organization (2007), and Medicis (2006). Professor Garrett’s dataset is available at [http://lib.law.virginia.edu/Garrett/prosecution agreements/home.suphp](http://lib.law.virginia.edu/Garrett/prosecution agreements/home.suphp).

\(^{47}\) “DOJ Fine” includes all sums described as a fine or penalty imposed by the DOJ. It excludes any guilty pleas by subsidiaries, unless expressly incorporated into the agreement as payable by the parent corporation.

\(^{48}\) Total monetary penalty is all penalties included under the DPA, including restitution, disgorgement, all amounts owed to other government actors that are mentioned in the DPA, and parallel agreements entered into at the same time as the DPA based on the same alleged misconduct. It excludes any private class actions that are mentioned in the agreement, but includes shareholder class action funds that DOJ or SEC requires the firm to create in case of any future litigation. These amounts also do not include penalties imposed by foreign enforcement authorities.

\(^{49}\) Averages and medians are based on the total firms subject to DPAs. In every year except 2003, at least one firm did not have a recorded monetary sanction.

\(^{50}\) Even a mandate that merely requires the firm to comply with the requirements for an effective compliance program set forth in the sentencing guidelines may in effect alter the policing standards. The reason for this is that the guidelines requirement is non-specific and leaves the firm with a lot of discretion as to how much to spend on compliance, the size of the office, what information to collect, whom to train and how to do the training etc. Thus firms largely determine what constitutes effective compliance and are free from intrusion or sanction for breach unless a crime occurs and is detected. By contrast, a DPA allows the prosecutor to provide on-going input on whether she thinks the firm is putting in a program that is “effective”—especially when there is a monitor—and can threaten immediate sanction of revoking the DPA. While technically this would be subject to court oversight, in general there are good reasons to believe that firms will comply with prosecutor/monitor directives rather than standing
adopt a compliance program with a particular structure. Some require programs targeted to at deterring a specific crime (e.g., money laundering) or change the structure of internal responsibility over the firm’s compliance program (e.g., by requiring that the firm designate the Chief Compliance Officer (CCO) to report directly to an independent Chairman of the Board or to outside directors or that the firm hire an outside monitor to regularly audit the firm to ensure its compliance with the duties imposed by the agreement).

Table Two
Policing Duties Imposed Through Federal Criminal DPAs 2003-2010

<table>
<thead>
<tr>
<th>Total DPAs</th>
<th>Compliance Program</th>
<th>Monitor</th>
<th>Other Duties</th>
<th>Duration</th>
</tr>
</thead>
<tbody>
<tr>
<td>163</td>
<td>104 (65%)</td>
<td>54 (35%)</td>
<td>35 (20%)</td>
<td>3.5-60</td>
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As an example of the often detailed, firm-specific ex post mandates imposed by a DPA, consider the agreement with Bristol-Myers Squibb (BMS). Under the agreement, BMS agreed to:

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their ground and going to the judge (with the risk of noncompliance hanging over them). Thus by moving from harm contingent to non harm contingent liability, one only changes the probability of sanction for breach but may in fact shift primary authority over what constitutes “effective compliance” from the firm (subject to ex post review) to the prosecutor (with ability to intervene ex ante).

Many require firms to adopt compliance programs that are consistent with the provisions of the U.S. Sentencing Guidelines governing an “effective” compliance program. In so doing, this translates the guideline provision from a precatory provision that simply affects the magnitude of the potential sanction, to a quasi-regulatory mandate non-compliance with which can result in a conviction. This is significant since the effective program outlined in the Organizational Guidelines differs materially from those that firms tend to adopt voluntarily. For example, whereas voluntary programs often integrate compliance efforts into the corporate divisions most directly affected by compliance efforts and focus on ethics training, mandated programs generally require the adoption of a compliance office separate from the core workings of the firm and adopt a more enforcement-oriented approach. Finder, et al., supra note 1, at [15 in draft]; cf. Cristie Ford & David Hess, Can Corporate Monitorships Improve Corporate Compliance, 34 J. CORP. L. 679, 692 (2008-09) (evidence suggests that the most effective programs are those that are integrity-based, as opposed to compliance-based programs that focus on punishment for rule violations). Thus, the use of DPAs to require compliance with the Organizational Guidelines’ compliance program (or any other program) does constitute the imposition of a crime-contingent policing duty to which the firm would not otherwise be subject (or necessarily voluntarily comply with). Moreover, many of the compliance program duties deviate from the provisions of the Guidelines. See Garrett, supra note (discussing this issue). Provisions in DPAs involving money laundering, health care fraud and FCPA violations are particularly likely to differ from the standard compliance program outlined in the Guidelines and tend to be crime-specific.

See infra…. For a detailed discussion of the monitoring provisions of these agreements see Khanna & Dickinson, supra note 3, at 1724 (discussing corporate monitor provisions in DPAs).

This is all crime-contingent duties other than a compliance program and a monitor. This does not include the duty to cooperate with the investigation of the current crime or the duty to fire specific officers complicit in the crime.

Duration is in months. We exclude any agreements without a set term limit.
• adopt a *specified* compliance program;
• mandate that certain employees undergo a training program covering specified topics;
• separate the positions of Chairman of the Board and CEO and appoint an additional outside director, approved by the U.S. attorney’s office, to the board;
• require that the Chairman participate in preparatory meetings held by the CEO, CFO, General Counsel and others in anticipation of BMS’s quarterly conference calls for analysts and that the Chairman, CEO and General Counsel contemporaneously monitor these calls;
• hire and pay for a prosecutor-approved corporate monitor who would have authority to oversee compliance with the agreement and with federal law; on a quarterly basis with the CEO, Chairman, General Counsel the prosecutor’s office; and file quarterly reports;
• have the CEO and CFO submits reports to the Chairman, the Chief Compliance Officer and the monitor on four specific topics relating to sales, earnings, budgeting and projections, have the CFO, General Counsel and Chief Compliance Officer provide direct regular reports to the Chairman; and
• make disclosures of specific facets of its sales in its SEC reports that go beyond those required under the securities laws.⁵⁶

⁵⁵ Corporate probation orders also can involve firm-specific duties. They differ from DPAs because they are governed, or least influenced by, the Organizational Sentencing Guidelines, and thus their mandated compliance programs tend to conform to these guidelines. Moreover, extensive mandates that reach beyond a compliance program are less common. Nevertheless, to the extent that plea agreements also impose firm-specific crime-contingent duties, this analysis applies to such interventions.

⁵⁶ Bristol-Myers Squibb DPA, *reprinted* in KATHLEEN BRICKEY, CORPORATE AND WHITE COLLAR CRIME: SELECTED STATUTES, GUIDELINES AND DOCUMENTS 153–80 (2011–12). In addition, BMS agreed to waive the attorney client privilege. The Bristol-Myers Squibb DPA also included an extraordinary restitution award, requiring BMS to spend $5 million to endow a chair in business ethics at Seton Hall Law School—the alma mater of Christopher Christie, the U.S. Attorney supervising the case. Interview with Mary Jo White, 19 CORP. CRIME REP. 48 (Dec. 12, 2005); see also Christopher J. Christie & Robert M Hanna, *A Push Down the Road of Good Corporate Citizenship: The Deferred Prosecution Agreement Between the U.S. Attorney for the District of New Jersey and Bristol-Myers Squibb Co.*, 43 AM. CRIM. L. REV. 1043, 1052–53 (2006). We do not focus on the issues of waiver, extraordinary restitution, or efforts to prohibit a firm from honoring its contractual obligations to pay its employees’ attorneys’ fees because the DOJ has intervened to prohibit or curtail such abuses. See infra note (discussing these efforts); see U.S. Att’y Manual 9-28.710–720 (prosecutors generally should not require firms to waive their attorney-client privilege but can require them to produce all the facts concerning the crime, including those gained by the General Counsel); Memorandum from Mark Filip to Holders of the U.S. Attorneys’ Manual Re: Plea Agreements, Deferred Prosecution Agreements, Non-Prosecution Agreements and “Extraordinary Restitution” (May 14, 2008) (“[P]lea agreements, deferred prosecution agreements, and non-prosecution agreements should not include terms requiring the defendants to pay funds to charitable, educational, community, or other organization or individual that is not a victim of the criminal activity or is not providing services to reduce the harm caused by the defendant’s criminal conduct.”). It also now discourages prosecutors from interfering with corporate payments of employees’ legal fees. Principles of Federal Prosecution of Business Organizations, Memorandum from Mark R. Filip, Deputy Attorney General, to Heads of Department Components and United States Attorneys (Aug. 28, 2008).
Moreover, DPAs not only impose crime-contingent duties, they also enable prosecutors to sanction the firm if it breaches its duties even if this breach is not accompanied by a future crime. Specifically, DPAs give prosecutors the right to terminate the agreement and file criminal charges against any firm that fails to comply with the policing mandates specified in the DPA. This amounts to an enhanced sanction tied to breach of the firm’s newly imposed policing duties because DPAs generally require a firm to agree to a statement of facts under which the firm in effect admits it committed the crime. This results in a materially enhanced expected penalty for any firms that might have escaped conviction or might have been eligible for sanction mitigation prior to the DPA. Thus, DPA-imposed mandates transform a liability regime that is harm-contingent into a regime that is non-harm-contingent. Prosecutors in effect are able to use DPAs to engage in a form of firm-specific regulation of corporate policing, enforced through non-crime-contingent sanctions.

DPAs imposed mandates, and the accompanying use of non-harm-contingent liability, raise several questions. What justifies the transformation of the liability regime from harm-contingent liability to non-harm-contingent liability, sometimes coupled with the change in the underlying policing duties? Why should such mandates be imposed only on firms with a prior substantive violation—and only on a subset of those firms—with the ultimate authority over these duties resting to a large extent with federal prosecutors? And, if such mandates are sometimes justified, on what firms should they be imposed and what should be their proper scope? The remainder of this Article seeks to answer these questions.

III. DPA MANDATES VERSUS LIABILITY AND REGULATION

DPA-imposed mandates are one of several mechanisms available to enforcement authorities in their effort to deter corporate crime by inducing optimal corporate prevention and policing. Two other alternative mechanisms are duty-based corporate liability and ex ante regulation. DPA-imposed mandates operate as a supplement to duty-based liability and as an alternative to the imposition of general policing duties through ex ante regulation. This Part compares DPA-imposed mandates to the two more common sanctions regimes, duty-based corporate liability and ex ante regulation, identifying the core features that distinguish these various regimes. We then show that duty-based corporate liability is generally superior to either of the non-harm-

57 Accord Garrett, supra note 1, at 857, 928. These terminations and subsequent convictions do occur. For example, in 2008 the DOJ concluded that Aibel Group “failed to meet its obligations” under its DPA and revoked its DPA with the firm. The firm pleaded guilty to charges of conspiracy to violate the Foreign Corrupt Practices Act and to a substantive violation of the anti-bribery provisions of the FCPA. Aibel was required to pay a $4.2 million fine and serve two years on organization probation. Press Release, Department of Justice, Aibel Group Ltd. Pleads Guilty to Foreign Bribery and Agrees to Pay $4.2 Million in Criminal Fines (Nov. 21, 2008), http://www.justice.gov/opa/pr/2008/ November/08-crm-1041.html.

58 Finder et al., supra note 1.
contingent mechanisms (regulation and DPA-mandates) for inducing optimal policing and prevention measures. This implies that the DPA-mandates are optimally employed (if at all) as a supplement to duty-based corporate liability, and only when two conditions are met. First, duty-based liability must fail to create proper incentives for corporate policing. Second, DPA-imposed mandates must be superior to general duties imposed through ex ante regulation. In this Part, we identified the central tradeoffs between DPA-mandates and regulation. The next Part applies this analysis to identify the precise situations where duty-based liability is not sufficient and where DPA mandates, not regulation, should be used to supplement it.

A. Taxonomy of Potential Corporate Deterrence Regimes

We now identify the central distinctions between DPA-imposed duties and the leading (and more dominant) alternative liability regimes: the duty-based corporate liability regime and regulation. Corporate liability regimes can be distinguished along two dimensions: (1) whether or not liability is contingent on the firm having failed to adopt requisite policing measures (duty-based versus non duty based liability) and (2) whether or not liability is contingent on a firm agent having committed a substantive violation (i.e., a violation of a duty other than a policing duty) (harm contingent versus non-harm-contingent liability). Figure One shows the possible choices.

Existing duty-based corporate liability is a composite regime consisting of corporate criminal liability that when properly imposed is imposed on firms with detected wrongdoing only if they also failed to satisfy their policing duties, combined
with residual monetary sanctions imposed on firms with detected wrongdoing even when they did satisfy their policing duties, in order to induce corporate prevention.\textsuperscript{59} \textsuperscript{60} We focus on the duty-based liability prong of such corporate liability as that prong creates incentives to take policing measures.\textsuperscript{61}

Duty-based liability and regulation share a common feature. They each impose duties (here policing duties) and make a firm’s violation of those duties a precondition for the imposition of any sanction. Moreover, duty-based liability and regulation also can (and generally do) impose generally applicable \textit{ex ante} policing duties on all firms (or all firms in a particular industry or with particular characteristics). The central distinction between duty-based liability and \textit{ex ante} regulation is that duty-based liability is enforced with a harm-contingent sanction. Thus, under duty-based liability, a firm cannot be sanctioned for breaching its policing duties unless a crime occurred. By contrast, regulatory duties generally are enforced by liability that is not harm-contingent. Thus, firms that fail to comply with their regulatory duties can be sanctioned even if no harm results.\textsuperscript{62}

\textit{DPA-imposed policing mandates have elements in common with, and divergent from, each of these mechanisms. DPA-imposed mandates differ from both \textit{ex ante} regulation and duty-based liability in that they do not involve generally applicable (\textit{ex ante}) duties devised by a regulatory agency, the Sentencing Commission, or announced in advance by DOJ officials.}\textsuperscript{63} Instead, the duties are imposed \textit{ex post}, on a subset of firms that have allegedly committed some substantive violation, they differ on a firm-by-firm basis even within that subset, and their scope is determined by prosecutors. Moreover, DPA-imposed mandates differ materially from the duty-based liability regime that they supplement because the policing duties imposed through DPA-imposed mandates are enforced through non-harm-contingent liability, whereas firms cannot be sanctioned for violating the general policing duties imposed through duty-based liability unless a crime occurs. In this regard, DPA-imposed mandates resemble regulation in that they impose liability that is duty-based, but not harm-contingent, even as they differ from regulation in imposing non-general duties that also are crime-contingent.

\textsuperscript{59} Residual government-imposed sanctions can be imposed by the DOJ through DPAs, by federal civil enforcement authorities (such as the SEC).

\textsuperscript{60} Of course, in specified areas, corporations are also subject to \textit{ex ante} regulations that duty-based and not harm contingent. The existence and scope of such regulations, however, is not central to our analysis which focuses on the shift from (\textit{ex ante}) harm-contingent liability to (\textit{ex post}) non harm-contingent liability for breach of DPA mandates.

\textsuperscript{61} Arlen & Kraakman, \textit{supra} note 7.

\textsuperscript{62} For example, the federal securities laws require companies to have their financial statements audited by independent accountants. A failure to get financial statements audited exposes the company to sanctions regardless of whether the financial statements contain any misstatements.

\textsuperscript{63} Regulatory non-crime-contingent sanctions tend to require government auditing, reporting requirements, or monitoring designed to detect violations of the legal duty.
B. Advantages of Harm-Contingent Corporate Liability

DPA-mandates are imposed on many, but not all, firms with detected criminal wrongdoing, and as a supplement to duty-based corporate liability. Here we consider the justification for the primacy of duty-based liability and examine whether DPA-mandates or regulation might be a superior substitute for it. Because DPA mandates, like regulation, impose sanctions that are not harm-contingent, the classic argument regarding harm-contingent versus non-harm-contingent liability as a mechanism for inducing corporate policing generally apply to DPA mandates. Thus, we begin by examining whether it is generally superior to enforcing policing duties through harm-contingent liability or non-harm-contingent liability.

As previously explained a properly structured duty-based corporate liability regime can induce profit-maximizing firms to undertake optimal prevention and policing measures. As a mechanism for inducing corporate policing, harm-contingent corporate liability has significant advantages over non-harm-contingent liability (regulation and DPAs). Corporate policing entails measures along multiple separate dimensions: adoption of an effective compliance program, effective oversight of the program; investigation of suspected wrongdoing; self-reporting of detected wrongdoing; and cooperation with enforcement authorities. Many of these policies duties only arise if the firm has a suspected substantive violation. Thus, for example, it would be difficult to evaluate whether a firm properly self-reports substantive violations in a context where no such violations have occurred. Accordingly, harm contingent liability clearly is a superior mechanism for enforcing these duties because it focuses the state’s limited enforcement resources on evaluating the effectiveness of the firm’s policing measures in those situations where such evaluation can be best performed.

Moreover, harm-contingent liability also generally is superior to non-harm-contingent liability as a mechanism for enforcing policing duties not harm contingent, in that they are independent of a suspected substantive violation (e.g., the adoption of a compliance program). First, harm-contingent liability for failure to adopt an effective compliance program economizes on enforcement resources. When a suspected

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64 Arlen & Kraakman, supra note 7. Thus, we assume that injurers have sufficient assets to bear the optimal sanction, which equals the social cost of crime divided by the probability that a criminal wrongdoing is detected and sanctioned, as least under certain conditions. See Arlen, supra note 16 (discussing this rule and its exceptions). As discussed in Section II.A infra, non-crime-contingent liability often is superior to crime-contingent liability when defendants do not have sufficient assets to pay the optimal crime-contingent sanction.

65 In other words, the duty to monitor is really composed of two sub-duties—an ex ante duty to adopt an effective compliance program and an ex post duty to oversee it effectively and respond appropriately to red flags. This latter duty also is crime-contingent, arising once there is suspected wrongdoing. The Delaware Court explicitly recognized the dual nature of this monitoring-for-crime duty when it created this duty. In re Caremark Int'l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch. 1996) (finding that directors have a duty to shareholders to adopt an effective monitoring and reporting system and to take overseeing it in good faith).
substantive violation has occurred, the enforcement authorities already must expend the resources to investigate the crime and the adequacy of the firm’s response. The additional cost of evaluating the firm’s compliance program, given those expenditures, is much less than the cost of a compliance audit in the absence of a substantive violation. Moreover, harm-contingent liability also is superior because compliance program efficacy often depends on soft inputs—e.g., the level of attention, commitment and courage of the compliance department-- that can be hard to evaluate in the abstract. Harm-contingent liability enables enforcement authorities to identify those firms with perfunctory as opposed to genuine compliance programs by examining how they work when actually needed. Finally, harm-contingent liability is superior because it is costly to assess whether a firm has complied with its policing duties. Enforcement authorities can best use their enforcement resources by targeting their oversight activities at firms most likely to have deficient corporate policing. Harm-contingent liability achieves this aim, if, as seems likely, firms with detected wrongdoing are more likely to have deficient compliance programs than those without detected wrongdoing. Both DPAs and regulation therefore share the disadvantage, relative to harm-contingent liability, that potential breaches of policing duties are more difficult to evaluate ex ante, outside the context of any specific crime.

This analysis has two implications for non-harm-contingent interventions, such as DPA-mandates and policing-duty regulation. First, they generally are optimally employed as a supplement to duty-based corporate liability and not an alternative to it. Second, neither should be employed except in situations where duty-based liability cannot provide optimal incentives to undertake corporate policing.

66 Consistent with this, the U.S. Sentencing Guidelines imposes a duty on firms to adopt an “effective compliance program” which is composed of a limited number of specific requirements plus a more general “standard” that the program be “effective.” U.S. SENTENCING GUIDELINES MANUAL, ch. 8 (2011). DOJ Guidelines also focus on compliance program effectiveness. Under both, prosecutors are free to look beyond these requirements in determining whether the compliance program was effective.

Ex ante oversight of a duty to oversee an effective compliance program would be extremely costly, and probably not particularly effective, because regulators cannot detect most monitoring duty breaches at a glance from afar; thus, non-crime-contingent liability would require regulators to audit and inspect firms at random, incurring the cost of detailed investigations of firms that are likely to be complying with their duties. Regulatory oversight thus would require an in-depth assessment of compliance program effectiveness, which would be difficult for regulators absent evidence of whether the program operated effectively when there was a wrong. For a discussion of the cosmetic compliance program problem see William S. Laufer, Corporate Liability, Risk-Shifting, and the Paradox of Compliance, 52 VAND. L. REV. 1343, 1415 (1999) (observing that “cosmetic compliance” programs, purchased solely to reduce the firm’s liability, and not to truly reduce corporate crime, could result in increased crime when combined with a corporate leniency program); see also Kimberly D. Krawiec, Cosmetic Compliance and the Failure of Negotiated Governance, 81 WASH. U. L. Q. 487, 504–05 (2003).

67 See Steven Shavell, A Fundamental Enforcement Cost Advantage of the Negligence Rule over Regulation, Harvard Law School Discussion Paper No. 731 (Sept 2012) (by targeting intervention at situations where an accident has occurred, negligence economizes on enforcement costs as harms are more likely to occur when someone was negligent).
C. Efficacy of DPA-Mandates vs. Ex Ante Regulatory Duties and Enforcement

We now turn to the relative efficiency of DPA mandates and regulation as mechanisms to induce corporate liability in situations where it is optimal to supplement duty-based liability. Both DPA-mandates and regulation both impose policing duties that are enforced through non-harm-contingent sanctions. Yet these mechanisms differ in several important respects. First, regulatory duties are generally imposed ex ante without regard to whether the firm has committed a prior substantive violation, whereas DPA mandates are imposed ex post only on firms that have allegedly committed a substantive violation. Second, regulatory mandates are announced in advance and generally are imposed on all firms with a particular characteristic, By contrast, DPA-mandates are discretionary and thus are imposed only on a subset of firms with detected wrongdoing and often are firm-specific (or prosecutors’ office-specific) in their design. Third, regulatory duties are generally imposed by an agency with substantive expertise and after a notice and comment period, whereas DPA policing mandates are imposed and can be designed by prosecutors, with little effective guidance from main justice. These differences suggest that regulatory duties are generally superior to DPA

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68 In this part, we are comparing ex ante regulatory duties (under which the duty is imposed ex ante on all firms of a certain type) with policing mandates that are imposed only on a subset of firms with a detected wrong. Although we focus on DPA-mandates imposed by prosecutors, our analysis of DPA-mandates would also apply to post-crime policing duties imposed by regulatory authorities on select firms with detected wrongdoing.

69 Prosecutors’ offices vary significantly in their use of DPAs (and DPA-mandates). A small number of US Attorneys’ Offices and DOJ divisions are responsible for the vast majority of DPAs. Spivack & Raman, supra note 3, at 166; GAO Report, supra, at 3 (reporting results of a preliminary survey finding only 12 offices with two or more DPAs or NPAs).

70 The variation is greatest in the DPAs imposed by U.S. Attorneys’ offices. There is more consistency in the DPAs imposed by the specialized enforcement divisions of the DOJ, such as the Antifraud and Money Laundering Division.

71 Although prosecutors often work directly with regulators in designing DPAs and NPAs, not all prosecutors’ offices work closely with regulators. GAO report, supra note [48], at 17 (noting that 8 of 13 offices interviewed stated that they commonly design compliance programs with the cooperation of the relevant regulatory agency). Moreover, the prosecutors who do work closely with regulators still retain full authority to impose the mandates they prefer. For a discussion of arguments favoring vesting regulatory agencies with primary authority over policing mandates wherever feasible see Arlen, supra note 5; Spivack & Raman, supra note 3, at 186 (“[P]rosecutors these days are ‘fashioning themselves as new corporate governance experts, positions for which they are singularly unqualified’” (quoting Mary Jo White)); Cf. Miriam H. Baer, Insuring Corporate Crime, 83 IND. L.J. 1035, 1044-1071 (2008) (critiquing the current system).

72 The DOJ has not adopted guidelines governing the policing mandates that prosecutors can impose. Garrett, supra note 1, at 893 (“[N]o DOJ guidelines define what remedies prosecutors should seek when they negotiate structural reform agreements.”). By contrast, the DOJ has issued guidance on a variety of other issues relating to corporate prosecutions, including (1) whether to impose extraordinary restitution, (2) when to seek a waiver of the attorney-client privilege, U.S. Att’y Manual 9-28.710-720, and (3) the decision to impose a corporate monitor. Memorandum from Craig Morford, Acting Deputy Att’y Gen., U.S. Dep’t of Justice, to Heads of Dep’t Components, (March 7, 2008) [hereafter “Morford Memo”], U.S. Att’y Manual 9-28.0000, Principles of Prosecution of Business Organizations, available at http://www.justice.gov/opa/ documents/ corp-charging-guidelines.pdf. Free from adequate guidance,
mandates as a mechanism for imposing duties enforced through non-harm-contingent sanctions is desirable because \textit{ex ante} regulation enables enforcement authorities to impose duties on (and improve the behavior of) all firms with particular characteristics, rather than affecting only subset of those with detected wrongdoing.\footnote{Of course, in theory the crime-contingent duties could affect firms’ \textit{ex ante} policing incentives. Nevertheless, it is reasonable to conclude that duties and sanctions imposed \textit{ex ante} are more effective at regulating the \textit{ex ante} period than those imposed only after a crime occurs on a subset of firms. This is particularly likely given that firms cannot easily determine \textit{ex ante} whether they are likely to be subject to a DPA policing mandate.} Nevertheless, in order to implement \textit{ex ante} regulatory duties effectively it must be possible to specify \textit{ex ante} the criteria for determining whether a firm is subject to the duty based on information available \textit{ex ante} to both firms and regulators. In the case of non-crime-contingent regulatory duties, the deterrence benefits (if any) from imposing duties \textit{ex ante} (instead of only select firms \textit{ex post}) should exceed the cost of monitoring all affected firms for breach \textit{ex ante}, as compared with focusing on select firms with detected wrongdoing.\footnote{It may be argued that DPA mandates have an advantage in targeting intervention at firms with detected wrongdoing (which may have a heightened risk of future wrongdoing). This advantage only applies to \textit{ex ante} non-crime-contingent regulatory duties. It would be possible to obtain this benefit of DPA-mandates through \textit{ex ante} regulations that impose pre-specified higher duties on all firms with prior offenses.} Regulation is also superior when it is better to leave the design of the duties to regulators who have expertise and are required to follow certain procedures, rather than to \textit{ad hoc} determinations by prosecutors. By contrast, DPA-mandates are likely superior when it is not possible to determine \textit{ex ante} which firms should be subject to the policing duty and/or the optimal policing duty is best determined post-crime, based on information and expertise available to prosecutors.

\textbf{D. Summary}

In sum, in order for DPA mandates to be justified, two conditions must be satisfied. First, the harm-contingent liability regime must be plagued by a deficiency such that even properly-structured liability cannot be relied on to induce the firm to engage in optimal prevention and policing. Second, there must be some reason why, DPA mandates are preferable to \textit{ex ante} regulation as a mechanism for addressing this deficiency.

\textbf{IV. DETERRENCE JUSTIFICATIONS FOR MANDATES IMPOSED THROUGH DPAS}

The Part ascertains when it is optimal to employ DPA policing mandates. As previously explained, DPA-imposed mandates are not optimal unless harm-contingent liability is plagued by an inefficiency as applied to that firm and DPA- mandates are superior to \textit{ex ante} regulation as a mechanism for addressing this problem.\footnote{See supra note [84]}

\footnote{some prosecutors have abused their discretion. See Garrett, supra note , XX-XX (discussing abuses, such as the extraordinary restitution clause in the Bristol-Myer Squibb DPA, discussed in note [71] supra).}
identify three potential justifications for supplementing duty-based liability with an additional mechanism, such as DPA mandates: asset insufficiency, policing agency costs, and the need to impose heightened duties on firms with detected wrongdoing (or in certain industries). We show, however, that only one of these three, policing agency costs, justifies the use of DPA policing mandates. Neither asset insufficiency nor targeted heightened duties justify DPA mandates. Asset insufficiency is generally regarded as the primary justification for moving from harm-contingent liability (such as negligence and criminal liability) to non-harm-contingent liability. Yet this problem is better address through ex ante regulation, rather than DPA mandates. Likewise, targeted heightened duties for firms with detected wrongdoing are best established ex ante, whether through targeted harm-contingent sanctions or through regulation.

By contrast, we show, however, that DPA mandates may be justified as a mechanism for addressing agency costs afflicting corporate policing. Agency costs affecting corporate policing justifies additional intervention because duty-based corporate liability with increased monetary sanctions imposed ex post on firms for failure to police is not an effective way to address a failure to police due to policing agency costs. DPA-mandates are the superior solution because policing agency costs combine two important features: First, it is difficult for regulators to observe, ex ante, which firms suffer from significant policing agency costs; and is much easier for prosecutors to do so in the context of an investigation of a substantive crime. Second, prosecutors gain information during the investigation about the causes of the policing failure that can be useful in determining which policing duties/reforms are needed. As a result of these two features, DPA mandates may be superior to harm-contingent sanctions and ex ante regulation in inducing proper policing. Finally, we examine the implications of the policing agency cost rationale on the type of firms on which DPA mandates should be imposed and on the content of these mandates.

A. The Judgment Proof Problem

Asset insufficiency is the most obvious limitation on the effectiveness of duty-based corporate liability. Traditional duty-based harm-contingent liability does not provide firms with adequate incentives to invest in prevention or policing if the firm does not have sufficient assets to pay (and the state therefore cannot impose) the

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76 In assessing these mandates, we need to distinguish between corporate governance reform mandates that firms embrace (or would adopt voluntarily once fully informed) and those that firms would not otherwise adopt. We focus on crime-contingent duties that impose mandates that the board of directors would not have adopted voluntarily.

77 Steven Shavell, Liability for Harm Versus Regulation of Safety, 13 J. LEGAL STUD. 357 (1984) (identifying asset insufficiency as a justification from employing ex ante regulation instead of just liability to regulate risk); Steven Shavell, A Model of the Optimal use of Liability and Safety Regulation, 15 RAND J. ECON. 271 (1984) (same); see Khanna & Dickinson, supra note 3 (concluding that corporate asset insufficiency is the primary justification for imposing corporate monitors).
optimal harm-contingent sanction.\textsuperscript{78} Duties enforced by non-harm-contingent sanctions can be an effective solution to this problem because the optimal non-harm-contingent sanction is generally lower than the optimal harm-contingent sanction. Asset insufficiency is therefore less of a concern with non-harm-contingent liability.\textsuperscript{79}

The explanation, which tracks the general argument for regulation versus liability for harm,\textsuperscript{80} is most easily shown through an example that assumes that it is optimal to assure absolute compliance with the requisite policing duty.\textsuperscript{81} In order to induce firms to comply, the government must ensure that each firm’s expected costs are lower when it incurs the costs, $C$, to comply with the duty than when it does not.\textsuperscript{82} With harm-contingent liability, the state can only sanction a firm that breaches a duty if harm occurred. Given this, in order to ensure that firms never benefiting from breaching, the state must impose a sanction on firms that breach and have detected harm at least equal to $C/P$, where $P$ is the probability that (assuming the firm does not comply with the duty) both the substantive crime occurs and is detected and breach of the duty is detected.\textsuperscript{83} If that probability is small, the minimal optimal sanction may substantially exceed compliance costs, $C$. By contrast, with non-harm-contingent sanctions, the state can provide optimal incentives by imposing a sanction at least equal to $C/p$ whenever it detects a breach of duty, where $p$ is the probability that the breach of the duty is detected. This sanction is smaller since the probability that a breach of the duty is detected, $p$, exceeds the probability that a breach of the duty is detected and a substantive crime occurs and is detected.\textsuperscript{84} Thus, when a firm’s assets are below $C/P$

\textsuperscript{78} See Steven Shavell, The Judgment Proof Problem, 6 INT’L REV. LAW & ECON. 45 (1986) (showing that tort liability does not provide optimal incentives when defendant’s wealth is less than the optimal damage award); see also Arlen, supra note 16 (discussing why the test for asset insufficiency depends on whether the firm can pay the maximum optimal sanction for firms that do not engage in any optimal policing, as opposed to the sanction imposed on those which do police optimally); see also Henry Hansmann & Reinier Kraakman, Towards Unlimited Shareholder Liability for Corporate Torts, 100 YALE L.J. 1879 (1991) (arguing that limited liability for corporate torts is inefficient because it enhances the asset insufficiency problem).

\textsuperscript{79} See Shavell, Harm Versus Regulation, supra note 77; Shavell, Optimal Use, supra note 77.

\textsuperscript{80} See Shavell, Harm Versus Regulation, supra note 77; Shavell, Optimal Use, supra note 77.

\textsuperscript{81} Although our discussion here will refer to policing duty, the arguments apply to equal force to prevention measures and the choice between harm contingent liability and non-harm contingent liability for failure to adopt proper prevention measures.

\textsuperscript{82} By contrast, in order to induce optimal compliance with a duty, the government needs to ensure that the firm is better off incurring the costs to comply with the duty whenever the social cost of compliance is less than the expected cost to society of the increased crimes that result from the firm’s failure to comply, given here by $H$.

\textsuperscript{83} This result is in effect that of Gary Becker, Crime and Punishment: An Economic Approach, 76 J. POL. ECON. 169 (1968), modified to induce absolute compliance.

\textsuperscript{84} The probability that breach occurs and is sanctioned is higher than $P$ because it equals $P$ (the probability that breach and crime both occur and are detected and sanctioned) plus the probability that breach occurs and is detected, even though no crime occurred.
but above C/p, harm-contingent sanctions will fail to induce firms to comply with policing duties, but non harm-contingent sanctions can induce compliance.\textsuperscript{85}

Although asset insufficiency justifies non-harm-contingent sanctions, it generally does not call for DPA mandates.\textsuperscript{86} The government can better address asset insufficiency concerns by imposing general regulatory duties enforced by non-harm-contingent liability on firms at risk of asset insufficiency. Regulation is superior because firms vulnerable to asset insufficiency often can be identified ex ante. Moreover, all asset insufficient firms can profit from violating their policing duties. Accordingly, deterrence is best served by imposing duties and regulatory oversight on all firms where asset insufficiency is a concern, rather than limiting intervention to a subset of firms with detected wrongdoing. Moreover, the fact that a firm come to the attention of prosecutors through a prior alleged substantive crime is not closely connected to whether a firm will have insufficient assets to pay the harm-contingent sanction for the next crime. Many firms with past violations are perfectly solvent, and many firms who have never committed any violation may have inadequate policing because they know they do not have enough money to pay the first duty-based harm-contingent sanction.\textsuperscript{87}

\textbf{B. The Policing Agency Cost Problem}

Although duty-based composite liability induces firms to adopt optimal policing and prevention when firms are managed to maximize their profits, optimal corporate criminal liability will not induce optimal policing and prevention. If directors or officers obtain private benefits from other employees committing substantive crimes, they may induce firms not to take proper policing measures\textsuperscript{88} even if taking such

\textsuperscript{85} This liability is particularly effective if coupled with monitoring or audits designed to detect breaches.

\textsuperscript{86} Compare with Khanna & Dickinson, supra note 3 (suggesting that asset insufficiency would justify corporate monitor, which is one type of harm-contingent duty and sanction).

\textsuperscript{87} The use of DPAs to impose non harm-contingent liability is only superior to regulation in those rare situations where (i) government authorities cannot cost-effectively identify firms (or industries) at heightened risk of asset insufficient problems ex ante; (ii) prosecutors obtain information about the asset insufficiency ex post in the course of investigating the initial crime; (iii) the benefits of the ex post information advantage outweigh decreased deterrence associated with ex post intervention; and (iv) prosecutors have sufficient industry or crime-specific information to determine optimal policing or prevention duties for these firms or industries. These conditions are likely to be met, if at all, only in rare circumstances.

\textsuperscript{88} Again, although our focus here is on policing measures, analogous arguments apply to prevention measures and would justify the inclusion of prevention mandates in DPAs. For example, Managerial agency costs may result in managers selecting a compensation structure that is not optimal for the firm. As previously discussed, firms can significantly reduce employees’ (including managers’) incentives to commit crime by predicing incentive compensation rewards on long-term performance instead of short-term results. Yet this imposes a cost on managers by tying their financial fate to the firm for a longer period, and even after they are no longer in charge. Management thus may eschew crime-deterring compensation structures even when shareholders might benefit from their use.
measures would maximize the firm’s profits. Consider, for example, a CEO who is not all that keen to detect violations of the Foreign Corrupt Practices Act (FCPA) because such violations increase sales and reported profits, thereby enabling him to meet his bonus targets and increase the value of his stock options. These private benefits may cause the CEO to turn a blind eye to FCPA violations that shareholders might wish to deter, given their expected cost to the firm. Similarly, a manager may also prefer not to detect or report a crime that helps preserve his tenure at the firm—as is often the case with securities fraud. In addition, senior managers may eschew policing measures that entail oversight of their own actions by compliance officers, even if they plan to be compliant, when oversight reduces their power and thwarts their autonomy.

Thus, even when a corporate liability regime is structured such that taking optimal policing measures is in the shareholders’ interests, the particular management, compensation and incentives structure of managers in a given company (including the length of their time horizon) may cause them to rationally decide not to take such measures. We will refer to this phenomenon as “policing agency costs.”

1. Scope of the Agency Cost Problem

Policing agency costs are particularly likely to infect corporate enforcement decisions when managers own only a small portion of the firm’s stock and thus do not directly bear the sanctions imposed on the firm for failure to satisfy policing duties. This is the case with publicly-held firms, but also can be the case with large firms that

89 Moreover, it is difficult and perhaps impossible to induce optimal compliance by raising the corporate sanction. To the extent the agent in charge does not at all take the corporation’s interest into account, no corporate sanction will induce the agent to have the company adopt optimal measures. To the extent that the agent in charge takes the corporation’s interest into account, there is a corporate sanction that will induce the agent to have the company adopt optimal measures. However, to determine that sanction, one would have to know to what extent the agent in charge takes the corporation’s interest into account. Moreover, the amount of such sanction may be very high relative to the expected harm prevented by compliance and imposing such a sanction may be politically infeasible.

90 A recent noteworthy example of a CEO turning a blind eye to evidence of FCPA violations is discussed in [cite NY Times article on WalMart].

91 See Arlen & Carney, supra note 21 (discussing how internal monitoring can be ineffective at deterring securities fraud because often senior managers are tempted to commit fraud in situations where the fraud would benefit many others at the firm by enabling it to survive bad times, which may reduce managers’ incentives to detect fraud when the firm is in dire financial straits); cf. Bethany McLean, SMARTEST GUYS IN THE ROOM: THE RISE & SCANDALOUS FALL OF ENRON (2003) (showing widespread knowledge within Enron of serious financial problems that were being hidden by numerous efforts to hide losses and debt and inflate reported income).

92 Of course, compliance programs can benefit managers and directors, by providing them higher quality information about the firm that enables them to perform their managerial and oversight functions at lower cost. But in other situations, compliance programs impose a burden, to the degree to which they require additional record-keeping, bureaucracy, and oversight, which managers feel burdens them and impedes their ability to act quickly on important business matters. Managers also may find compliance programs costly when the firm is operating in an area where the legal duties are vague, as the compliance officer may constrain the firm from taking profitable actions that senior management believes are legal in an abundance of caution.
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are closely-held, but owned by organizations (such as private equity funds) that do not participate in day to day management.

Yet the mere fact that a firm is publicly-held (or otherwise has ownership separated from day-to-day control) does not imply that its managers will fail to implement optimal policing measures. Properly structured incentive compensation and other mechanisms can align the interests of managers and shareholders to a significant extent. Accordingly, many managers of publicly-held firms have incentives to expend corporate resources on policing to the extent such measures maximize profits. Moreover, a firm may have effective policing even when managers would prefer suboptimal policing as a result of the intervention of the directors, especially independent directors. This oversight depends on the character of the directors and their relationship to management, as well as on directors have the ability and incentive to understand the firm’s legal duties, and obtain (and accurately assess) evidence of noncompliance. Thus the separation of ownership and control over policing is not sufficient to create sufficiently significant policing agency costs to render duty-based corporate liability ineffective. Such agency costs are likely to be significant only for a subset of publicly-traded firms where the combination of the compensation structure, the management structure, board structure, the type of business the firm is engaged in, the type of criminal liability to which the firm is subject, and the feasibility of board oversight of compliance enables managers to benefit ex ante from and implement unchecked suboptimal policing.

94 For example, directors are less able to monitor effectively for compliance when the firm operates in an area governed by criminal laws that prohibit profitable activities that are malum prohibitum (as opposed to malum in se) and where the criminal law does not clearly delineate the boundary between permitted and unpermitted conduct in a way that would allow directors—who are often far removed from the criminal act—to determine whether the act is illegal. This can be a particular problem with respect to wrongs that depend on the intent of the actor who may be far removed from the board.

95 By contrast, shareholders cannot effectively monitor corporate compliance efforts, and thereby reduce policing agency costs, because many of the features that distinguish a truly effective program from an ineffective one involve matters that are difficult if not impossible to verify externally. Nor can shareholders address the agency cost problems associated with compliance programs entirely through incentive pay that since the private benefits of noncompliance can be so great and the corporate harm from ineffective compliance may not be realized until after current management has left the firm.

96 It may nevertheless be optimal to impose non-crime-contingent policing duties on all publicly-held firms (or all firms over a certain size) when the state can relatively easily ascertain compliance with this duty. The requirement that firms obtain an external audit of their financial statements is an example of such a regulatory duty. But one could not induce optimal policing and prevention across all firms through ex ante regulation because optimal policing and prevention varies across firms, deviation from optimal ex ante policing is difficult to determine from the outside, and deviation from optimal ex post policing necessarily must be evaluated after a crime has occurred. See supra text accompanying notes Error! Bookmark not defined.-66 (discussing harm-contingent liability vs. non-harm-contingent regulatory sanctions for breaches of policing duties).

97 In some cases, the agency costs may arise entirely from the interpersonal dynamic between a small constellation of replaceable managers and directors. In this case, the firm may be able to eliminate the problem by replacing them with outsiders. Analysis of the DPAs reveals that many firms with detected wrongdoing replace management, even when they are not directly involved in the wrong. Moreover, firms with detected wrongdoing implicating contracting parties often hire outsiders to replace
For example, consider a company that does a lot of business with foreign officials in a country where corruption is a problem, has regional sales team consisting of a small number of sales agents who have worked with each other for a long time, establishes sales targets (with significant bonuses for meeting the targets) for sales managers, and has an executive compensation plan where the number of stock options awarded in any year is a function of short-term stock performance and profitability. Policing agency costs may be substantially higher for such a company than for the run-of-the-mill publicly traded company, especially when contact with, and information from foreign activities, goes through managers, thereby limiting director oversight.98

2. Type of Intervention: DPAs vs. Ex Ante Regulation

When significant policing agency costs are present, authorities cannot rely on harm-contingent corporate liability to induce optimal policing. Accordingly, it may be desirable to supplement traditional duty-based harm-contingent liability with more direct oversight of firm’s compliance with their policing duties, for example through the imposition of policing duties enforced through non harm-contingent liability.

One possibility is to impose ex ante regulatory duties on all firms likely to be afflicted by policing agency costs. For such duties to be effective, however, regulators must have a mechanism to ensure compliance that does not rely principally on the deterrent effect of ex post sanctions imposed on the company. The reason is that the very policing agency costs that make harm-contingent corporate liability unreliable in inducing firms to undertake optimal policing will also undermine ex ante non harm-contingent duties enforced primarily through such ex post sanctions.

The problem of policing agency costs undermining the effectiveness of ex ante duties imposed on the company can be overcome in several ways. First, regulations could shift responsibility and power for policing to a corporate agent who is not (or less) afflicted by policing agency costs. Second, the regulations could be sufficiently precise to advise firms with a high degree of certainty as to their scope of their policing duties and make a specific, high-level person in the company responsible for a failure to police. When regulations are sufficiently precise and responsibility is specifically assigned, an agent could be penalized for failure to undertake proper policing (either through personal liability imposed on the agent or through sanctions imposed by the corporation that can be channeled back to the agent by shareholders. 99 The possibility

existing managers, no doubt in an effort to assure the market that the firm has turned over a new leaf. Cindy Alexander, On the Nature of the Reputational Penalty for Corporate Crime: Evidence, 42 J. L. & ECON. 489 (1999); see Arlen, supra note 16, Section 2._(discussing the factors influencing the reputational penalty for corporate crime).

98 For example, WalMart is an example of a firm with apparently high policing agency costs even though had a compliance program and management initially responded promptly to evaluate evidence of suspected wrongdoing. The CEO’s ability to obtain information on suspected wrongdoing first, and control both access to that information and the firm’s response, enabled him to pursue a policy of covering up evidence of wrongdoing without effective board oversight. []

99 Shareholders finding clear evidence of breach, and knowing who to blame, could pressure the firm to terminate the agent. The shareholder also might be able to shift the corporate sanctions onto the
of such penalties could counteract policing agency costs. Third, regulators could use orders or similar mechanisms to compel firms to adopt the requisite policing standards.\textsuperscript{100} This approach can work, and has been used, in some areas.

Yet ex ante regulatory duties coupled with \textit{ex ante} oversight is not a general solution to the problem of policing agencies costs undermining the effectiveness of duty-based corporate liability. Often the optimal solution to policing agency costs involves imposition of duties designed to address policing agency costs (hereinafter a meta-policing duty). Yet the optimal meta-policing duties often are reliably welfare-enhancing only when imposed on firms subject to policing agency costs (or subject to a particular form of policing agency cost), and would not be optimal to impose on all firms generally.\textsuperscript{101} As to these meta-policing duties, it is important to find a mechanism for imposing them that targets them at firms afflicted with policing agency costs, while leaving most other firms unaffected. \textit{Ex ante} regulation is not this type of mechanism.

Unlike asset insufficiency, it generally is difficult to identify the firms subject to high policing agency costs \textit{ex ante}. As previously discussed, policing effectiveness cannot be easily assessed externally, outside the context of an actual wrong.\textsuperscript{102} Thus, it is also difficult or excessively costly for regulators to identify firms with high policing agency costs based on criteria that are easily observable \textit{ex ante}. Moreover, for similar reasons, regulators cannot effectively address policing agency costs by imposing meta-policing duties only on firms with “high policing agency costs,” enforced through harm-contingent sanctions. Such a regulation would not provide targeted incentives if firms face uncertainty \textit{ex ante} as to whether they are afflicted (and would be deemed to be afflicted) by policing agency costs—given that the criteria for identifying policing agency costs often is not readily observable activities \textit{ex ante}, prior to evidence of any wrongdoing. If it is \textit{ex ante} uncertain whether a firm was subject to such a regulation,

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\textsuperscript{100} Even if violation of a specific order would be sanctioned through damages, it is likely that firms would comply.

\textsuperscript{101} Ex ante regulation can be optimally used to impose those meta-policing duties that would be optimal to impose on all firms, even those with no policing agency costs. This would be the case for measures either are costless or that confer benefits on the firm beyond those associated with corporate policing of crime such that it is optimal to impose the duty on the firm even when there is little risk of crime or no policing agency costs—as long as authorities can readily ascertain compliance with the duty \textit{ex ante}. Of course, in this situation, it often will be optimal for authorities to rely on ex ante regulation (instead of duty-based liability) to impose this duty in the first place—as for example with the duty imposed on publicly-held firms to have their financial statements audited by an independent accounting firm. Thus, the existence of such regulatory opportunities does not undermine our claim that in those situations where duty-based liability is preferable to ex ante regulation absent policing agency costs, then ex ante regulation is not the optimal solution to the existence of policing agency costs.

\textsuperscript{102} Indeed, one of the reasons we rely primarily on duty-based harm-contingent liability to induce optimal corporate policing is that we cannot effectively induce optimal corporate policing through ex ante regulation coupled with non-harm contingent sanctions because we cannot accurately assess breach of policing duties \textit{ex ante} absent evidence of wrongdoing. See supra Section III.B.
many firms – and, in particular, those with high policing agency costs – might take the position that they are not, or (depending on the sanctions) to many non-agency-cost firms might comply with mandates that are not optimal as applied to them. Furthermore, when it is \textit{ex ante} uncertain whether a regulation applies to a certain firm, it is difficult to penalize management for failure to comply. Even if the compliance decision is made by a board that is not itself subject to high policing agency costs, the board would have to rely on information and analysis provided by other parties (like the General Counsel who reports to the CEO) who may be subject to higher policing agency costs. Thus, if the applicability of a regulation to a specific firm is uncertain, the regulation would generally have to be enforced through \textit{ex post} sanctions imposed on the firm.\textsuperscript{103} But, as explained, for firms with significant policing agency costs, this enforcement mechanism is ineffective in eliciting compliance.

In addition, the specific regulations on policing may not be optimal for firms that are not subject to high policing agency costs and that can be trusted, on their own, to adopt policing measures that maximize the firm’s profits. For example, a firm may have high policing agency costs because the outside directors did not have sufficient expertise in corporate compliance to identify the deficiencies with the firm’s policing measures. Directors of some firms can be expected to remedy their policing problems, upon learning about the firm’s policing deficiencies through the firm’s internal investigation of the crime and its aftermath (as well as conversations with outside counsel and prosecutors). Thus, it may not be desirable to require all firms, regardless of whether they suffer from high policing agency costs, to adopt the measures designed for firms with high agency costs. Because of the difficulty in imposing \textit{ex ante} regulations selectively on firms with high policing agency costs and the undesirability of imposing them generally (on all firms), \textit{ex ante} regulation may not be effective in addressing policing agency costs.

DPA mandates generally are a preferable, albeit still imperfect, mechanism for dealing with policing agency costs that undermine duty-based corporate liability. DPA mandates are imposed after the firm has been investigated for committing a substantive crime and has had the opportunity to employ its policing measures. In the course of their investigations, and as a by-product, prosecutors often obtain information about the firm’s policing, including information indicating that the firm’s policing was plagued by agency costs. Thus, high policing agency costs are more easily observed by prosecutors \textit{ex post} than by regulators \textit{ex ante}. Moreover, prosecutors may be able to identify firms with high policing agency costs are relatively low marginal cost, given that the collect the information \textit{ex post} and in the context of an investigation for a substantive crime.

\textsuperscript{103} In theory, compliance could also be enforced through \textit{ex post} uncompensable sanctions imposed on specific persons within a corporation. However, this would generate several problems. First, it may not be easy to identify a specific person within a corporation who is responsible for the failure of the corporation to take a certain action. Second, to the extent one can identify the person and the person would be subject to high penalties, it may be difficult to find a person willing to serve in that role. Finally, any such person would tend to have the company spend excessive resources on compliance to minimize the risk of personal liability.
Once prosecutors have identified a firm as suffering from high policing agency costs, it may be optimal to use a DPA to impose duties on that firm designed to address its policing agency costs (including meta-policing duties).

Generally, we believe that the comparative advantage of prosecutors over regulators in identifying firms with high policing agency costs, and thus the comparative advantage of DPA mandates over regulation, is most pronounced in instances where the firm failed to report potential crimes and cooperate in the investigation diligently. When a firm has not acted diligently in reporting a potential crime to prosecutors or in cooperating in its investigation, prosecutors may, as a result of other facts and impressions they obtain in their investigation, attribute this failure to policing agency costs (rather than, say, to trying to shield the firm from liability or to protect valuable and potentially innocent employees).

To be sure, policing agency costs may also affect other elements of corporate policing, such as the firm’s compliance program, including the kind of training provided and the manner in which suspected substantive crimes are handled internally prior to any self-reporting. However, an apparent deficiency in ex ante compliance cannot be instantly attributed to policing agency costs, even if a substantive violation has occurred. Companies may adopt programs deemed deficient by prosecutors for reasons other than policing agency costs. Directors may in good faith have a different view regarding the costs or the effectiveness of certain compliance measures either correctly or because they have less expertise than prosecutors on the probability of wrongdoing and relative effectiveness or certain measures. Or it may be that a “deficient” program is profit maximizing. Thus, when faced with evidence of a crime and apparently inadequate compliance program, prosecutors need additional evidence of agency costs afflicting policing by managers or the board. Often the best evidence can be obtained by evaluating the behavior of managers and the board when faced with evidence of potential wrongdoing. Firms that diligently reported the potential crime at issue (before it was likely to be detected) and fully cooperated are less likely to be afflicted by serious policing agency costs. By contrast, DPA mandates are not justified merely because the compliance program is deficient in the opinion of a prosecutor (whether or not the

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104 Our discussion of the comparative advantage of prosecutors also applies to civil enforcement authorities, such as the SEC, that intervene ex post through duty-based harm contingent liability supplemented with DPA-like harm-contingent policing duties.

105 By diligently, we mean that the firm self-reported and cooperated both voluntarily and in a reasonable manner, without undue delay, without having to be threatened by prosecutors with sanctions, and without having received information that prosecutors have started or are about to start an investigation.

106 DPA-mandates are not the proper solution to situations where it is profit maximizing, and possibly even socially desirable, for the company not to have an “effective” compliance program. The proper response is either to increase the penalty (to the extent the company’s failure is not socially desirable) or to do nothing (to the extent less than effective compliance is socially optimally). DPA mandates are not the appropriate response.
prosecutor is correct in this assessment), but only if the deficiency is due to policing agency costs.\textsuperscript{107}

3. The Proper Scope of DPA Mandates

Because policing agency costs reduce the effectiveness of monetary sanctions imposed on the firm to induce corporate policing, DPA mandates should include mechanisms to reduce agency costs; they cannot simply impose additional policing duties enforced by corporate liability. Most directly, they generally need to include meta-policing provisions that shift the internal allocation of power and information over policing measures to people likely to pursue optimal corporate policing. One set of meta-policing measures simply shift authority over, and information about, corporate compliance to outside directors who are less subject to policing agency costs. Examples of such terms, include the requirement in the BMS DPA that certain reports by submitted to the Chairman of the Board (who is separate from the CEO) and for the Chairman to attend certain meetings. Other such terms include requiring that Chief Compliance Officer be located outside the General Counsel’s Office and have authority to report directly to the board of directors. Mandates establishing a system for anonymous whistleblowing that reaches the board also reduce managerial agency costs.\textsuperscript{108} These measures are likely needed for all firms with significant policing agency costs. They also may be sufficient when only senior managers are afflicted by hard agency costs, and outside directors can be relied upon to respond appropriately if the compliance program ensures them prompt and accurate evidence to information about potential wrongdoing.

In some situations, policing agency costs affect the board of directors as well as management, as when directors benefit from the crime itself, suffer a private harm from detection of and reporting the crime, or are dominated by management who benefit from the crime or its nondetection. In this situation, the optimal response involves external monitoring of corporate policing. The primary example of this type of meta-policing measure is a requirement that the firm hire a prosecutor-approved Corporate Monitor who reports to prosecutors. Other weaker forms of meta-policing include requirements that firms provide periodic reports on corporate policing to either prosecutors or regulator.\textsuperscript{109}

\textsuperscript{107} Policing agency costs nevertheless can be significant at firms which cooperated. After all, agents’ ability to mute policing in return for private benefits depends on the expected benefit and expected cost of suboptimal policing, both of which depend on the likelihood that the wrong will be detected and successfully prosecuted even if the agent causes the firm not to police optimally. Thus, evidence that managers fully cooperated with federal authorities who already have notice of the wrong does not indicate that agency costs would not afflict policing when corporate policing is needed to bring the wrong to light. In this case, prosecutors may need to carefully examine the structure of corporate policing for evidence of policing agency costs by managers or the board.

\textsuperscript{108} The effectiveness of these measures can be enhanced by mandates designed to enhance board independence, including those separating the Chairman of the Board from the CEO and those adding specific independent directors.

\textsuperscript{109} Examples of such terms include…
Finally, in some situations prosecutors may need to supplement meta-policing mandates with regular policing mandates, such as those dictating the structure of the firm’s compliance program. Policing mandates are particularly likely to be needed when directors can be relied on to satisfy clear legal obligations, but are subject to soft agency costs which leave them reluctant to challenge senior management absent a clear duty. In this situation, prosecutors may mandate the structure of the firm’s compliance program to ensure that it is effective.\footnote{This presents the question whether, when managers are affected by agency costs, it is reasonable to conclude that the outside directors cannot be relied upon to adopt an effective compliance program that shifts power away management and yet could be relied upon to oversee and respond to evidence from an optimal compliance program that gives them prompt and accurate information about corporate wrongdoing. This situation can arise when directors’ are subject to only “soft” agency costs which leave them reluctant to challenge management absent a clear mandate or clear evidence that triggers a duty to respond, but are not affected by any hard agency costs that would provide them with a private benefit for breaching any clear duties. In this situation, prosecutors may be able to circumvent the effect of soft agency costs by mandating the structure of the compliance program and ensuring that outside directors obtain direct evidence of wrongdoing. This may be sufficient in light of directors’ clear duty under state law to respond to evidence of suspected wrongdoing, for example by instituting an internal audit. Caremark; Stone. This is not reliably effective if directors can comply with this duty by placing management in charge of the firm’s response, with no genuine outside director oversight. [See WalMart]}

Examples of such terms include the provisions in the BMS DPA requiring the firm to disclose additional information in SEC reports and implement a training program for employees covering specified topics.\footnote{Even if the DPA contains no meta-policing duties, the mere fact that a specific policing duty was imposed through a DPA may well affect management behavior. Suppose, for example, that the CEO of BMS, for whatever reason, would prefer that employees not receive training on one of the required topics. Yet, non-compliance with a specific DPA provision could well indicate to the board, to shareholders, and to the market participants that the CEO is not an effective manager. Moreover, non-compliance could expose the CEO and the board to liability under Caremark. See supra note [discussing Caremark] These adverse consequences that fall directly on a manager would induce the manager to have the company comply with its policing duties because doing so is now in the manager’s personal interest.}

Technically, of course, DPA mandates—including meta-policing duties—are enforced by non-harm-contingent corporate sanctions, and thus would also appear to be undermined by policing agency costs. Well-designed, however, meta-policing duties are less affected by agency costs. First, effective meta-policing duties usually involve clear commandments (e.g., hire a specified monitor) rendering non-compliance easily observable and obviously intentional. Second, responsibility for ensuring adherence often falls on the board, which often is less affected by policing agency costs. This makes it very likely that DPA-imposed meta-policing duties are complied with. Finally, directors and officers facing clear meta-policing duties have an additional incentive to comply because knowing non-compliance could subject them to personal liability under Caremark should their sustained non-compliance with known policing duties subject the firm to liability.\footnote{Delaware imposes a duty on directors to ensure that their firms have an effective monitoring and reporting program, but permits boards to determine what measures satisfy this duty, absent clear legal mandates. Directors are liable for breach only if they acted in bad faith, through deliberate sustained neglect of their monitoring duties. In re Caremark Int’l Inc. Derivative Litig., 698 A.2d 959 (Del. Ch.}
that the firm will comply with its (non-meta) policing duties—whether they are generally applicable or imposed by a DPA—by shifting significant responsibility for corporate compliance (and response to evidence of wrongdoing) from management (which may suffer from policing agency costs) to actors who can be relied on to respond appropriately.\footnote{See supra note (discussing Caremark).}

4. DPA Mandates versus Agent Liability

DPA mandates are only desirable if they are superior to (or a needed supplement to) imposing personal liability on the agents responsible for the company’s failure to adopt optimal policing measures. Such liability is, in theory, the most direct way to address policing agency costs. In practice, however, imposing such liability for a general failure to act is difficult.\footnote{For a discussion of the difficulties of holding directors liable for corporate crimes see Reinier Kraakman and Assaf Hamdani, \textit{Rewarding Outside Directors}, 105 MICHIGAN LAW REVIEW 1677 (2007).} First, in the corporate structure involving many agents, it is often impossible to identify a single person who should be held responsible for a failure to act. Thus, for example, the failure to adopt an effective compliance program with respect to Foreign Corrupt Practices regarding Country X could be attributed, among others, to (i) the compliance officers in country X, (ii) the head of the compliance department, (iii) the CFO who set the budget for the compliance department, (iv) the CEO who appointed the CFO and the head of the compliance department and to whom the CFO and the head of the compliance department report, or (v) the board of directors.

Second, to the extent such a person is identified, imposing personal liability for the company’s failure to police is likely to induce that person to have the company engage in excessive compliance. This is especially true if the person identified is the CEO or the board of directors and has control over the amount the company spends on compliance. Managers are particularly likely to divert excessive attention to compliance when that activity is directly regulated by sanctions but alternative activities (such as making good business decisions) are not closely supervised.\footnote{But if the person identified does not control the amount the company spends on compliance, it may be difficult to find someone to take the position. To be sure, for the right price, the company will be able to fill the position. Note, however, that the requisite compensation structure—high salary to compensate for the possibility of legal sanction for failure to comply—is likely to be attractive to individuals who are risk seekers, which may not be the optimal personality for type for a person in charge of compliance.} And if the person identified does not control the amount the company spends on compliance, it may be difficult to hold him or her responsible for the policing failures.

Third, it may not be possible to sanction the agent effectively. The person identified as responsible for policing may have insufficient assets to satisfy the optimal liability amount.\textsuperscript{117} Or the person may be outside the jurisdiction of the United States and beyond the reach of its criminal and civil authorities. Thus, imposing liability on a firm agent for the firm’s failure to police properly may not be effective in addressing policing agency costs.

Nevertheless, while agent liability for general failure to police effectively tends not to be effective, there does exist limited agent liability for deliberate bad faith failure to police. DPA-mandated policing and meta-policing mandates can render this liability more effective, as discussed previously.\textsuperscript{118}

5. Outer Limits of the Agency Cost Justification

While DPA mandates can be justified on policing agency cost grounds, the agency cost justification also places limits on their use. First, direct government intervention is costly (involving both the direct costs of adopting a compliance program and other mandates and any productivity consequences of the oversight associated with them).\textsuperscript{119} Thus, in considering whether policing agency costs justify intervention, reasons exist to avoid government mandates unless such costs are a serious issue and cannot be reasonably addressed by shareholders. These conditions are unlikely to be met if a controlling shareholder has a substantial equity stake in the firm (or its parent). More generally, the government should generally not require company to take measures that can be implemented by shareholders and compliance with which can be easily observed.

Second, policing agency costs do not justify DPA mandates that should be optimally imposed on all firms, including those not subject to policing agency costs. DPA mandates are also inferior to \textit{ex ante} regulation even when the mandate is optimally imposed on a subset of firms if firms and regulators have sufficient easily available \textit{ex ante} information to identify and target the mandates at these firm.\textsuperscript{120} Thus,

\begin{itemize}
\item[\textsuperscript{117}] For a discussion of why bounties would be superior to liability see Hamdani and Kraakman.
\item[\textsuperscript{118}] See text accompanying notes \_\_\_ supra [preceding paragraph] (discussing how clearer duties subjects managers and directors to greater oversight by shareholders and potential liability under Caremark).
\item[\textsuperscript{119}] Care is particularly needed with mandated policing measures that generally are not adopted by firms voluntarily and these present the possibility that firms are not adopting the measures because they are not welfare-enhancing. These measures can be optimal, but prosecutors should be required to defend their use (and study their effectiveness over time).
\item[\textsuperscript{120}] For example, agency costs tend to infect corporate policing of all large publicly-held firms with respect to securities fraud because managers are likely to commit securities fraud when facing corporate performance problems that increase the risk of job loss. Yet in these circumstances the fraud also benefits other managers, including those in charge of compliance, who benefit from ignoring red flags. Arlen & Carney, \textit{supra} note 21. Accordingly, this is a situation where it may be optimal to impose particular policing duties on all firms, especially duties to employ non-managerial gatekeepers which government authorities can readily oversee (such as the requirement to have an external auditor and an independent audit committee with expertise). Nevertheless, even here government authorities cannot—and do not—rely on regulatory enforcement to ensure that the firm has an effective compliance program for the
for example, mandates imposing specific compliance duties on financial institutions to detect money laundering are not optimally imposed through DPAs if these duties are optimally imposed on all financial institutions.

Third, DPA mandates that rely principally on the deterrent effect of *ex post* sanctions imposed on the company to ensure compliance are unlikely to be effective in reducing policing agency costs. An example includes a DPA requiring adoption of a generic compliance program (as or less detailed than the effective compliance program specified by the U.S. Sentencing Guidelines\textsuperscript{121}), unaccompanied by any meta-policing duties that shift oversight to agents or outsiders with reduced agency costs. Imposition of such duties enforced by non-harm-contingent corporate liability is unlikely to improve corporate policing and risks penalizing innocent shareholders, who bear the economic costs of corporate liability, for the self-interested actions of their agent. While it is, in theory, possible for shareholders to have any agents responsible for breach removed – by electing a different board which will do so – the practical ability of dispersed shareholders to do so is limited, especially when the policing duty is generic, making bad faith breach difficult to identify.

Fourth, the government should have sufficient information to believe that, given the policing agency costs at the firm, the DPA-imposed duties are efficient. Given prosecutors’ specific areas of expertise and the substantial information burden associated with identifying optimal corporate governance reforms, this suggests that the policing-agency-cost justification usually does not justify mandates that are not specifically targeted to policing agency costs, but instead simply reduce general agency costs. Prosecutors may well have special expertise, through the information they learned in investigating the firm and through their general law-enforcement expertise, in assessing the benefits of a mandate in inducing superior policing measures. But they do not have expertise in assessing the optimal system of corporate governance and agency costs generally. Thus, other things being equal, the more narrowly DPA-imposed duties relate to policing and policing agency costs, the more likely is it that the imposed duty is efficient.

For example, we are skeptical that a free-standing DPA-imposed mandate to separate the Chairman of the Board and the CEO is efficient. The desirability of separating these positions is debated among corporate governance experts and we doubt that prosecutors have any special expertise to resolve this debate. Shareholders can at least exert substantial pressure on boards to separate these positions.\textsuperscript{122} Moreover, the benefits from such a separation in reducing policing agency costs from would be

\textsuperscript{121} [add cite]

\textsuperscript{122} Shareholders can, and often do, file precatory resolutions under Rule 14a-8 to separate the CEO and chairmen positions. Firms often implement resolutions that receive majority shareholder support. See Kahan & Rock, Embattled CEOs, cite. Yet nevertheless not all firms with strong institutional shareholders have adopted these measures.
tangential. On the other hand, a DPA-imposed mandate to separate the Chairman of the Board and the CEO that is coupled with a clarification of the firms policing duties plus other provisions shifting responsibility for corporate policing to the Chairman or other low-agency-cost actors may be justified. Such a mandate would assure that a corporate officer who is not subordinated to the CEO has responsibility for policing and is targeted to the possibility that policing agency costs afflict the CEO.

C. Targeted Heightened Duties

A final potential argument for employing DPAs to impose heightened policing duties on some firms is that prosecutors have concluded that, although the standard crime-contingent corporate liability regime creates optimal incentives for most firms, it creates sub-optimal incentives for the firm at issue. This is most likely when the optimal policing duties for that firm are higher (or different) from the policing duties imposed *ex ante* on all firms through the duty-based corporate liability regime. For example, the optimal compliance program with respect to the Foreign Corrupt Practices Act may differ between firms who do business in Sweden and firms that do business in Uzbekistan, or between firms that engage in a lot of government contracting or operate in regulated industries and firms that do neither. While the *ex ante* duty to adopt an effective compliance program accounts for some differences, prosecutors may not be able to legitimately sanction a firm for ineffective compliance based on a compliance program that resembles the programs of other firms in the industry, based on *ex post* evidence of specific heightened risks of crime. Prosecutors who obtain information in the course of their investigations that a higher or more detailed policing mandate is needed may be inclined to use a DPA to impose this heightened policing duty on the firm going forward.

Nevertheless, we do not believe that, outside the context of policing agency costs, such differences among firms generally justify DPA mandates. Using DPAs to impose heightened mandates is particularly suspect when the heightened mandate is ostensibly justified by firm characteristics that heighten its risk of crime: such as its regular presence in certain countries (e.g., Nigeria and China), its industry (e.g., financial institution) or its risk of environmental violations. Generally, if particular firm characteristics justify different policing standards, these different standards should be imposed on all firms with the requisite characteristics *ex ante*, either as part of a differentiated duty-based, harm-contingent liability regime or through *ex ante*

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124 Note that the argument we made in the preceding Section that policing agency costs may justify certain DPA mandates is, in some respects, a special case of the more general argument that heightened duties are desirable for some firms. As for policing agency costs, prosecutors may obtain, in the course and as a by-product of their investigation of a substantive violation, information that is difficult to observe *ex ante* and that indicates that the firm if of a type for which different policing standards are optimal.
regulation. The characteristics relevant for the imposition of a differentiated duty can be specified in precise (rule-like) or more general (standard-like) terms.

Importantly, in order to generate optimal incentives under a harm-contingent liability regime, it is not generally necessary for enforcement authorities to observe ex ante which firm is subject to which policing duties. As long as the firm is managed to maximize profits (and the duty and sanctions are set at proper levels) - that is, outside the context of policing agency costs – authorities can provide optimal incentives so long as they can specify ex ante the type of firm subject to the heightened duty and firms have sufficient information to determine ex ante, with sufficient certainty, which duty applies to them.

For example, statutes can require firms to have more elaborate compliance program with respect to foreign corrupt practices if they have “significant government contracts” in countries with a “heightened corruption problem” (as identified by the IMF). For such a differentiated duty to be effective, it is only necessary that the firm itself has ex ante information about its type (e.g., knows about the extent of its government contracting in different countries). Should a substantive violation occur, prosecutors can determine ex post whether the firm was subject to and complied with the requirements for a heightened duty, based on the information they obtain in investigating the substantive violation, similar to the way they may use such information to impose DPA mandates.

Ex ante imposition of differentiated duties, whether through harm-contingent liability or even through non-harm contingent ex ante regulation would have all the advantages of these types of liability regime relative to ex post mandates that we discussed in Part III. Thus, the fact that prosecutors may have significant ex post information on company type generally is not sufficient to justify DPA mandates.

D. Summary

Accordingly, we find that enforcement authorities can promote social welfare by using DPAs to impose policing mandates on firms, but generally only when these mandates are needed to (and structured to) address policing agency costs. Asset insufficiency and other forms of heterogeneity warranting heightened policing duties generally do not justify DPA mandates. Moreover, we conclude that the policing agency cost justifications limits the type of justifiable mandates. In particular, crime-contingent duties are reliably welfare enhancing only when they are designed to reduce agency costs through the effective meta-policing provisions.

V. EVALUATING EXISTING FEDERAL PRACTICE

[This section is not written. I am including one core result]

The preceding Part has shown that certain DPA mandates may be justified to address policing agency costs. This Part examines current federal enforcement practice with respect to DPAs to determine whether it is consistent with our analysis: are DPA
mandates imposed on firms where one could plausibly conclude that policing agency costs are significant and are these mandates structured in a manner that would plausibly reduce such agency costs.

The DOJ has provided prosecutors with little clear guidance on when to impose and few restrictions \(^{125}\) on the form of DPA mandates.\(^{126}\) To make this evaluation, we therefore focus on the actual DPAs from 2003 to 2010.\(^{127}\) We focus on DPAs that impose some form of policing mandate.

[This analysis is in progress. I have deleted everything except the result on meta-policing duties. For what it’s worth, we do find that DPA mandates are not used to address asset insufficiency and are imposed in circumstances consistent with agency costs).

**C. Concerns Associated with Current Practice**

Examination of the current practice on DPA mandates reveals features that appear inconsistent with the use of mandates to address policing agency cost.

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\(^{125}\) The DOJ has intervened to provide clear guidance to prosecutors on a narrow set of specific issues relating to DPAs and pleas. For example, it has constrained prosecutors’ ability to (1) require firms to waive its attorney-client privilege, U.S. Att’y Manual 9-28.710-720; (2) prohibit a firm from paying its employees legal expenses, or (3) impose extraordinary restitution on firms. Memorandum from Mark Filip to Holders of the U.S. Attorneys’ Manual Re: Plea Agreements, Deferred Prosecution Agreements, Non-Prosecution Agreements and “Extraordinary Restitution” (May 14, 2008) (prohibiting the use of pleas or DPAs to require firms to make extraordinary restitution to third parties unrelated to the harm); Principles of Federal Prosecution of Business Organizations, Memorandum from Mark R. Filip, Deputy Attorney General, to Heads of Department Components and United States Attorneys (Aug. 28, 2008) (discouraging) prosecutors from interfering with corporate payments of employees’ legal fees). The DOJ also imposed constraints on the use of corporate monitors. Craig Moreford, Memorandum to Heads of Department Components and U.S. Attorneys: Selection and Use of Monitors in Deferred Prosecution Agreements and Non-Prosecution Agreements with Corporations (March 7, 2008) [http://www.justice.gov/dag/morford-useofmonitors memo-03072008.pdf].

\(^{126}\) DOJ Guidelines state that pretrial diversion may be appropriate when “the person’s timely cooperation appears to be necessary in the public interest.” Yet the DOJ provides little genuine guidance on when to employ pretrial diversion instead of straight non-prosecution. It also provides little guidance on the type of mandates to impose. Cf. infra note **Error! Bookmark not defined.** Consequently, prosecutors’ offices vary enormously both in their use of DPAs and in the duties they impose—variation that is unlikely to serve federal enforcement objectives. Moreover, some prosecutors have abused their discretion. The most notable example is the requirement that Bristol-Myers Squibb endow a chair at Seton Hall Law School, the alma mater of the supervising U.S. Attorney, Christopher Christie. See supra note 56. Other examples include the DPA requiring the New York Racing Association to install “video lottery terminals” at its race tracks to provide state officials with revenues needed for schools, and mandate requiring Operations Management International to donate money to the Alumni Association of the Coast Guard Academy to endow a chair for in environmental studies. See Garrett, supra note 1 (examining the problem of prosecutor discretion over DPAs); see generally Rachel Barkow, *Organizational Guidelines for the Prosecutor’s Office*, 31 CARD. L. REV. (2011); Rachel Barkow, *Institutional Design and the Policing of Prosecutors: Lessons from Administrative Law*, 61 STAN. L. REV. 869 (2009) (discussing the general problem of and remedies for abuse of prosecutor discretion).

\(^{127}\) In conducting this analysis, we do not consider crime-contingent mandates that prosecutors imposed in the past, but which the DOJ has since restricted. See supra note.
1. Meta-Policing: Monitors and Other Mechanisms for Reducing Agency Costs

DPA mandates are justifiable only to the extent that they address policing agency costs. This implies that they generally need to include meta-policing mandates. When agency costs and the risk of crime are significant, optimal meta-policing is likely to involve some enhanced external oversight. The strongest (as well as the most expensive and intrusive) of these mechanisms is the corporate monitor.

Analysis of the crime-contingent duties imposed suggests that prosecutors increasingly are imposing policing duties without supplementing these duties with any meta-policing mechanism designed to reduce the agency costs that otherwise would compromise the firm’s genuine compliance with these duties.\footnote{128} Table Four reveals a decline in the percentage of crime-contingent policing duties which are subject to oversight by a corporate monitor. Thus, whereas monitors were imposed in 84% of the DPAs imposing compliance programs in 2003-2005, from 2008-2010 there were 56 compliance program mandates but only 19 monitors, for a rate of less 35%.

Monitors, of course, are not the only meta-policing. Accordingly, we examined the 52 DPAs signed from 2003-2010 that imposed a compliance program mandate without also requiring oversight by a corporate monitor, to ascertain whether these agreements employed substitute oversight mechanism.\footnote{129} We adopted a broad view of additional oversight mechanism to include (i) regular reporting to federal authorities about compliance efforts (even absent external oversight), (ii) issue-specific oversight by some other external authority, and (iii) the requirement that the Chief Compliance Officer by appointed or report to to (or a member of) senior management to provide some insulation from pressure to be soft on compliance.\footnote{130} We found that 65% of these DPAs did imposed some type of meta-policing, with 35% relying on some form of external oversight and 19% relying entirely on internal meta-policing. Yet 35% did not employ a discernible meta-policing mechanism for addressing agency costs.\footnote{131}

The imposition of DPA-mandates that do not address policing agency costs is not consistent with optimal deterrence. It also represents a change in enforcement practice. We thus examined one possible explanation for the decline in meta-policing:

\footnote{128} By contrast, a monitor might be less important when the firm requested that the prosecutor include a compliance program duty as a way of assuring the markets that the firm is actively seeking to detect wrongdoing, although even here one would expect that the bonding function of the DPA would be well-served by the addition of a cost-effective monitor.

\footnote{129} [ ]

\footnote{130} The DOJ Criminal Antifraud Division particularly favors DPAs which allocate compliance responsibility to a particular senior executive or appoint the Compliance Officer to senior management. One firm was required to appoint the CFO of Berkshire Hathaway to its board.

\footnote{131} Moreover, many of the DPA-imposed policing mandates do not require the firm to undertake any subsequent assessment of the compliance program’s effectiveness. By contrast, such an assessment is required if a compliance program is imposed under the Organizational Guidelines. U.S. Sentencing Guidelines § 8B2.1(b)(5) (“The organization shall take reasonable steps—(A) to ensure that the organization's compliance and ethics program is followed, including monitoring and auditing to detect criminal conduct; (B) to evaluate periodically the effectiveness of the organization's compliance and ethics program.”).
the possibility that this decline is attributable to political, instead of genuine deterrence, consideration. In particular, we examined the pattern of monitor-impositions before and after the September, 2007 Zimmer Holdings DPA. The Zimmer Holdings DPA generated negative press- and political- attention to DOJ practices regarding corporate monitors as a result of Christopher Christie’s decision to appoint his former boss, John Ashcroft, as the well-paid monitor in that case. The vast majority (71%) of “unsupported” compliance program mandates--DPAs that impose a compliance program duty but do not impose a monitor or alternative oversight device that mutes agency costs-- were imposed after the Zimmer Holding DPA. This is suggestive of the possibility that prosecutors may have weakened the mechanisms for ensuring corporate compliance with DPA-imposed duties in response to political pressure.133

Table Five
Compliance program mandate no monitor

<table>
<thead>
<tr>
<th>Compliance Program/No Monitor</th>
<th>Total</th>
<th>Post-Zimmer</th>
<th>Not DOJ, E/SDNY</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compliance Program/No Monitor</td>
<td>52</td>
<td>37 (71%)</td>
<td>17 (33%)</td>
</tr>
<tr>
<td>Public firm: CP/No Monitor</td>
<td>43 (83%)</td>
<td>32 (86%)</td>
<td>11 (65%)</td>
</tr>
<tr>
<td>No Agency Cost Reduction134</td>
<td>18 (35%)</td>
<td>13 (35%)</td>
<td>8 (47%)</td>
</tr>
<tr>
<td>Other Monitor (Agency)</td>
<td>4 (8%)</td>
<td>2 (5%)</td>
<td>3 (18%)</td>
</tr>
<tr>
<td>Reporting Only (with no monitor)</td>
<td>18 (35%)</td>
<td>15 (41%)</td>
<td>5 (30%)</td>
</tr>
<tr>
<td>CCO/senior management report to board as only measure used</td>
<td>10 (19%)</td>
<td>9 (53%)</td>
<td>0 (0%)</td>
</tr>
</tbody>
</table>

VI. CONCLUSION

Over the last five years, federal prosecutors overseeing corporate criminal enforcement increasingly are stepping out of the courtroom and entering into corporate reform, making structural reform decisions on behalf of firms more normally the province of management or civil regulators. In so doing, prosecutors have transformed their relationship with the firms subject to their jurisdictions, assuming the role of firm-specific regulators. Moreover, they are doing so without adequate guidance from the

132 Christopher Christie’s office also produced the BMS DPA (with its large gift to Seton Hall Law School). See supra note 56.
134 Agency Cost Reduction includes other agency imposes monitor, a third party is designated as a monitor, the CCO reports to the board or is a member of senior management, reporting requirement for the CCO or senior management to the DOJ/USAO, or the CCO or senior management has authority to report to board.
DOJ on what circumstances justify the use of mandates or what reforms are the appropriate subjects of an enforcement mandate.

Our analysis of structural reform mandates highlights the importance of the DOJ both continuing this practice, while also providing clear guidance to cabin their use. Policing agency costs arise when existing managers derive personal benefits if the firm does not pursue a compliance program that maximizes the firm’s profits. In the presence of policing agency costs, *ex post* penalties imposed on the firm may not induce firms to adopt optimal policing measures.

Our analysis has shown that DPA could rectify this problem. DPA mandates may be efficient when prosecutors are in a better position than regulators to identify firms in which, and in fact find evidence that indicates that, the failure to police is due to policing agency costs. DPAs could then contain terms to ensure compliance – such as mega-policing duties or detailed policing provisions – that do not principally rely on the deterrent effect of *ex post* company sanctions. On the other hand, we do not believe that DPAs are warranted for companies with a large, controlling shareholder; in circumstances where the firm diligently self-reported and co-operated in the investigation of the substantive crime; or to impose provisions that relate to agency costs generally (rather than to policing agency costs more specifically) or that could easily be imposed, and compliance with which could easily be observed, by shareholders.

Finally, our analysis of the actual use of these mandates reveals that they increasingly are being imposed in ways inconsistent with optimal deterrence. Instead of intervening to mute policing agency costs, prosecutors appear to be focusing on substantive compliance program structure, unsupplemented by measures to ensure that policing is effective. This use of DPA mandates is not justifiable.