

CORPORATE GOVERNANCE REGULATION THROUGH NON-PROSECUTION

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Abstract

Over the last decade, federal corporate criminal enforcement policy has undergone a significant transformation. Firms that commit crimes are no longer simply required to pay fines. Instead, prosecutors and firms enter into pretrial diversion agreements (PDAs). Prosecutors regularly use PDAs to impose mandates on firms creating new duties that alter firms' internal operations or governance structures. This Article evaluates PDA mandates to determine whether and when prosecutors can appropriately use them to deter corporate crime. We find that mandates can be justified. But, contrary to DOJ policy favoring mandates for any firm with a deficient compliance program at the time of the crime, we find that mandates should be imposed more selectively. Specifically, mandates are only appropriate if a firm is plagued by "policing agency costs"—in that the firm's managers did not act to deter or report wrongdoing because they benefited personally from tolerating wrongdoing or from deficient corporate policing. We show that this policing agency cost justification provides guidance on how to reform federal policy to make appropriate use of mandates, guidance which reveals that many mandates are inappropriate.

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I. INTRODUCTION

Over the last decade, corporate criminal enforcement in the U.S. has undergone a dramatic transformation. Federal officials no longer simply fine publicly held firms that commit crimes. Instead, they use their enforcement authority to impose mandates on these firms—mandates that can require firms to alter their compliance program, governance structure, or scope of operations.¹

Prosecutors generally impose mandates through pretrial diversion agreements (PDAs). In a PDA, the prosecutor agrees not to pursue a criminal conviction of a firm. In return, the firm typically agrees to pay a fine and cooperate in the investigation. In addition, PDAs usually contain mandates that govern the firm's future behavior. These mandates may require the firm to adopt a corporate compliance program with specified features, to alter its internal reporting structure, to add specific individuals to the board of directors, to modify certain business practices, or to hire a prosecutor-approved corporate monitor.²

Prosecutors' use of PDAs to impose such mandates fundamentally alters both the structure of corporate criminal law and the role of the prosecutor.³ Traditionally, federal enforcement policy has in effect imposed a form of corporate criminal liability that is both "harm-contingent" and "duty-based." Firms that commit a substantive criminal violation⁴ are subject to heightened fines (and are more likely to face formal conviction) if they also failed to comply with *ex ante* duties⁵ designed to help detect a crime and sanction wrongdoers—

¹ PDA mandates can be imposed on any firm but generally are imposed on publicly held firms and their controlled subsidiaries. See Cindy R. Alexander and Mark A. Cohen, *The Evolution of Corporate Criminal Settlements: An Empirical Perspective on Non-Prosecution, Deferred Prosecution, and Plea Agreements*, 52 AMER. CR. L. REV. 573, 589 (2015) (showing that compliance and related mandates are more commonly included in PDAs than in guilty pleas with publicly held firms and their controlled subsidiaries).

² See generally, Brandon L. Garrett, *Structural Reform Prosecution*, 93 VA. L. REV. 853, 898-99 (2007); Peter Spivack & Sujit Raman, *Regulating the "New Regulators": Current Trends in Deferred Prosecution Agreements*, 45 AM. CRIM. L. REV. 159, 186 (2008); 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 Update – 2008*, 28 CORP. COUNS. REV. 1, 2-4 (2009); see also Vikramaditya Khanna & Timothy L. Dickinson, *The Corporate Monitor: The New Corporate Czar*, 105 MICH. L. REV. 1713, 1724 (2007) (discussing corporate monitor provisions in PDAs).

³ Prosecutors can impose mandates on firms through PDAs or guilty pleas. The conclusions we reach regarding the appropriate purposes and forms of PDA mandates applies as well to mandates imposed through corporate guilty pleas.

⁴ Throughout this Article we use the terms "substantive crime," "substantive violation," "substantive wrongdoing" and "harm" to refer to wrongdoing that causes direct immediate social harm—e.g., wire fraud, bribery, etc. We distinguish such "substantive" violations from violations taking the form of failing to undertake corporate policing intended to deter and detect substantive violations (e.g., a failure to have an independent audit).

⁵ Although the law does not technically require all firms to adopt an effective compliance program and self-report, the existing regime can be characterized as imposing duties to adopt an effective compliance program, self-report and cooperate enforced by harm-contingent sanctions in that firms that fail to take these actions face higher sanctions for detected wrongdoing than those that do undertake them under the Organizational Sentencing Guidelines. United States Sentencing Commission, U.S. Sentencing Guidelines Governing Organizations, §8C2.5

specifically, if they failed to adopt an “effective” compliance program, to self-report detected wrongdoing, and to cooperate with investigations by federal authorities (“policing duties”).⁶ Firms that satisfy these policing duties generally avoid formal conviction and are subject to lower monetary sanctions. This regime for determining criminal monetary sanctions is harm-contingent because firms can usually only be sanctioned if a substantive crime occurred. It is duty-based because sanctions do not depend simply on whether a substantive crime occurred, but rather are contingent on (or enhanced by) the firm’s failure to comply with *ex ante* policing duties.

PDA mandates deviate from this traditional regime in two ways. First, the policing duties in PDA mandates are imposed *ex post*, on select firms with detected wrongdoing, rather than generally applicable *ex ante*. Indeed, mandated duties not only are imposed after a substantive violation occurs, but the content of the mandates is often *determined* only at that time. Thus firms do not know beforehand what additional duties they will become subject to should they commit a substantive violation and become subject to a PDA mandate. Second, liability for violating PDA mandates is *not* harm-contingent. That is, a mere violation of the firm’s *ex post* policing mandate, without the commission of (another) substantive violation, exposes the firm to liability.

In combination, these two features of PDA mandates transform prosecutors into firm-specific quasi-regulators. Prosecutors can impose specific duties on a subset of firms with alleged wrongdoing; and they enforce compliance with these duties through sanctions for a mere failure to comply with the duty, even if no substantive crime occurs.

Department of Justice (“DOJ”) policy has promoted this transformation by encouraging broad use of PDA mandates. DOJ policy in effect encourages prosecutors to impose mandates on any firm with detected wrongdoing that did not have an effective compliance program at the time of the crime. The DOJ, however, has not adopted any effective standards governing what mandates to impose.⁷

Unsurprisingly, this assertion by prosecutors of quasi-regulatory authority has given rise to charges of prosecutorial abuse of discretion⁸ and calls for greater DOJ guidance.⁹ There is

(f)-(g) (2014). In addition, federal enforcement authorities focus on effective compliance, self-reporting and cooperating in deciding whether to indict a firm or give it a PDA. See *infra* Section II.A.

⁶ Policing measures are measures that increase the probability that a crime is detected or sanctioned. By contrast, “prevention measures” deter by reducing employees’ direct incentives to commit the crime. Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687 (1997) (defining corporate policing)).

⁷ Accord Garrett, *supra* note 3, 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; Jennifer Arlen, *Prosecuting Beyond the Rule of Law: Corporate Mandates Imposed Through Pretrial Diversion Agreements*, J. LEGAL ANALYSIS (forthcoming 2016).

⁸ See *infra* notes 52 and 42 (discussing examples of prosecutorial abuse of discretion in this area).

⁹ See Garrett, *supra* note 3; Spivak & Raman, *supra* note 2; see Lawrence Cunningham, *Deferred Prosecutions and Corporate Governance: An Integrated Approach to Investigations and Reform*, 66 FLA. L. REV. 1

little doubt that greater DOJ guidance and oversight is needed.¹⁰ Yet, to provide effective guidance, one must first address two fundamental questions. First, when, if ever, should prosecutors use PDAs to create and impose corporate governance mandates on firms with detected wrongdoing? Second, in situations where mandates are justified, which types of mandates plausibly enhance social welfare?

In this Article, we seek to answer these questions by determining whether, and when, the imposition of compliance programs and other mandates through PDAs is an efficient component of the overall liability regime. In particular, we identify the situations where the most cost-effective way to deter corporate crime is for prosecutors to impose PDA mandates. The circumstances in which mandates are desirable, in turn, determine what mandates are justified. We then use our analysis to show how existing DOJ policy should be modified to ensure that mandates are only imposed when, and in the form that is, appropriate.

We begin by identifying the central goal of corporate criminal liability for publicly-held firms: to induce optimal corporate policing. We show that this goal is generally best achieved through a regime, such as the traditional corporate criminal liability regime, where sanctions are imposed on firms that breached their policing duties and committed a substantive wrong. Mandates are neither needed nor desirable.¹¹

Nevertheless, enforcement authorities cannot rely entirely on such a duty-based, harm-contingent liability regime. We identify three circumstances where duty-based, harm-contingent liability may not be able to induce firms to undertake optimal corporate policing: corporate asset insufficiency, policing agency costs, and the need for targeted duties. Yet these situations do not all justify the use of PDA mandates. Examining these three situations, we find that only one of these—policing agency costs—justifies granting prosecutors the authority to create and impose mandates on select firms with detected wrongdoing. The other potential problems are more appropriately addressed through *ex ante* regulations or modifications in the harm-contingent regime, rather than through PDA mandates.

Traditional corporate liability or *ex ante* regulations, however, may be ineffective when firms are plagued by policing agency costs because, by definition, top managers of these firms benefit personally from either tolerating wrongdoing or from deficient policing. Thus, they cannot be relied on to act in the firm's best interests when designing or overseeing compliance or deciding whether to self-report and cooperate.

Therefore, to combat policing agency costs, duties must be designed to impose personal costs on managers for tolerating deficient policing or shift authority over policing to persons who do not suffer from policing agency costs. As we explain, this generally requires that the firms

(2014). Indeed, some commentators have gone beyond calls for guidance and have exhorted the DOJ to abandon PDAs altogether. See David M. Uhlmann, *Deferred Prosecution and Non-Prosecution Agreements and the Erosion of Corporate Criminal Liability*, 72 MD. L. REV. 1295 (2013).

¹⁰ E.g., Arlen, *supra* note 7.

¹¹ Arlen & Kraakman, *supra* note 6 (identifying corporate policing and prevention as the two central goals of corporate liability); see also Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL STUD. 833 (1994) (explaining that a central goal of corporate liability is to induce firms to help increase the probability that the wrongful employees are sanctioned).

subject to such duties are clearly identified. But firms with severe policing agency costs are not readily identifiable *ex ante*. This makes it difficult to impose effective duties *ex ante*. PDAs mandates are a potentially effective solution because prosecutors should be able to both identify firms with policing agency costs *ex post* and employ information gained in the investigation to remedy the problem.

We conclude by evaluating the implications of our analysis for existing DOJ policy and for potential reforms. First, the current policy of encouraging prosecutors to impose PDA mandates whenever a firm with detected wrongdoing had a deficient compliance program is not justified. Rather, such mandates should be imposed only if the firm suffered from substantial policing agency costs.

Although identifying firms with policing agency costs inevitably requires *ex post* firm-specific analysis of the firm's policing, we identify factors that indicate that policing agency costs either do not explain previous deficient policing or are unlikely to be present in the future. In particular, policing agency costs are unlikely to be significant, and thus PDA mandates generally are not appropriate, when a publicly-held firm has a controlling shareholder with sufficient power and incentives to induce managers to act in the firm's best interest. Similarly, mandates are likely inappropriate when top managers proactively responded to suspected wrongdoing by taking reasonable, good faith steps to investigate the wrongdoing, report it to the enforcement authorities, and cooperate in their investigation. Such actions suggest that any deficiencies in the compliance program were inadvertent and not caused by policing agency costs. Finally, PDA mandates are questionable when the firm, after the substantive violation occurred, underwent a transformative change, such as a change in control, that affected the previously prevailing policing agency cost structure.

Finally, we consider the implications of our analysis for the type of mandates that should be imposed. Even when policing agency costs are present and likely to continue, PDA mandates are only justified to the extent that they are effectively designed to reduce policing agency costs. To do this, PDAs must either impose precise duties falling on specific people who should expect to be held accountable for breach of the duties; or shift responsibility over policing to those not afflicted by agency costs, such as outside directors or external monitors. Mandates that are not designed to reduce policing agency costs, or mandates designed to improve corporate governance generally, rather than policing agency costs specifically, are generally inappropriate.

This Article proceeds as follows. Part II shows how PDA mandates transform corporate criminal liability. Part III examines optimal corporate liability. Part IV identifies situations where harm-contingent liability may not be effective and finds that only one situation, policing agency costs, justifies the use of PDA mandates. Part V examines the implications of our analysis for existing DOJ policy and presents suggestions for reform. Part VI concludes.

II. CORPORATE CRIMINAL ENFORCEMENT AND PDAS

This Part examines corporate criminal enforcement policy as applied to publicly-held firms. In Section A, we describe the federal corporate liability regime applied to such firms. In Section B, we review the use and typical terms of PDAs. In Section C, we show how PDA-

imposed mandates fundamentally change the structure of corporate criminal liability from a regime that relies on harm-contingent sanctions to enforce generally applicable policing duties imposed upfront to a regime where select firms are subject to differing policing duties that are both created and imposed *ex post*, (after a substantive violation occurs) and that are enforced by sanctions that are not harm-contingent.

A. U.S. Corporate Criminal Enforcement

In the U.S., corporations can be held strictly criminally liable¹² for crimes committed by employees in the scope of employment through the doctrine of *respondeat superior*.¹³ The scope of this liability is unusually broad. Corporations can be held criminally liable for crimes committed by low-level employees,¹⁴ contrary to corporate directives,¹⁵ or notwithstanding the firm's adoption of an effective compliance program.¹⁶ Convicted corporations can be subject to substantial monetary sanctions, including fines, restitution, and remediation, as well as non-monetary sanctions (such as corporate probation). They also may be subject to civil penalties and administrative sanctions.¹⁷ Administrative sanctions can include delicensing and debarment from contracting with federal agencies with potentially ruinous consequences for the firm.¹⁸

Yet, in practice, federal prosecutors do not hold publicly-traded corporations strictly liable for their employees' crimes.¹⁹ Instead, the Department of Justice instructs prosecutors to

¹² Corporations are "strictly" criminally liable in the sense that in the U.S. firms are liable for all crimes committed by employees in the scope of employment even if the firm did all it reasonably could to prevent the crime and no member of senior management or the board participated in or condoned the crime.

¹³ Individuals also are criminally liable for crimes committed with the requisite *mens rea* even if they acted on behalf of the firm and were following instructions.

¹⁴ *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).

¹⁵ *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); *United States v. Ionia Mgmt. S.A.*, 555 F.3d 303 (2d Cir. 2009).

¹⁶ Under the Organizational Sentencing Guidelines, a corporation that had effective compliance programs, self-reported and cooperated is eligible for a reduced fine. See *supra* note 5. Yet the mitigation granted to larger firms is too low to incentivize firms to undertake effective compliance or self-reporting. Jennifer Arlen, *The Failure of the Organizational Sentencing Guidelines*, 66 U. MIAMI L. REV. 321 (2012) (symposium issue). Moreover, convicted firms remain subject to the collateral penalties triggered by indictment or conviction, such as debarment, that can discourage corporate policing.

¹⁷ Non-fine sanctions plus civil penalties 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) (providing empirical evidence).

¹⁸ See Miriam H. Baer, *Governing Corporate Governance*, 50 B.C. L. REV. 949 (2009).

¹⁹ The USAM guidelines apply to all firms. Yet prosecutors tend to impose PDAs on firms where control is separated from day to day management, such as publicly held firms. Owner-managed firms tend not to receive PDAs because owner-managers often are implicated in their firm's criminal activity; these firms thus are unlikely to self-report and cooperate in return for leniency. See Jennifer Arlen, *Corporate Criminal Liability: Theory and Evidence*, 152-53, in RESEARCH HANDBOOK ON CRIMINAL LAW (Keith Hylton & Alon Harel, eds.) (2012) (finding that substantially more publicly-traded firms obtain PDAs than are convicted of crime governed by the Organizational Sentencing Guidelines). Indeed, there is evidence that prosecutors are particularly inclined to use

consider alternatives to criminal conviction based on a variety of factors, including (and especially) whether the firm maintained an effective compliance program, self-reported, and cooperated in the investigation of the wrongdoing.²⁰ Firms that fully self-report the wrong prior to threat of detection and cooperate are rarely prosecuted.²¹ Firms that avoid prosecution are generally subject to pretrial diversion agreements (PDAs).²² PDAs enable prosecutors to sanction the firm without triggering the collateral consequences of a formal conviction.²³

Thus, in practice, the corporate liability governing publicly held firms is not strict but instead resembles what one of us has called “composite liability.” Under composite liability, firms are subject to both “duty-based” criminal liability and a residual layer of strict liability. Duty-based liability imposes general upfront duties on all firms to adopt an effective compliance program, self-report detected wrongdoing, and fully cooperate with the government’s investigation (“policing duties”). Firms that breach these policing duties are subject to enhanced sanctions—including criminal conviction with enhanced fines—if a substantive violation occurs.²⁴ By contrast, firms that satisfy all of these policing duties avoid formal conviction. These firms nevertheless are liable for the misconduct, but face substantially lower sanctions, often imposed through PDAs.²⁵

PDAs to sanction parent corporations. See Alexander & Cohen, *supra* note 1, at 580 (finding that, from 2007-11, 58% of criminal resolutions with parent corporations were done through PDAs; by contrast 70% of criminal resolutions with subsidiaries involved guilty pleas).

²⁰ Then-Deputy Attorney General Eric Holder issued the first guidelines to federal prosecutors 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, which build on the Holder memo, are contained in Principles of Federal Prosecution of Business Organizations, § 9-28.900 of the United States Attorneys Manual (USAM).

²¹ Firms also can avoid conviction under other circumstances, including when the firm would be subject to ruinous collateral penalties and agrees to fully cooperate. See USAM Principles of Federal Prosecution of Business Organizations, § 9-28.900; see also 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).

²² In some cases, the DOJ will formally decline to pursue a firm instead of imposing a PDA. The DOJ does not release data on most declinations, and thus it is hard to determine how often this happens. Declination appears to be more likely when the wrongdoing is limited and the firm self-reported and fully cooperated.

²³ See USAM § 9-28.900. It might appear that PDAs also enable the firm to avoid the reputational consequences of a criminal conviction. But under the DOJ’s current policy, it is unlikely that the decision of most prosecutors to impose a PDA instead of a guilty plea has a material effect on the reputational sanction, holding constant the nature of the crime and other publicly disclosed information about the firm and the crime. Cindy R. Alexander and Jennifer Arlen Does Conviction Matter?: The Reputational Effects of Corporate Crime, RESEARCH HANDBOOK ON CORPORATE CRIME AND FINANCIAL MISDEALING (Jennifer Arlen ed. forthcoming).

²⁴ See *supra* note 4 (defining substantive violation and distinguishing it from violations predicated on the failure to comply with policing duties).

²⁵ Arlen & Kraakman, *supra* note 6; Arlen, *supra* note 11. For a discussion of when and why firms that satisfy all their policing duties should still bear monetary sanctions if a wrong occurs, see Arlen and Kraakman, *supra* note 6; Arlen, *supra* note 7.

B. PDAs and Corporate Reform Mandates

PDAs have become federal prosecutors' primary tool for imposing monetary sanctions and mandates on publicly held firms for offenses, other than antitrust and environmental crimes, since 2003.²⁶ In a conventional PDA, the firm acknowledges that its employees committed the acts that constitute the crime, agrees to waive its right to a speedy trial, and agrees to fully cooperate with the prosecutors' investigation.

In return for the firm's compliance with the PDA, prosecutors agree to not seek the firm's conviction. Under some PDAs, the prosecutor agrees not to file formal charges against the firm (non-prosecution agreements); under others, the prosecutors files charges but agrees not to seek conviction (deferred prosecution agreements).²⁷ PDAs thus occupy a middle ground between no criminal sanction and formal conviction, and are often employed with firms that had a deficient compliance program but provided valuable cooperation.

PDAs further provide that if a firm fails to comply with the terms of the PDA, the prosecutor can proceed to convict the firm using its statement of facts admitting the crime against it. A firm that fails to comply with a PDA thus faces nearly guaranteed criminal conviction even when it does not commit any subsequent crime.²⁸

The majority of PDAs require firms to pay fines and other monetary penalties. Monetary penalties imposed through PDAs can be substantial. PDAs entered into by the U.S. Attorney's

²⁶ Alexander and Cohen, *supra* note 1, at 571; Arlen, *supra* note 19 (comparing PDAs with federal convictions of publicly held firms). Pre-trial diversion agreements were used prior to 2003, most prominently in the 1994 PDA 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 2003 Thompson memo was the first official endorsement of these agreements, *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], and dramatically increased their use. In the entire period prior to 2002, prosecutors negotiated only 18 PDAs. *See* Garrett, *supra* note 3. By contrast, we find that they entered into at least 267 PDAs from 2004 through 2014 based on our dataset (we exclude agreements involving antitrust, tax, and environmental). *See also* Alexander and Cohen, *supra* note 1 (finding prosecutors entered into 155 PDAs against publicly held firms for all crimes from 2003-2011, and only 8 PDAs for antitrust or environmental). PDAs issued after the Thompson memo are more likely to impose firm-specific 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 2, 166-67; *see also* Baer, *supra* note 18, at 969-70.

²⁷ NPAs are expressed in the form of a letter, often not filed in court. Garrett, *supra* note 3, at 928.

²⁸ For example, in 2008 the DOJ concluded that Aibel Group "failed to meet its obligations" under its PDA and revoked its PDA with the firm. The firm pleaded guilty of its original offense and 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>; Christopher Matthews, Aruna Viswanatha, and Devlin Barrett, US Moves to Tear Up Past UBS Settlement, Wall Street Journal C1 (May 15, 2015) (discussing DOJ's move to convict UBS for 2012 Libor fixing, notwithstanding a 2012 PDA, following discovery of additional wrongs that occurred after that agreement). Courts have held that prosecutors have discretion to determine whether a firm's conduct constitutes a sufficient breach of PDA mandates to justify a decision to indict. *E.g.*, *See Stolt-Nielsen v. U.S.*, 442 F.3d 177 (3rd Cir. 2006) (federal courts do not have authority to enjoin a prosecutor from indicting a firm that the prosecutor concludes violated a PDA); *U.S. v. Goldfarb*, No. C 11-00099 WHA, 2012 WL 3860756 (N.D. Cal. Sept. 5, 2012) (denying motion to dismiss indictment because of claimed substantial performance with DPA).

Office or the DOJ's Criminal Division in 2010-2014²⁹ imposed mean fines of approximately \$32 million. Total sanctions imposed contemporaneously with the PDA averaged over \$85 million and total sanctions imposed on the entire corporate group at the time of the PDA averaged \$167 million.³⁰

In addition, most PDAs over the last ten years imposed various types of mandates on firms.³¹ PDA mandates usually govern the design and oversight of the firm's compliance program. Many PDA policing mandates require firms to adopt a compliance program with specific features the firm otherwise would not be required to employ.³² For example, the PDA may mandate the type of compliance information to be collected, the type and frequency of employee training, or the additional due diligence procedures or specific policies governing payments and disbursements. PDAs can also require firms to materially increase compliance expenditures.³³ Other compliance mandates simply require the firm to adopt an effective compliance program as defined by the Organizational Sentencing Guidelines.³⁴ Yet even these mandates can impose new duties on the firm because, but for the PDA, the firm generally could

²⁹ Our summary data on PDAs is based on an analysis of all PDAs except those involving antitrust, environmental or tax which fall under the Antitrust Division, Environmental Division and Tax Division respectively. These divisions have different policies on PDAs from the Criminal Division and the leading U.S. Attorney's Offices. See Alexander & Cohen, *supra* note 1 (finding few PDAs for antitrust or environmental violations).

³⁰ Between 2010-2014, PDAs imposed on publicly held firms subjected them to mean fines of approximately \$41 million; the total sanction imposed on the entire corporate group at the time of the PDA was approximately \$219 million, based on an analysis of our PDA data.

Firms subject to particularly large penalties enforced by a PDA include JP Morgan Chase (\$1.7 billion); HSBC Holdings and HSBC Bank USA (\$1.256 billion); GlaxoSmithKline PLC (\$1 billion, through PDA requiring firm to ensure subsidiary pays this amount); UBS AG (\$500 million in 2012; this is in addition to the criminal fine imposed on UBS Japan through a guilty plea); UBS (\$780 million in 2009); Adelphia Communications (\$715 million); Boeing Co. (\$615 million); Science Applications Int'l (\$500 million); KPMG (\$456 million); Credit Suisse (\$536 million); and Deutsche Bank (\$404 million). These estimates come from a hand-collected data set on all PDAs that we crossed checked against the data set on Brandon Garrett's website. We excluded firms listed on that website that we could not confirm independently, because we found a few that were not PDAs. We also excluded PDAs involving antitrust, environmental and tax offenses because these cases are under the jurisdiction of specialized divisions that have their own guidelines governing PDAs and sentencing.

Our findings are consistent with the results of Alexander and Cohen, *supra* note 1, Table 13.

³² PDA-imposed compliance program mandates also generally require firms to adopt compliance programs that differ materially from the programs firms generally adopt voluntarily. For example, whereas voluntary programs often integrate compliance efforts into the corporate divisions most directly affected by compliance efforts, the mandated programs generally require the adoption of a compliance office separate from the core workings of the firm. Finder et al., *supra* note 3. Moreover, voluntary programs tend to focus on addressing ethics issues that can lead to crime, and thus employ ethics officers, and not lawyers. By contrast, mandated compliance programs tend to take an enforcement approach, and generally employ lawyers as compliance officers. *Id.*

³³ PDA compliance provisions often dictate investment levels through provisions stating that the firm has increased its compliance to a particular level (usually following negotiations with prosecutors) and agrees to maintain at least this investment in compliance going forward. See, e.g., Alpha Natural Resources, Inc. NPA and the HSBC DPA.

³⁴ Organizational Sentencing Guidelines, §8B2.1 (listing criteria to be employed to determine whether the firm has an effective compliance program).

not be sanctioned for its failure to adopt such a program³⁵ unless a substantive violation occurs.³⁶ We refer to mandates governing compliance and other efforts by the firm to detect violations of the law as “policing mandates.”

Further, PDAs often include provisions governing internal and external oversight of the firm’s efforts to comply with the law. For example, a PDA may require the appointment of a Chief Compliance Officer with authority to report directly to the board; the addition of specific independent directors;³⁷ the establishment of new board³⁸ or senior management committees;³⁹ or the separation of the positions of CEO and Chairman of the Board. Most PDAs with mandates also require firms to regularly report to prosecutors and other federal authorities on the firm’s compliance activities. A substantial number of PDAs go even further and require firms to hire an outside monitor with authority to audit the firm to ensure its compliance with the duties imposed by the agreement and, in some cases, seek evidence of additional wrongdoing.⁴⁰ We refer to provisions governing the internal or external oversight of compliance as “meta-policing duties.”

³⁵ Some firms are subject to *ex ante* duties to adopt compliance programs to detect specific violations; willful breach of these duties often can be sanctioned even if no substantive violation occurred. These generally are aimed at ensuring the accuracy of their financial statements and books and record. Sarbanes-Oxley Act, 15 U.S.C. § 7262 (2012); Sarbanes-Oxley Act, 15 U.S.C. §78j-1 (2010) (requiring existence of a capable and empowered audit committee); Foreign Corrupt Practices Act, 15 U.S.C. §78m(b)(2)(A)-(B) (2012); *see also* 31 U.S.C. §5318(h) (2014) (discussing compliance requirements for financial institutions to guard against money laundering). These mandates also tend to be worded as general standards and leave the board nearly complete discretion to determine the investment and structure that it believes is needed to satisfy the firm’s legal duties.

³⁶ Moreover, whereas normally directors can determine how best to comply with the Organizational Guidelines’ definition of effective compliance, PDA mandates, as a practical matter, shift power to a specific prosecutor to determine whether the firm’s actions satisfy the standard set forth in the Organizational Guidelines, since the prosecutor is free to indict the firm if the prosecutor determines that it breached the PDA. Prosecutors have particularly strong leverage over firms with NPAs because courts have concluded that they will not review prosecutor’s decisions to indict a firm deemed to be in breach of an NPA. *See supra* note 28. While courts may review a prosecutors’ decision to proceed to convict a firm that the prosecutor deems to have breached the PDA, the threat of prosecutorial action is significant since if the prosecutor does proceed she will be armed with an admissible statement of guilt made by the firm. *See supra* note 28 (discussing prosecutorial authority to determine whether a firm’s actions constitute a violation of the PDA that warrants sanction).

³⁷ For example, CA Technologies, Inc. was required to appoint three new independent directors to the board, including former SEC Commissioner Laura Unger.

³⁸ For example, Monsanto’s DPA required that the board create a new committee to oversee the appointment of all foreign agents and to evaluate all joint ventures; General Reinsurance Corporation’s PDA required a new Complex Transaction Committee with power to reject any proposed transactions.

³⁹ Merrill Lynch & Co., Inc. was required to create a special structured products committee of senior management to review all complex financial transactions with a third party; company X was required to create a new “Disclosure Committee” consisting of c-suite executives and other senior management.

⁴⁰ For a detailed discussion of the monitoring provisions in these agreements *see* Khanna & Dickinson, *supra* note 2, at 1724 (discussing corporate monitor provisions in PDAs).

In addition, PDAs occasionally contain mandates that are more properly characterized as prevention, rather than policing measures. Prevention measures reduce the probability of a violation, but (unlike policing measures) do not increase the likelihood of detection if a violation occurs. Mandates that alter a firm’s compensation and promotion policies that make wrongdoing less attractive to employees are prevention measures. As one of us has shown, a company can be induced to undertake optimal prevention measures either through strict or through duty

Table One
Policing Mandates Impose through PDAs, 2008-14

Year	Total PDAs	Public firms ⁴¹	Compliance Program	Monitor	Other Mandates
2008-14	185	130 70%	152 82%	58 31%	138 75%
2008-10	76	60 79%	60 79%	26 34%	55 72%
2011-14	109	70 64%	92 84%	32 29%	83 76%

To understand the breadth of the mandates that can be imposed, consider the PDA with Bristol-Myers Squibb (BMS) for conspiracy to commit securities fraud. Under the agreement, BMS agreed to adopt a compliance program with features specified in the PDA; to institute a training program covering specified topics; to separate the positions of Chairman of the Board and CEO; to have the Chairman participate in preparatory meetings held by senior management prior to BMS's quarterly conference calls with analysts; to have the Chairman, CEO and General Counsel monitor these calls; to appoint an additional outside director to the board, approved by the U.S. Attorney's office; to hire and pay for a prosecutor-approved corporate monitor with authority to oversee compliance with both the agreement and federal law and to report to management and the prosecutor's office; and, finally, to have the CEO and CFO make specific reports to the Chairman of the Board, the Chief Compliance Officer, the monitor, and the SEC relating to sales, earnings, budgeting and projections, and other matters.⁴²

C. Mandates as a New Form of Liability

PDA policing mandates fundamentally change the structure of the corporate liability regime faced by publicly-held firms. The change is evident when we compare their core features with those of more traditional corporate liability regimes governing publicly held firms, both criminal and regulatory.

Corporate liability rules can be distinguished along two dimensions, as shown in Figure One. The first is whether firm-level liability is strict or "duty-based." Corporate liability is strict

based liability regime, whereas only duty-based liability can practically be used to induce optimal policing. Arlen and Kraakman, *supra* note 6. Our analysis in Parts IV and V of when it is desirable to supplement harm-contingent liability generally or with PDAs, as well as our discussion of how PDAs should be structured, applies equally to PDAs with prevention mandates with one qualification. Firms tend to face strict (rather than duty-based) liability with regard to prevention measures because DOJ leniency focuses appropriately on policing. In this situation, the arguments in Sections IV.C. and IV.D. relating to the use of PDAs to address limitations with duty-based liability are not relevant to the analysis.

⁴¹ Publicly held firms include all publicly held firms and all firms that are controlled (50% or more) by a publicly held firm.

⁴² Bristol-Myers Squibb DPA, <https://www.law.virginia.edu/pdf/faculty/garrett/bristol-meyers.pdf>.

when the firm is liable for all violations by its employees, as under *respondeat superior*. Corporate liability is “duty-based” when the firm is subject to liability for its employees’ actions *only if* it failed to engage in proper corporate-level policing, for example by failing to have an effective compliance program, self-report or cooperate.⁴³

Figure One
Taxonomy of Corporate Liability Regimes

Is a Policing Duty Imposed? Is the Sanction Harm-Contingent?	Strict Corporate Liability	Policing Duty Imposed <i>Ex Ante</i> on All Firms	Firm-Specific Policing Imposed <i>Ex Post</i>
Breach can be Sanctioned even if no harm-producing crime occurs		Regulations imposing <i>ex ante</i> policing duties	PDA Mandates
Sanction is Harm-Contingent	<i>Respondeat superior</i>	Duty-based Corporate Liability for Substantive Violations	

Duty-based regimes vary across a second dimension: whether liability for breach of a policing duty is harm-contingent or non-harm-contingent. Liability is harm-contingent to the extent that liability is imposed only if the firm’s employees also committed a substantive violation (beyond failing to comply with any policing duties). Liability is non-harm-contingent to the extent that a firm’s failure to adhere to its policing duties suffices to trigger liability.⁴⁴ The traditional corporate *criminal* liability regime for publicly held firms, in effect, imposes liability that is harm-contingent, as well as duty-based. A corporation with inadequate policing generally cannot be convicted unless its employees committed a substantive criminal violation.⁴⁵ By contrast, non-harm-contingent corporate liability generally is the province of regulators, such as the Securities and Exchange Commission.⁴⁶

⁴³ See supra note 7 (defining policing and prevention) and text accompanying note 24 (discussing composite liability).

⁴⁴ In the case of individual liability, tort liability for injuries resulting from the defendant’s negligent failure to take reasonable care is an example of harm-contingent liability. Government imposed sanctions on people who breach certain legal duties (e.g., who run a red light), whether or not a harm occurs, are an example of non-harm-contingent liability.

⁴⁵ A few statutes, such as the books and records provisions and effective compliance provisions of the Foreign Corrupt Practices Act, and the Suspicious Activity Report provisions and Know Your Customer provisions of the Patriot Act and Bank Secrecy Act, criminalize the willful failure to adopt or maintain an effective or reasonably compliance program. Foreign Corrupt Practices Act, 15 U.S.C. §78m(b)(2)(A)-(B) (2012); USA Patriot Act, 31 U.S.C. 5318(g), (l) (2014). These statutes impose non-harm-contingent criminal liability in theory. In practice, criminal liability for breach of these compliance provisions often is harm-contingent in that enforcement authorities tend not to enforce these provisions unless the parent or its controlled subsidiary committed a substantive violation.

⁴⁶ Examples of non-harm-contingent liability are the requirement under the Foreign Corrupt Practices Act to maintain a proper system of internal accounting controls (Foreign Corrupt Practices Act, 15 U.S.C. §78m(b)(2)(B) (2012)) or the requirement under the Securities Exchange Act to have financial statements audited. 15 U.S.C. §78j-1

PDA mandates supplement this regime with a new form of liability that differs from traditional corporate liability, whether criminal or regulatory. First, whereas duty-based corporate liability imposes policing duties on all firms upfront, PDA mandates impose policing duties *ex post* on select firms with detected wrongdoing.⁴⁷ Indeed, the duties imposed by PDAs are not merely *imposed* on firms *ex post*, but the content of the duties is often specified *ex post* by individual prosecutor offices, regularly with limited, if any, apparent oversight by, or guidance from, the DOJ.⁴⁸ Second, whereas the traditional corporate *criminal* liability regime is harm-contingent, PDA mandates impose non-harm-contingent liability: a mere breach of PDA mandates without any subsequent substantive violation can result in sanctions. PDA mandates thus in effect transform individual prosecutors into firm-specific quasi-regulators with authority to devise and impose new duties on a firm with detected wrongdoing, enforced by liability that is non-harm-contingent.

DOJ policy encourages this exercise of *ad hoc* regulatory authority by prosecutors.⁴⁹ Calls abound for increased DOJ guidance to prosecutors on when PDA mandates should be imposed and what they should entail.⁵⁰ To provide such guidance, however, one must understand how mandates fit into the corporate liability regime and what shortcomings in the regime they are designed to address. To date, neither the DOJ nor academic commentators have provided a satisfactory analysis of these issues. The remainder of this Article seeks to fill this void.

(2010). Failure to comply with these requirements exposes a firm to liability even if the underlying accounting and financial information is accurate. See *supra* note 45 (discussing non-harm-contingent criminal liability).

⁴⁷ Accordingly, in our view these mandates are not simply a nonmonetary sanction for past wrongdoing. Compare with Khanna and Dickerson, *supra* note 3. Sanctions generally are backward looking in that they are designed to induce compliance with the original duty—here the *ex ante* policing duty imposed on all publicly held firms. While the threat of PDA mandates may have *ex ante* effects, the specific mandates imposed create new duties to alter future conduct.

⁴⁸ The Department of Justice has a decentralized approach to prosecution. Each individual United States Attorney generally exercises full authority over the content of PDAs, except in a limited set of cases (e.g., FCPA, Antitrust, Tax, and environmental) where enforcement decisions are channeled through specialized divisions within main justice. In addition, the DOJ has not provided guidelines governing the policing mandates that prosecutors can impose governing corporate policing and other internal governance matters. The few guidelines issued on mandates apply to (and limit the use of) a narrow range of provisions: extraordinary restitution, waiver of the attorney-client privilege, the firm's right to advance legal cost of their employees; and the decision to impose a corporate monitor. U.S. Att'y Manual 9-28.710-720.

Indeed, prosecutors' offices not only are given considerable discretion to create and impose duties, but to date the DOJ takes the position, supported by the limited caselaw, that that federal judges reviewing PDAs do not have authority to reject or alter specific mandates imposed unless the mandate violates the constitution, a statute or the USAM. See Arlen, *supra* note 9 (discussing the narrow scope of judicial review over PDAs in more detail).

⁴⁹ The Organizational Sentencing Guidelines recommend that prosecutors impose a compliance mandate on firms subject to probation, but the Organizational Guidelines do not provide support for broad *ex post* duties. Instead, they indicate that prosecutors should require firms to adopt a compliance program that satisfies the standard of effective compliance set forth in the Organizational Guidelines. Organizational Sentencing Guidelines, §8D.1.4(b)(1).

⁵⁰ E.g., Arlen, *supra* note 7; Garrett, *supra* note 3; Rachel Barkow, *The Prosecutor as Regulatory Agency*, in *PROSECUTORS IN THE BOARDROOM: USING CRIMINAL LAW TO REGULATE CORPORATE CONDUCT* (Anthony Barkow & Rachel Barkow eds., 2011).

III. LIABILITY REGIMES AND DETERRENCE

Current federal policy favors the imposition of policing mandates on any firm that did not have an effective compliance program at the time of the violation.⁵¹ The vast majority of PDAs impose such mandates.⁵² This broad policy favoring policing mandates raises the question of whether policing mandates should generally be imposed on firms with detected wrongdoing that did not have an effective compliance program at the time of the crime.

To address this question, in this Part, we first identify a central purpose of corporate criminal liability for publicly held firms—which is to induce optimal corporate policing. We show that duty-based liability imposed on firms with detected wrongdoing (i.e., harm-contingent liability) generally is the most appropriate regime for achieving this goal.⁵³ In particular, pursuing harm-contingent actions against firms with deficient policing is generally more effective at inducing proper corporate policing than non-harm-contingent liability, of the type imposed by PDAs mandates. Similarly, imposing policing duties *ex ante* on all firms is generally more effective than allowing prosecutors to devise and impose policing duties *ex post* on select firms with prior detected wrongdoing. We conclude that, contrary to the current policy, prosecutors should not be imposing PDA mandates merely because the firm's compliance program was deficient. Whether PDA mandates are justified in more limited circumstances is discussed in Part IV.

A. Optimal Deterrence in Publicly-Held Firms

Criminal law cannot optimally deter crime by publicly held firms unless the individuals responsible for the crime are personally sanctioned for the wrongs they commit.⁵⁴ Corporate sanctions alone are not sufficient because, in publicly-held firms, the individuals who actually commit crimes⁵⁵ generally own only a small percentage of the firm's stock. Thus, these

⁵¹ Although the DOJ does not have a formal policy governing when mandates should be incorporated into PDAs, the USAM provisions governing plea agreements contain a provision covering mandates. These favor imposing mandates requiring the firm to implement a compliance program or reform an existing one if the firm is subject to organizational probation, in addition to any monetary sanction. See U.S. Att'y Manual 9-28.1300—Plea Agreements with Corporations, *available at* <http://www.justice.gov/opa/documents/corp-charging-guidelines.pdf>. In turn, the Organizational Sentencing Guidelines provide that probation is appropriately imposed on any firm with over 50 employees that did not have an effective compliance program at the time of the offense. Organizational Sentencing Guidelines, § 8D1(a)(3).

⁵² Approximately 80 percent of the PDAs impose compliance program mandates. See *supra* Table One.

⁵³ Arlen & Kraakman, *supra* note 6. In theory, strict liability could be employed, but only if fines could practicably adjust so that any corporate action that increases the probability of detection and sanction produced an equivalent reduction in the fine. *Id.*

⁵⁴ Arlen & Kraakman, *supra* note 6; see also Sally Quillian Yates, Memorandum on Individual Accountability for Corporate Wrongdoing (Sept. 9, 2015) <http://www.justice.gov/dag/file/769036/download> (discussing the importance of individual liability for corporate crime). By contrast, corporate liability could be used to optimally deter crime by owner-managers of closely held firms provided the firm has sufficient assets to pay the optimal fine. Arlen, *supra* note 19 (discussing corporate liability for closely held firms).

⁵⁵ This discussion focuses on the type of corporate crimes that cause direct social harm, such as securities fraud and bribery, which generally require an affirmative act of individuals who know they are acting unlawfully.

individuals are not likely to be motivated by the benefit they derive as shareholders. Instead, they are motivated by a personal benefit, such as increased job security, additional compensation, or promotion resulting from an undetected crime that boosts real or apparent profits.⁵⁶ Put differently, crimes by publicly-held firms often are an agency cost, best deterred by imposing liability directly on the individual wrongdoers.⁵⁷

Nevertheless, individual liability alone generally cannot optimally deter corporate misconduct by publicly-held firms. Left to their own resources, enforcement authorities generally will be unable to detect wrongdoing or sanction individual wrongdoers with sufficient regularity to ensure that crime does not pay.⁵⁸ Evidence of crimes by employees of publicly-held firms rarely lies out in the open. Detecting crime, identifying wrongdoers, and obtaining evidence needed to convict them requires significant upfront expenditures to monitor corporate activities, as well as significant resources devoted to investigations of suspected wrongs (hereinafter “corporate policing”). Firms often are far better able than the government to undertake these policing activities.⁵⁹ Thus, to effectively deter most crimes by employees of publicly-held firms, government enforcers must induce firms to come to their aid by adopting

This discussion does not liability for breach of corporate or individual oversight duties. Responsibility for compliance with these duties can be diffuse and there can be circumstances where the firm is liable (or subject to a PDA) even though no individual in the firm made an affirmative decision to violate the law for personal benefit.

⁵⁶ Many of the gains employees seek—such as promotions, bonuses, and avoiding termination—are one-way effects: employees can get a promotion or bonus by committing a crime to benefit the firm which the employee may retain even if the wrong is detected either because the wrong is not attributed to the employee or the firm decides not to sanction or fire the employee. See Arlen, *supra* note 19 (discussing why the government generally cannot rely on corporate liability alone to optimally deter crime by employees of publicly-held firms).

⁵⁷ See Arlen, *supra* note 11; Jonathan Macey, Agency Theory and the Criminal Liability of Corporations, 71 B.U. L. Rev. 315 (Symposium 1991); Arlen, *supra* note 19, at 194 n. 39 (discussing why corporate crime can be treated as the product of self-interested rational decision-making even if many street crimes are not); see also 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).

⁵⁸ Arlen, *supra* note 19, at 167-71 (providing conditions necessary for optimal deterrence with individual liability alone); cf. Arlen and Kraakman, *supra* note 6; see 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).

Individual liability fails to optimally deter when the probability of detection and sanction is very low for two reasons. First, rational actors are not deterred unless the expected sanction—given by the sanction multiplied by the probability of sanction, P —equals or exceeds the benefit of crime, B . Thus the actual sanction must at least equal B/P . Gary Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968). When the probability of sanction is low, the optimal sanction will often exceed the amount that can be optimally imposed on individuals given their limited wealth and the high social cost of imprisonment. Second, behavioral analysis suggests that individuals may not be deterred when the probability of sanction is too low because people often discount very low probability events to zero. Corporate liability should reduce both problems because well-structured corporate liability should increase the probability individuals are sanctioned, thereby increasing individuals’ expected sanction and lowering the optimal individual sanction. Arlen, *supra* note 19.

⁵⁹ Arlen & Kraakman, *supra* note 6. For a detailed discussion of why firms are the least cost provider of many policing measures see Arlen, *supra* note 19.

compliance programs designed to detect crime, investigating suspected wrongs, self-reporting, and cooperating with the government's efforts to prosecute individuals.⁶⁰

Policing measures, however, are costly. Firms will not adopt policing measures unless their benefit from doing so exceeds the cost of these measures. A regime where corporate liability is duty-based and harm-contingent can provide firms with the requisite incentive to adopt optimal policing.⁶¹ Corporate liability needs to be duty-based because effective corporate policing both imposes substantial direct costs⁶² and increases the probability that enforcement authorities will detect and sanction any crimes a firm's employees commit. To induce firms to bear both these direct expenses and the increased probability of future sanctions, corporate sanctions imposed for detected wrongdoing must be adjusted to ensure that firms face lower *expected* liability if they police optimally than if they do not. Thus, firms that engage in proper policing need to be subject to a substantially lower sanction should employees commit a crime;⁶³ by contrast, firms with deficient policing should face enhanced sanctions for employee wrongdoing sufficient to ensure that the firm has higher expected costs if has deficient policing *even though* deficient policing results in a lower probability of being sanctioned. Corporate liability that is duty-based and harm-contingent can ensure that firms are better off if they engage in optimal policing. It thus can induce firms to undertake proper policing, and thereby help to deter wrongdoing by corporate employees.⁶⁴

⁶⁰ Arlen & Kraakman, *supra* note 6; Arlen, *supra* note . Firms also can lower the net social cost of crime both by adopting "prevention measures," such as compensation policy reform, and reducing activity levels. Arlen & Kraakman, *supra* note 6; see A. Mitchell Polinsky and Steven Shavell, *Should Employees Be Subject to Fines and Imprisonment Given the Existence of Corporate Liability*, 13 INT'L REV. L. & ECON. 239 (1993)

⁶¹ To be precise, firms should be subject to a composite duty-based liability regime that combines enhanced duty-based criminal liability for failure to adopt effective policing with strict civil liability for any harm caused. See *supra* text accompanying note 25. Duty-based liability is superior to strict *respondeat superior* because firms subject to strict corporate liability with a fixed fine have suboptimal incentives to undertake measures that increase the probability that wrongdoing is detected and sanctioned, as these actions can increase the firm's own expected liability. See Arlen, *supra* note 6; Arlen & Kraakman, *supra* note 6; accord Arlen, *supra* note 19, at 174-7 (showing that *respondeat superior* with a fixed fine cannot induce both optimal prevention and policing); compare with 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); Arlen and Kraakman, *supra* note 6 (same).

⁶² *Ex ante* corporate policing in the form of compliance programs can be very expensive. For example, according to HSBC's 2012 DPA, the firm spent over \$240 million on antifraud and money laundering compliance in 2011 alone.

⁶³ Criminal liability should be reserved for firms that violate their policing duties as this enables the state to offer a sufficiently big reward to firms that comply with their policing duties to make a firm willing to self-report even when substantial civil sanctions will be imposed.

⁶⁴ Arlen, *supra* note 19, at 185-7; Arlen & Kraakman, *supra* note 6. In fact, 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. Firms that undertake optimal policing should bear expected sanctions equal to the social cost of the crime to induce optimal prevention. See *supra* note 25; For an in-depth discussion of the justifications for and optimal structure of corporate liability see Arlen & Kraakman, *supra* note 6; Arlen *supra* note 19, at 177-85. Nevertheless, firms that police optimally should not bear monetary sanctions when shareholders internalize the full cost of the crime absent liability, as often is the case with securities fraud. Arlen & Carney, *supra* note 57; Arlen, *supra* note 19, at 187-8.

PDA mandates differ from duty-based, harm-contingent liability in two respects. First, the policing duties in these mandates are imposed *ex post* on select firms with detected wrongdoing, instead of *ex ante* on all (or a specified subset of) firms. Second, liability for breach of these duties is not harm-contingent, but may be imposed even if no substantive violation occurs. In the next two Parts, we examine whether these two features of PDA mandates—*ex post* duties or non-harm-contingent sanctions—justify their imposition on firms with detected wrongdoing that did not have an effective compliance program.

B. Advantages of Harm-Contingent Corporate Liability

Enforcement authorities generally can more effectively induce optimal corporate policing by pursuing harm-contingent, rather than non-harm-contingent, actions against firms with deficient policing, whether non-harm-contingent liability is imposed through PDA mandates or regulation. Corporate policing entails duties along four separate dimensions: adoption of an effective compliance program; effective oversight of the program, including the proper response to reports of suspicious activities; self-reporting of detected wrongdoing; and cooperation with enforcement authorities. Most of these policing duties—such as duties to respond effectively to evidence of wrongdoing,⁶⁵ self-report detected wrongdoing, and cooperate with enforcement authorities—only arise, and thus only can be breached, in the context of an actual or suspected substantive violation. Harm-contingent liability is effective as applied to these duties because it focuses the state's limited enforcement resources on evaluating the firm's adherence to its policing duties on those situations where all of the firm's policing duties have arisen and evaluation of breach can encompass the full panoply of duties. By contrast, inducing policing by deploying enforcement resources in the absence of any wrongdoing is generally less effective because several dimensions of corporate policing have not yet arisen.

Of course, some duties do arise before any wrongdoing occurs. For example, firms may have investigatory duties when wrongdoing is suspected, even if misconduct did not occur. Nevertheless, harm-contingent enforcement actions tend to be superior because bringing enforcement actions in the absence of actual wrongdoing presents an increased risk of error. When enforcement authorities evaluate policing by firms that have not actually committed a substantive violation, they could conclude that the firm failed to properly investigate and report a suspected violation even if the firm had a reasonable basis for being confident that no such violation occurred.

In addition, firms have a duty to adopt and maintain an effective compliance program regardless of any wrongdoing. Again, however, focusing enforcement resources on firms that also committed a substantive violation will tend to be a more cost-effective way to induce effective compliance. Although prosecutors can evaluate certain facets of a compliance program

⁶⁵ The duty to have an effective compliance program is 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 arises only once there is suspected wrongdoing. See *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 overseeing it in good faith); see *Stone v. Ritter*, 911 A.2d 352 (Del. 2006) (adopting the duty and standard of liability announced in *Caremark*).

prior to any wrongdoing—such as whether the firm established a compliance office and hired a compliance officer at all—most aspects of compliance program effectiveness depends on soft inputs—e.g., the level of attention, commitment, and courage of the compliance department—that are difficult to evaluate in the abstract. Enforcement authorities can better distinguish firms with “paper” compliance programs from those with genuine compliance programs by examining how compliance programs operate in the context of an actual substantive violation.⁶⁶

C. Advantages of *Ex Ante* Rules over PDA Mandates

The second distinguishing feature of PDA policing mandates is that they impose duties only on firms with prior detected wrongdoing and that they do so in an *ad hoc* fashion.⁶⁷ PDA policing mandates thus differ both from standard, duty-based, harm-contingent corporate criminal liability and *ex ante* regulation, which each impose general duties upfront on all firms (or on a subset of firms with particular characteristics, such as banks or publicly-traded companies).

Ex ante duties have an obvious advantage over mandates imposed selectively on firms with detected wrongdoing: the policing duties imposed—and thus the incentives they create—apply to a wider set of firms. *Ex ante* rules are presumably superior whenever it would be desirable to impose policing duties on a broader set of firms that includes firms without detected wrongdoing.

A further difference between *ex ante* duties and PDA mandates lies in the identity of the governmental body in charge of the decision to impose a duty and the design of the duty. *Ex ante* duties are often imposed through rules adopted by regulatory agencies or central enforcement authorities (e.g., the Sentencing Commission) after careful deliberation and after

⁶⁶ For a discussion of the problem of cosmetic compliance programs, 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).

In the torts context, it has been argued that harm-contingent enforcement is more cost-effective because it focuses enforcement resources on firms that are more likely to have violated their duties. The idea is that if compliance with legal duties reduces the risk of harm, it is likely that firms with detected harms are more likely to be firms that failed to satisfy their duties. See Steven Shavell, *A Fundamental Enforcement Cost Advantage of the Negligence Rule over Regulation*, 42 J. LEGAL STUD. 275 (2013) (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). This argument from the torts context does not apply to corporate crime, however. This is because corporate policing has two competing effects. On the one hand, it reduces the probability of crime. On the other, it increases the probability that wrongs that occur are detected and sanctioned. Arlen, *supra* note 11; Arlen and Kraakman, *supra* note 6. If the latter “liability enhancement effect” exceeds the former “deterrent effect,” then firms with detected wrongdoing are likely to be those with excellent policing that reveals any wrongs that occur. Were this the case, then firms with detected wrongdoing would rarely have policing breaches. Of course, in this situation, prosecutors would have little reason to impose PDA mandates as firms with detected wrongdoing generally would have optimal policing.

⁶⁷ This analysis focuses on the deterrence implications of having *ex post* mandates on firms with prior detected wrongdoing. For a discussion of the rule of law issues raised by prosecutors’ offices’ authority to create *ad hoc* mandates, usually without any genuine external review, see Arlen, *supra* note 7.

obtaining input from experts, the affected parties, and the public. These bodies generally have subject matter expertise and mechanisms for obtaining information on the costs and effectiveness of policing measures.⁶⁸

By contrast, PDA mandates are created and imposed by individual prosecutors' offices,⁶⁹ with little, if any, effective guidance from the DOJ.⁷⁰ With the exception of substantive violations that tend to be handled by a single prosecutorial office (e.g., violations of the FCPA), the prosecutors designing PDA mandates may have no expertise with the type of violation involved.⁷¹ Moreover, even when prosecutors have experience with a particular type of violation, they still may lack the expertise needed to design and impose an optimal compliance program tailored to firms in a particular industry or with a particular organizational structure. Finally, prosecutors often lack the resources or incentives to provide on-going assessment of the policing measures they impose.⁷² The fact that regulators generally have greater experience and access to more information than the prosecutors who impose PDA mandates is thus a further reason why it is generally preferable to impose policing duties through *ex ante* rules rather than through PDA mandates.

D. Enforcement Policy and Practice Favoring PDA Mandates

As we have shown, a regime that imposes liability on corporations when the firm's employees committed a substantive violation and the firm failed to comply with its policing duties is generally more effective than the non-harm-contingent liability imposed by PDAs. In addition, it is preferable to impose policing duties *ex ante*, through generally applicable rules or standards, rather than through PDA mandates, which impose duties selectively on firms with detected wrongdoing and are fashioned in an *ad hoc* manner by prosecutors. PDA mandates are thus generally not part of the optimal liability regime.

⁶⁸ For an additional discussion of these issues see Baer, *supra* note 18, at 1004; Jennifer Arlen, *Removing Prosecutors from the Boardroom: Detering Crime Without Prosecutor Interference in Corporate Governance*, 79-871 in *PROSECUTORS IN THE BOARDROOM: USING CRIMINAL LAW TO REGULATE CORPORATE CONDUCT* (Anthony Barkow & Rachel Barkow eds., 2011).

⁶⁹ Prosecutors' offices vary significantly in their use of PDAs. A small number of US Attorneys' Offices and DOJ divisions are responsible for the vast majority of PDAs. See GAO Report, *supra*, at 3 (reporting results of a preliminary survey finding only 12 offices with two or more PDAs). The content of PDAs also varies. The variation is greatest in the PDAs imposed by U.S. Attorneys' offices. There is more consistency in the PDAs imposed by the specialized enforcement divisions of the DOJ, such as the Antifraud and Money Laundering Division.

⁷⁰ See *supra* note 48 and Arlen, *supra* note 67 (neither the DOJ nor the judiciary provides guidance or oversight that constrains the policing mandates prosecutors can impose in most cases).

⁷¹ Assistant U.S. Attorneys in certain U.S. Attorney's offices—such as the Southern District of New York, Eastern District of New York, District of New Jersey—and in specialized sections such as those covering Antitrust, Environmental, the Fraudulent Corrupt Practice Act, Antifraud and Money Laundering, and Tax often will have considerable expertise in this area. Yet many AUSAs in other offices do not.

⁷² Although some prosecutors work directly with regulators in designing PDAs, many do not. GAO report, *supra* note 21, at 17 (noting that 8 of 13 offices interviewed stated that they commonly design compliance programs with the cooperation of the relevant regulatory agency). Those who do retain full authority to impose the mandates they prefer. See Arlen, *supra* note 68 (discussing the benefits of vesting regulators with primary authority over mandates); *Cf.* Baer, *supra* note 18, at 1044-1071 (critiquing the current system).

Nevertheless, existing DOJ policy encourages the imposition of PDA mandates on firms with detected wrongdoing whenever the firm had a deficient compliance program. The rationale for this policy is presumably that the standard harm-contingent and duty-based corporate liability failed in these cases to induce proper policing and needs to be supplemented.

Evidence that a firm adopted a deficient compliance program, however, does not indicate that PDA mandates are superior in inducing proper policing to appropriate monetary sanctions for breach of harm-contingent duties and to generally applicable *ex ante* duties that are not harm-contingent. First, firms may actually or apparently under-invest in compliance because managers erred in determining the optimal level of compliance. While the Organizational Sentencing Guidelines and federal enforcement policy in effect impose an *ex ante* duty on all firms to adopt an effective compliance system, this duty takes the form of a fairly general standard that leaves considerable room for interpretation. Directors or managers of firms with deficient compliance programs may have believed in good faith that their firm complied with the requisite policing standard, only to find out later that the firm did not. In such a situation, clarifying the required compliance measures and educating firms on their compliance deficiencies, rather than imposing non-harm-contingent mandates, is the proper response.⁷³

Second, firms may have actually and knowingly under-invested in compliance, or otherwise breached their policing duties, because the existing regime did not provide them with adequate incentives to adopt an effective compliance program.⁷⁴ Yet, while these cases indicate that additional incentives are needed, PDA mandates are not the best solution. Instead, the DOJ should focus on remedying deficiencies with duty-based liability so that the policing duties and monetary sanctions imposed ensure that firms are better off when they adopt effective compliance and self-report than when they do not.

Thus, existing federal enforcement practice favoring mandates, as a *standard* component of a PDA whenever a firm had compliance deficiencies, is not justified.⁷⁵ In the next Part, we consider whether mandates may be justified in special cases where duty-based, harm-contingent corporate liability cannot be employed effectively.

⁷³ Alternatively, perceived compliance deficiencies may, in some cases, result from prosecutorial error. See *infra* Part IV.

⁷⁴ E.g., Arlen, *supra* note 16 (showing that Organizational Sentencing Guidelines provide insufficient fine mitigation to large firms that adopt an effective compliance program to induce them to incur the added cost and enforcement risk of these programs).

⁷⁵ Indeed, the availability of PDA mandates may undermine efforts to implement an effective duty-based regime with monetary sanctions. Individual prosecutors seeking to obtain a high profile conviction may be tempted to substitute mandates for adequate sanction enhancements for firms with deficient compliance if they incorrectly believe the mandate will achieve the same goal and firms are more amendable to the mandate. Firms are more likely to adopt effective compliance programs if provided clear upfront guidance and subject to very serious enhanced penalties for inadequate compliance, especially given prosecutors' limited ability to undertake the active oversight needed to ensure that the firm has truly complied with any mandate imposed.

IV. ARE PDAs OPTIMAL IN SPECIAL CIRCUMSTANCES?

Although duty-based, harm-contingent liability is generally superior to PDA mandates, all liability regimes have their limits. In this Part, we identify three circumstances when duty-based, harm-contingent liability may be deficient: corporate asset insufficiency, policing agency costs, and the need to impose heightened duties on some firms beyond those imposed by the general regime. In these situations, it may be desirable to supplement or replace duty-based, harm-contingent corporate liability with another form of liability. Two possibilities for supplementing or replacing the harm-contingent liability regime suggest themselves: PDA mandates imposing *ex post* policing duties that are non-harm-contingent and regulations that impose *ex ante* policing duties that are non-harm-contingent (*ex ante* regulation). PDA mandates should only be adopted if they, in fact, remedy deficiencies in a harm-contingent liability regime and are superior to *ex ante* regulation. In this Part, we show that policing agency costs can justify the use of properly designed PDA mandates. *Ex ante* regulation, however, is the superior response to the other two deficiencies.

A. Asset Insufficiency

Asset insufficiency is the most obvious limitation on the effectiveness of harm-contingent corporate liability. Duty-based, harm-contingent liability will not provide firms with adequate incentives to invest in policing if the firm cannot pay the optimal harm-contingent sanction.⁷⁶

In this situation, it may be desirable to impose non-harm-contingent sanctions on firms. Asset insufficiency is less of a concern under non-harm-contingent liability because the optimal non-harm-contingent sanction is generally substantially lower than the optimal harm-contingent sanction.⁷⁷ The explanation for why optimal sanctions can be lower when liability is non-harm-contingent is best illustrated through an example. Assume that it is optimal to induce firms to invest an amount *C* in corporate policing (e.g., compliance). In order to induce firms to incur this cost, the government must ensure that each firm's expected costs are lower if it invests *C* in compliance than if it does not.⁷⁸ Enforcement authorities can provide this incentive by imposing a duty to have effective policing enforced by a fine of *F* on any firm that breaches this duty. As long as the *expected* sanction, *P*·*F* imposed on firms with poor compliance—as given by the

⁷⁶ 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 19 (duty-based corporate liability will not induce optimal policing if the firm does not have sufficient assets to pay the optimal enhanced sanction if it fails to police optimally).

⁷⁷ This discussion tracks the general argument for why *ex ante* regulation is superior to tort liability when injurers are asset constrained. 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 2 (concluding that corporate asset insufficiency is the primary justification for imposing corporate monitors).

⁷⁸ 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.

amount of the fine (F) multiplied by the probability that policing breaches are sanctioned (P)—equals or exceeds the cost of optimal compliance (C), the firm will undertake optimal compliance. Accordingly, firms will police optimally so long as the sanction for inadequate policing, F , equals or exceeds the cost of optimal compliance divided by the probability that liability is imposed, C/P .⁷⁹ As a result, when the probability that a firm will be sanctioned (P) is higher, the requisite sanction (F) needed to induce firms to invest C in policing is lower.

Non-harm-contingent liability entails a higher probability of sanction than harm-contingent liability. With non-harm-contingent liability, the government can sanction any firm it detects breaching its policing duty, both those that also committed a substantive crime and those that did not. By contrast, with harm-contingent liability, enforcement authorities can only sanction a firm that breaches a duty if, in addition, the firm commits a substantive crime and they detect it. Because non-harm-contingent liability entails a higher probability of sanction than harm-contingent liability, the optimal sanction is lower. Accordingly, even when a firm would not have sufficient assets to pay the harm-contingent sanction required to induce optimal policing, enforcement authorities may still be able to use non-harm-contingent sanctions to induce optimal policing because the requisite sanctions are lower.

Asset insufficiency thus justifies supplementing or replacing harm-contingent duty-based liability with non-harm-contingent liability. Yet, it generally does not justify the imposition of PDA mandates.⁸⁰ Instead, asset insufficiency should be addressed through *ex ante* regulations that impose policing duties. *Ex ante* regulations are more effective at dealing with asset insufficiency than PDA mandates because *ex ante* regulations can impose non-harm-contingent liability on all firms where asset insufficiency is a concern. By contrast, PDA mandates can only impose non-harm-contingent liability on a subset of those firms where asset insufficiency is a concern – those with prior detected wrongdoing – leaving all others needing this intervention with inadequate incentives to police.⁸¹

This *ex ante* regulatory approach is possible because regulators generally have sufficient information to identify—and establish standards that would allow firms to identify—the firms or

⁷⁹ Arlen, *supra* note 11; see also Gary Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169 (1968) (optimal sanctions when some violations escape sanction).

⁸⁰ We thus agree with Khanna and Dickinson that in order to deter corporate crime, enforcement authorities should supplement harm-contingent sanctions with non-harm-contingent sanctions when firms are asset constrained. But we conclude that PDAs mandates are not the optimal form of supplementary liability. Compare with Khanna & Dickinson, *supra* note 2 (suggesting that asset insufficiency would justify corporate monitor, which is one type of harm-contingent duty and sanction).

⁸¹ Non-harm-contingent liability is effective only when government authorities incur sufficient monitoring and enforcement expenditures to detect and sanction breaches of policing duties. Thus, non-harm-contingent liability is optimal only when the expected social cost of policing plus government monitoring is less than the social cost of the crimes deterred. We focus on crimes where this condition is met. As applied to these crimes, it might appear that PDAs are superior to *ex ante* regulation because they apply to fewer firms, thus reducing monitoring and enforcement. Yet this is not necessarily the case for two reasons. First, total social costs may be higher under PDAs because PDAs deter fewer crimes since they are not imposed until wrongdoing is detected. Second, to induce optimal policing through PDAs, the government would likely need to incur higher per firm monitoring costs in order to yield the same expected sanction as can be imposed through regulation, since PDAs tend to be imposed on firms whose assets have been reduced by fines imposed for the detected crime.

industries where asset insufficiency is a concern *ex ante*. For example, they can target firms with a small amount of net assets, firms operating in an industry where optimal compliance expenditures are high relative to assets, or firms conducting operations that generate a small probability of very costly harm.⁸²

B. Policing Agency Costs

Duty-based, harm-contingent corporate liability also may fail to induce optimal policing as a result of agency costs that affect corporate policing (“policing agency costs”). PDA mandates may be an effective response to this problem.

Duty-based corporate liability alone can induce firms to adopt optimal policing when firms are managed by officers and directors who make policing decisions to maximize the firm’s profits. But it will not suffice to induce optimal corporate policing when managers benefit from making sub-optimal policing decisions because they obtain personal benefits either from facilitating substantive crimes or from tolerating deficient corporate policing. In addition, senior managers may eschew policing measures that entail oversight of their own actions by compliance officers, even if they plan to comply with the law, when oversight reduces their power and thwarts their autonomy.⁸³ In these situations, even when a corporate liability regime is structured such that taking optimal policing measures is in the shareholders’ interests, managers of some firms have self-interested reasons to induce or tolerate sub-optimal policing.⁸⁴ We will refer to private benefits that undermine managers’ incentives to police in the best interest of shareholders as “policing agency costs.”

⁸² Regulators can obtain firm-specific information through publicly-available financial statements or through regulatory examinations. Regulators also may be able to adopt regulations targeted at industries where firms tend to be asset constrained as firms in certain industries (e.g., hazardous waste management) tend to be strategically thinly capitalized to reduce expected liability.

Even if prosecutors cannot cost-effectively identify firms (or industries) at heightened risk of asset insufficiency *ex ante*, regulation generally will be superior to PDA mandates as a solution to asset insufficiency. Regulatory authorities could impose policing duties enforced by non-harm-contingent sanctions on all firms that have capital below a particular threshold, and address the identification problem by examining firms with suspected wrongdoing to see if they meet the threshold. This would increase the probability of sanction above a harm-contingent regime. The only mandate that would appear to be an effective supplement in this case would be monitors that help the government detect policing duty breaches by firms identified to be asset constrained and at risk of policing duty breaches that could be socially costly

⁸³ 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 compliance programs also can impose a burden. For example, additional record-keeping, bureaucracy, and oversight can impede managers’ ability to act quickly or creatively 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, in an abundance of caution, may constrain the firm from taking profitable actions that generally are legal but are susceptible to abuse.

⁸⁴ While FCPA violations commonly result in liability for both the firm and the individuals who directly made the bribe, senior managers of publicly held firms generally are not held liable, even when the DOJ claims that the firm knowingly and willfully conspired with a foreign subsidiary to bribe a public official or committed a crime by willfully violating its duty to adopt an effective compliance program to detect FCPA violations.

Consider, for example, the recent reports that Volkswagen engineers installed “defeat devices” in the company’s cars. These defeat devices artificially lowered nitrogen emissions to satisfy regulatory standards when the cars were tested, without adversely impacting engine performance when the cars were driven under regular conditions. At this point, VW’s internal investigation suggests that engineers installed the devices in order to meet otherwise unattainable emissions targets, in the expectation the devices would not be detected.⁸⁵ While it is not clear whether Volkswagen’s top managers were aware of the defeat devices, senior managers should have known defeat devices could be installed and VW could have performed tests to ensure they were not. Evidence that they failed to establish a compliance program designed to detect defeat devices, combined with evidence that at least one senior manager knew about the devices and said nothing, suggests that top managers may have cared more about achieving their long-standing objective of having Volkswagen become the largest car company in the world⁸⁶ *for their own benefit* than about having an effective compliance program. In other words, while a deficient compliance program may not have been in the best interest of shareholders, it may have advanced the interest of top managers in running the world’s largest car company.

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. Thus, publicly-held firms, whose managers generally own a small portion of the shares, are more likely than owner-managed closely held firms to have high policing agency costs.

Yet this does not imply that PDA mandates should be imposed on all publicly-held firms with detected wrongdoing. Although all publicly-held firms suffer from *some* agency costs, not all (or even most) publicly-held firms have high *policing* agency costs. Whether a publicly-held firm exhibits high policing agency costs depends on a variety of considerations. These include the structure of the firm’s compensation and promotion policies,⁸⁷ its financial situation, managers’ expected tenure at the firm, the business a firm operates, the particular relationship between the senior managers and the board, and whether the firm has an active controlling shareholder who ensures that the firm’s policing serves shareholders’ interests.⁸⁸ Thus, policing 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 and composition, the type of business the firm is engaged in, the type of criminal liability to which

⁸⁵ <http://www.reuters.com/article/us-volkswagen-emissions-investigation-idUSKCN0V02E7>.

⁸⁶ <http://www.usatoday.com/story/money/2015/07/28/volkswagen-surpasses-toyota-worlds-largest-automaker-first-half-2015/30772509/>

⁸⁷ Publicly-held firms can use compensation policy to reduce or enhance policing agency costs: policing agency costs are increased to the extent compensation is structured to enable managers to benefit from increases in the stock price or in corporate performance over the short term more than they are harmed by declines over a longer term.

⁸⁸ Individual shareholders generally 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 cannot readily be verified externally. Nor can individual shareholders address the agency cost problems associated with compliance programs entirely through incentive pay especially given managements’ influence over incentive pay at many publicly held firms.

the firm is subject, and the feasibility of board oversight of compliance, enables managers both to benefit *ex ante* from suboptimal policing and to implement it unchecked.

When the firm is plagued by significant policing agency costs, authorities cannot rely solely on the threat of sanctions for inadequate policing imposed *on the firm* to induce optimal policing. The very presence of policing agency costs undermines the incentive effects of corporate sanctions because managers benefit from deficient policing even when the firm does not. In these situations, it may be desirable to intervene to address policing agency costs through measures that would not be desirable absent policing agency costs.

One possible approach is to impose duties that are structured to combat policing agency costs. Another approach is to hold managers personally liable for the firm's failure to satisfy its policing duties.

PDA mandates can be an example of the first approach. PDA mandates are justified as a remedy to policing agency costs if three conditions are met. First, the duties imposed by the PDA must be properly designed to address policing agency costs. Second, imposing these duties through PDAs *ex post* (after a substantive violation has occurred) is superior to imposing them through *ex ante* regulation. Finally, mandates are superior to liability imposed directly on managers for failure to undertake optimal policing. The next three Subsections address these conditions.

1. Using Policing and Meta-Policing Duties to Reduce Agency Costs

One way to address policing agency costs is to impose additional duties on affected firms, either through PDAs or through *ex ante* regulation. The root problem of policing agency costs is that managers can benefit from a firm's failure to comply with its policing duties even though compliance would be in the firm's best interest. Accordingly, in order to reduce policing agency costs effectively, it is not sufficient to impose general policing duties enforced solely through corporate sanctions. Instead, to combat policing agency costs, policing duties must be structured to make it harder or more costly for *managers* to have the firm pursue suboptimal policing. Two types of duties can be used, separately or in concert, to achieve this goal.

First, PDAs mandates or *ex ante* regulations can require the firm to undertake *specific* policing measures. Imposition of specific policing duties can incentivize managers, even though liability ostensibly falls on the firm, if the required policing measures are clearly specified and senior managers know that they will be held responsible for ensuring that the company undertakes them. If the duty is clear and senior managers are responsible to ensure compliance, then these managers can expect to be blamed and sanctioned by shareholders, independent directors, and the market for any criminal conviction and sanctions imposed on the firm for failure to comply. Possible sanctions on managers include termination, reduced compensation, a suit for breach of fiduciary duty under *Caremark*, and reputational harm.⁸⁹ As a result, if a firm

⁸⁹ When policing duties and lines of authority are clear, shareholders of firms sanctioned for deficient policing can determine whether managers breached a known duty and know who to blame. This enables them to pressure the firm to terminate the agent. They also are better able to impose liability on directors and managers for bad faith breach of their oversight duty action under *Caremark*. *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996); see generally Jennifer Arlen, *The Story of Allis-Chalmers, Caremark, and Stone*:

violates a specific policing measure, the expected costs to the responsible *managers* are substantially higher than if a firm violates the firm's existing *ex ante* policing duties where both policing duties and managerial responsibility may be more ambiguous. Since specific policing duties enforced by non-harm-contingent liability raise the expected costs *to management* (as opposed to just the cost to the firm and shareholders) for policing failures, they are a plausible device for reducing policing agency costs.

Second, PDA mandates or *ex ante* regulations can mute policing agency costs by relocating authority over policing from persons within the firm who are afflicted by significant policing agency costs to other persons, within or outside of the firm, who are not. Because this approach relates to the oversight, or policing, of corporate policing, we refer to it as *meta-policing*. The required meta-policing can be internal or external.

Internal meta-policing measures shift authority over, and information about, corporate policing to people within the firm who are less plagued by policing agency costs, such as outside directors. Examples of such meta-policing duties include the requirements in the Bristol Myer Squibb (BMS) PDA that certain reports be submitted to the Chairman of the Board (a position the BMS PDA states may not be held by the CEO) and for the Chairman to attend certain meetings. Other examples of internal meta-policing duties include requiring that the Chief Compliance Officer be located outside the General Counsel's office and have authority to report directly to the board of directors, and requiring the establishment of a system for anonymous whistleblowing that reaches the board of directors.

External meta-policing measures give individuals outside the firm access to information about, and oversight authority over, the firm's compliance program. These external duties generally are needed when the outside directors cannot or will not provide the oversight needed to induce optimal policing.⁹⁰ External meta-policing can take the form of oversight accomplished through reporting obligations to, and periodic audits by, enforcement authorities or independent auditors. It also can be accomplished by requiring the firm to hire a monitor who has the authority to investigate the firm's compliance with its policing mandates and the law and who reports her findings to enforcement authorities.

As to both internal and external meta-policing, there is little concern that the company will fail to comply with its meta-policing duties. As long as internal meta-policing duties are specific, and sanctions for breach render compliance cost-effective, the outside directors can generally be relied on to ensure that the firm complies. For example, directors of a firm, required to make sure that the Chief Compliance Officer is given the authority to report directly to the board, are likely to do so. The directors would not benefit directly from breach and risk

Directors' Evolving Duty to Monitor, 323, in J. Mark Ramseyer (ed.), *CORPORATE STORIES* (2009) (discussing how Caremark liability is only effective at inducing effective compliance if the compliance duty is clearly defined).

⁹⁰ For example, outside directors often cannot provide sufficient oversight because they do not have the time to devote to policing oversight. They also may lack the information needed to effectively police compliance because genuine oversight over compliance often requires in-depth knowledge of the firm's overseas subsidiaries and independent contractors.

shareholder wrath (and potential liability) if they deliberately fail to ensure that the firm complies with the mandate.⁹¹

External meta-policing duties in turn provide their own oversight. Prosecutors can readily oversee whether the firm is complying with its external meta-policing duties, such as to report to prosecutors, hire a monitor, or regularly report to regulators. This should be sufficient to ensure that the firm complies with these duties.

2. PDA Mandates versus Ex Ante Regulation

Authorities could impose specific policing duties or meta-policing duties on firms with heightened policing agency costs by using either PDAs or *ex ante* regulations. The central difference is that *ex ante* regulations impose generally applicable duties on all firms, or on firms meeting certain criteria, regardless of whether a wrong was detected. PDA mandates, by contrast, can only impose duties on firms with detected wrongdoing.

Policing agency costs are significant in many firms without detected wrongdoing. Regulating policing agency costs through PDA mandates, rather than *ex ante* regulation, thus fails to reach many firms afflicted by policing agency costs.

Nevertheless, PDA mandates may be superior to *ex ante* regulation for mandates that are optimally imposed only on the subset of firms that are plagued by significant policing agency costs. Regulatory authorities cannot easily identify firms with high policing agency costs based on criteria they can easily observe *ex ante*. Unlike, for example, asset insufficiency, policing agency costs are not associated with any particular easily identifiable structural features of the firm (such as low equity). Regulators attempting to specify the set of firms subject to additional duties *ex ante* would inevitably have to use criteria that capture both firms with high policing agency costs and firms where policing agency costs are low.⁹²

By contrast, prosecutors can use PDAs to target mandates at firms with high policing agency costs. PDA mandates are imposed after the firm has had the opportunity to employ its policing measures and has been investigated for committing a substantive crime. Prosecutors often obtain information about the firm's policing in the course, and as a by-product, of their investigations. In addition, they obtain this information when the quality of policing is best observed: when a firm has committed a substantive violation. Moreover, given that prosecutors already have to spend resources investigating an alleged substantive crime and the company's policing, they may also be able to identify firms with high policing agency costs at no or

⁹¹ Directors are liable if they fail to act in good faith to ensure that the firm adopts an effective monitoring and reporting program, and takes other mandated actions to ensure compliance with the law. These duties should include any duties mandated by a PDA. See *In re Caremark Int'l Inc. Derivative Litig.*, 698 A.2d 959 (Del. Ch. 1996); *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362 (Del. 2006) (en banc) (same). Thus, directors should face personal liability if they engage in conscious disregard over their oversight duties by failing to ensure that the firm complies with the meta-policing duties imposed on the firm by a PDA.

⁹² Observe that uncertainty about whether the firm is subject to mandates designed to address policing agency costs also would undermine the effectiveness policing and meta-policing duties enforced by sanctions imposed on the firm. When firms are plagued by policing agency costs, corporate liability is effective only if managers who cause breach expect to be held responsible. This is possible only if shareholders and directors are confident that managers knew the duties they were required to comply with.

relatively low marginal cost. Thus, high policing agency costs are more effectively observed by prosecutors *ex post* than by regulators *ex ante*. Unlike regulations, PDA mandates that are imposed on post-crime, on a firm-by-firm basis, can therefore avoid the over-breadth problem.

Thus, the central advantage and disadvantage of *ex ante* regulation as compared to PDA mandates is that it is broader in scope: it generally reaches more firms with policing agency costs, including firms with no detected wrongdoing, but generally will also apply to more firms without policing agency costs. Accordingly, regulation generally is superior to PDAs when the benefit of broad imposition of the duty exceeds the costs of over-breadth. *Ex ante* regulation may thus be superior for imposing duties that entail low net costs even for firms without substantial policing agency costs but generate significant benefits for firms with high policing agency costs.

By contrast, PDA mandates are likely be superior to regulation for imposing policing and meta-policing duties that generate significant net social costs when imposed on firms without substantial policing agency costs. Compliance with several policing and meta-policing duties imposed by PDAs that address policing agency costs is, indeed, very costly. The costs include not just direct out-of-pocket expenses associated with compliance—which can be considerable—but also the potential adverse effect that the policing and meta-policing has on the firm's productivity. Policing imposes layers of oversight and scrutiny that may delay decision-making and reduce independent initiative. In addition, mandated policing may crowd out a different, more effective, policing system that managers without policing agency costs would institute on their own accord. Thus, PDAs are likely to be preferable for imposing monitorships and other measures that are not cost-effective in firms without substantial policing agency costs.

PDAs also are preferable for imposing policing and meta-policing mandates designed to address specific policing agency costs salient in particular firms. The post-crime investigation provides information about the *specific nature* of the firm's agency cost problem. This can enable prosecutors to impose duties that are designed to address the specific problem at hand. For example, *ex post* the prosecutor can better determine whether meta-policing should be done internally or requires external oversight. While prosecutors should have guidance on how to make these decisions, *ex post* imposition of mandates tailored to the specific situation of the firm may be superior to mandates imposed *ex ante* by regulators.

To be sure, because PDA mandates can only be imposed on firms with prior detected wrongdoing, they are an imperfect mechanism for addressing policing agency costs. PDA mandates will not reach firms with high policing agency costs that have no detected wrongdoing. Still, given the difficulty in identifying firms with high policing agency costs *ex ante*, PDA mandates are likely to be superior to *ex ante* regulation for imposing those policing and meta-policing duties that are optimal only when targeted at firms with, and impose high net costs for firms without, high policing agency costs.

3. PDA Mandates versus Agent Liability

PDA mandates are only justified by policing agency costs if they are superior to (or are needed as supplement to) duties enforced by personal liability on the agents responsible for the company's failure to undertake proper policing. Individual liability imposed on managers and directors who fail to implement the required policing is, in theory, the most direct way to address

policing agency costs. Yet there are several reasons why individual liability for breach of a corporate policing duty either should not be imposed or should be supplemented with PDAs mandates imposing corporate liability for policing breaches.

In practice, imposing direct agent liability for a general *failure to act* to ensure adequate corporate policing is difficult.⁹³ First, in a corporate structure that involves many agents with authority to influence policing, it is often impossible to identify a single person who should be held responsible for a failure to act. This is particularly true of compliance, which requires decisions by both the board and many officers, and attention across divisions of the firm and its subsidiaries.⁹⁴

Second, to the extent such a person is identified, broad personal managerial liability for any deficiency in the firm's policing is likely to induce managers to have the company engage in excessive policing. If, as will usually be the case, the precise scope of the policing duty is not completely clear, individual managers will inevitably worry that, in hindsight, their policing efforts will be deemed deficient should a crime occur. Imposing liability on upper-level managers and directors with control over the firm's purse strings can be expected to induce excessive expenditures on policing because managers spending the firm's money will over-invest in compliance if doing so could reduce their own expected liability.⁹⁵

In addition, even if agent liability is imposed, PDA mandates may be needed to supplement agent liability because it often will not be possible to sanction the agent optimally. The person identified as responsible for policing may have insufficient assets to satisfy the optimal liability amount. 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 only on managers for the firm's failure to police properly may not be effective in addressing policing agency costs. PDA mandates that relocate authority over policing decisions or have the effect of exposing

⁹³ For a discussion of the difficulties of holding directors liable for corporate crimes see Reinier Kraakman and Assaf Hamdani, *Rewarding Outside Directors*, 105 MICH. L. REV. 1677 (2007).

⁹⁴ For example, the failure to adopt and maintain 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 for the firm as a whole, (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 to whom the CFO and the head of the compliance department reported, or (v) the board of directors.

⁹⁵ 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. Cf. Bengt Holmstrom & Paul Milgrom, *Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design*, 7 J. L. ECON. & ORG. 24 (1991).

On the other hand, it may be difficult to hold a lower level executive who does not control the amount the company spends on compliance or the structure of the program responsible for the policing failures partly attributable to decisions outside his control. If the person identified and bearing personal responsibility for the company's failure to comply has no control over the amount the company spends on compliance, it may also 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.

managers outside the US jurisdiction to sanctions by the firm could compensate for these deficiencies in an agent liability regime.

C. Targeted Heightened Duties

In the course, and as a by-product, of their investigations, prosecutors may obtain information that indicates that a firm should be subject to heightened duties relative to those generally imposed *ex ante*. As we have argued in the preceding Section, information that prosecutors obtain about policing agency costs at a specific firm may justify the imposition of PDA mandates on such firm to address policing agency cost problems. This raises the question: Are prosecutors similarly justified in using PDAs to impose heightened duties when they obtain other information suggesting that additional duties are needed for reasons other than policing agency costs? The answer, in brief, is no.

To be sure, optimal policing duties are likely to vary among firms. For example, the optimal compliance program to deter violations of the Foreign Corrupt Practices Act should differ between firms doing business in countries with low levels of corruption, such as Sweden, and those doing business in countries with high levels of corruption, such as Uzbekistan.⁹⁶ PDAs enable prosecutors to impose mandates that can vary across firms in response to their different circumstances. But this aspect of PDA mandates does not justify prosecutors imposing mandates on firms *ex post*. Generally, the best response to the variation in optimal duties is to vary the policing duties imposed on firms *ex ante*, so heightened policing duties are imposed *ex ante* on all firms that need them.⁹⁷ This can be accomplished through heightened duties imposed *ex ante* through either harm-contingent corporate liability or regulation.

Ex ante duties are clearly superior when both the corporate characteristics warranting special or enhanced policing and the optimal policing responses to these characteristics can be identified *ex ante* based on observable criteria. In this situation, enforcement authorities can induce optimal policing by imposing the heightened duty *ex ante* on all firms with a particular characteristic.⁹⁸ This is preferable to using PDAs, which impose enhanced duties only on a small subset of the firms requiring enhanced policing—those with prior detected wrongdoing.

⁹⁶ Sweden received a (high) rank of 9.2 for perceived corruption in 2010 while Uzbekistan received a (low) rank of 1.6. See Corruption Percept Index 2010 Results, Transparency International, http://www.transparency.org/policy_research/surveys_indices/cpi/2010/results.

⁹⁷ Indeed, when properly applied, the duty of have an “effective” or “reasonable” compliance program recognizes that compliance programs must depend on a variety of factors, including the risk of wrongdoing.

⁹⁸ *Ex ante* duties are effective even if the government cannot determine the firms to which they apply *ex ante* as long as the government can specify the factors that trigger the duty, firms know whether they are subject to the duty *ex ante*, and the government can determine whether the firm was subject *ex post*. In this situation, enforcement authorities can announce the policing duty *ex ante*, and the conditions under which it applies, and wait until a wrong occurs to determine whether the firm was obligated to and did comply. To be sure, firms may make some mistakes in this assessment. But if firm sanctions are set at a proper level, profit-maximizing firms will have optimal *ex ante* incentives given the enforcement regime.

These enhanced duties could be imposed by prosecutors or regulators. In this article, we do not evaluate the proper allocation of authority over mandates between these actors. We note that when regulators have the incentives and will to act optimally, they often will be best situated to adopt effective mandates. They have the subject matter

But *ex ante* duties also may be preferable to PDA mandates when regulators and prosecutors cannot, *ex ante*, identify which firms should be subject to heightened duties. *Ex ante* duties are likely superior as long as regulators can establish standards that would enable firms to determine *ex ante* whether and which heightened duties they are subject to, and enforcement authorities can determine *ex post* whether firms were subject to and breached heightened duties. As long as the firm's policing is designed to maximize profits (and the duty and sanctions are set at proper levels)—that is, the firm is *not* subject to significant policing agency costs—authorities can provide proper incentives through such *ex ante* duties.

Ex ante regulation can be employed effectively to address circumstances warranting heightened policing, other than policing agency costs, by using firm-level liability to ensure that firms are better off if they comply with their enhanced duties. Absent policing agency costs, corporate liability can induce managers to ensure the firms complies with its heightened duties. It is in this crucial respect that policing agency costs differ from other aspects of a firm that potentially support heightened policing duties. In the presence of policing agency costs, *ex post* sanctions imposed on the firm will *not* induce the firm to assess the likely scope of its duties and police accordingly because managers are not seeking to undertake the policing that maximizes firm profits.

D. PDA Mandates as Second Best

Our analysis of when PDAs are justified so far has assumed that firms alternatively would be subject to proper duty-based corporate liability. But corporate liability may not be optimal. Government authorities may fail to establish optimal *ex ante* policing duties or impose optimal sanctions due to interest group capture, inertia, political gridlock, or time and resource constraints.⁹⁹ A prosecutor may thus encounter situations where she feels that the existing liability regime is not sufficient to induce optimal policing. The prosecutor may agree that the best way to address these problems would be to reform the existing *ex ante* duties and sanctions. But she may conclude that this is unlikely to happen, at least in the short run. Should an individual prosecutor try to remedy this situation by using PDAs to impose policing and meta-policing mandates on select firms with prior detected wrongdoing where the prosecutor has the power to do so? Our answer, again, is no.

First, individual prosecutors who conclude that incentives to adopt proper policing are insufficient may be wrong either in their assessment or in their choice of what mandates to impose. Prosecutors' expertise lies in detecting and sanctioning specific wrongdoing. Yet individual prosecutors are unlikely to have the expertise needed to substitute their judgment for that of Congress, regulators and other authorities acting *ex ante* as to the appropriate policing

expertise, have the capacity to evaluate duties holistically, and are more publicly accountable. They also employ a process designed to generate the input by the affected parties needed to correctly determine what duties are proper. See Arlen, *supra* note 68.

⁹⁹ See Arlen, *supra* note 28 (critiquing the Organizational Sentencing Guidelines). For a discussion of Congress's apparent use of intentional under-funding—through a failure to appropriate funds—to undermine the effectiveness of corporate enforcement laws that it adopted see Daniel Richman, *Corporate Headhunting*, 8 HARV. L. & POLICY REV. (2015).

duties and sanctions to impose across an entire set of firms. Unlike Congress, regulators and other authorities acting *ex ante*, individual prosecutors tend to lack industry-specific expertise, the staff needed to engage in studies or fact-finding, and the systematic input from firms subject to policing duties or potential victims of wrongdoing. The probability of error by individual prosecutors is heightened when the regime they are trying to adopt could have easily been put in place by Congress, regulatory agencies, or other authorities who have the requisite expertise and these bodies—explicitly or implicitly—decided not to adopt the regime that the prosecutor would prefer.¹⁰⁰ Thus, while authorities with rule-making power to act *ex ante* may err, individual prosecutors attempting to address their deficiencies are even more likely to err when they override the judgment of these authorities.

Prosecutors also may err because they pursue either the wrong social goal or private aims. Prosecutors are trained to think about what is needed to make sure crime does not happen. But this is not, and should not be, the standard employed to establish “effective” or “reasonable” compliance. Compliance is costly.¹⁰¹ Optimal compliance policy thus involves trade-offs between the goals of deterring wrongdoing and of not burdening the firm with excessive costs.¹⁰² Prosecutors have expertise in one side of this trade-off. Given their institutional bias, they are likely to overweigh the benefits of crime reduction while giving insufficient weight to the costs of compliance.

In addition, some prosecutors may be tempted to impose mandates to serve their own aims, not social aims. Prosecutors may agree to reduce the monetary sanctions and substitute a general mandate in order to obtain a faster resolution of a high profile case, while still appearing tough on crime. This practice may serve prosecutors’ personal aims, but it reduces the *ex ante* deterrent effect of duty-based corporate criminal liability if firms expect to persuade prosecutors to reduce the monetary sanction for the initial breach of policing duties. In addition, prosecutors may pursue personal aims when imposing mandates requiring the firm to appoint a certain independent director to the board or as an outside monitor¹⁰³ because a prosecutor has a significant say about the identity of these individuals.¹⁰⁴

¹⁰⁰ In the case of policing agency costs, the imposition of mandates by prosecutors rests not on other authorities having adopted an inadequate regime but on prosecutor’s special ability to identify firms with significant policing agency costs. Thus, the argument that prosecutors should defer to other bodies with greater expertise does not apply with equal force to mandates intended to address policing agency costs. The general argument, however, that prosecutors’ limited expertise results in a significant possibility of prosecutors adopting inefficient mandates does apply.

¹⁰¹ For example, in 2014 HSBC reported that it was spending \$750-800 million per year on its compliance and risk program. Martin Arnold, *HSBC Wrestles with Soaring Costs of Compliance*, FINANCIAL TIMES (August 4, 2014).

¹⁰² These costs can include both the direct costs of compliance and the indirect effect of compliance on the firm’s internal operations. See Geoffrey Miller, *An Economic Analysis of Effective Compliance Programs*, in RESEARCH HANDBOOK ON CORPORATE CRIME AND FINANCIAL MISDEALING (Jennifer Arlen, ed., forthcoming 2016).

¹⁰³ Recognizing the fact that prosecutors may pursue private benefits when deciding to impose or select a monitor, the DOJ has increased centralized oversight of both decisions, See USAM § . This oversight reduces but does not eliminate prosecutors’ ability to obtain private benefits from the decision to impose a monitor.

¹⁰⁴ Even when prosecutors are right that the existing system is inadequate, the social benefits of prosecutors using firm-specific mandates to address systemic deficiencies are likely to be low. First, and most obviously, firm-

To be sure, the risk of error by prosecutors and the risk that prosecutors may pursue the wrong social goal or private aims are also present with PDA mandates imposed on firms believed to suffer from policing agency costs. However, the context of policing agency costs differs from other contexts in two respects that may justify the use of PDAs despite these risks. First, prosecutors enjoy a comparative cost advantage over regulators in identifying specific firms that require additional regulation because of policing agency costs. Second, prosecutors imposing mandates to address policing agency costs are less likely to be overriding an *ex ante* informed decision by regulators that mandates are not necessary. Because regulators cannot easily identify firms with policing agency costs, their failure to impose *ex ante* duties that are justified by policing agency costs does not amount to an implicit rejection of the need for these heightened duties for firms identified as suffering from policing agency costs. As a result, as we have argued in Section IV.B., PDA mandates that are properly designed can be superior in addressing policing agency costs to *ex ante* regulations that are properly designed. And even taking into account the risks that prosecutors get it wrong (as well as the risks that legislators or regulators get it wrong), PDA mandates can be a desirable component of the liability regime in the context of policing agency costs.

Outside the context of policing agency costs, however, we do not see a basis for concluding either that individual prosecutors, as a rule, are superior at devising duties and sanctions or that an individual prosecutor can identify specific circumstances where she is superior. These considerations suggest that individual prosecutors should not design firm-specific duties to remedy general problems best addressed through a general solution.

E. Summary

Accordingly, we find that prosecutors are justified in imposing PDA mandates, but only to address one particular situation: where the firm failed to police properly because its managers or the board obtained private benefits from deficient policing. In such circumstances, it may be desirable to impose highly specific compliance duties or meta-policing duties through PDA mandates. Otherwise, Congress, regulators, and other authorities should address policing deficiencies through appropriate, generally applicable policing duties imposed *ex ante*.

V. OPTIMAL AND ACTUAL ENFORCEMENT POLICY GOVERNING MANDATES

In the preceding Part, we concluded that PDA mandates should be used to supplement duty-based corporate criminal liability only when firms are plagued by policing agency costs and then only when the mandates are both superior to *ex ante* regulation and likely to reduce policing agency costs in an efficient manner. This conclusion has implications for federal enforcement

specific duties created and imposed by individual prosecutors do not address the deficient *ex ante* incentives created by the existing system. Instead, they only affect a specific firm with detected wrongdoing after *ex ante* incentives have failed. Second, prosecutors' exercise of individual authority to impose heightened costly policing duties on some firms in an industry may distort competition in the industry and may decrease social welfare, particularly when all firms should be subject to the duty. General solutions are the superior response to deficiencies of general application.

policy. It helps to identify the type of firms that are appropriately subject to mandates and the appropriate structure of these mandates.

A. WHEN SHOULD MANDATES BE IMPOSED? OPTIMAL VS. ACTUAL POLICY

PDA mandates should only be imposed if two conditions are met. First, the firm with detected wrongdoing had a policing deficiency prior to the PDA attributable to policing agency costs. Second, the firm is likely to be plagued by policing agency costs in the future absent intervention.

Existing DOJ policy encourages prosecutors to impose mandates whenever the firm did not have an effective compliance program at the time of the wrong. This is too broad. Evidence of deficient policing is not sufficient, on its own, to support a mandate. Any policing deficiencies identified by prosecutors may have been due to causes other than policing agency costs — including uncertainty about the scope of the required policing duties, inadequate monetary sanctions for breach of policing duties, asset insufficiency, or plain mistakes— or due to policing agency costs that no longer persist. The current federal policy should be replaced with one favoring mandates *only* when a firm with detected wrongdoing had policing deficiencies that are attributable to substantial policing agency costs that are likely to continue absent intervention.

Although prosecutors should be given better policy guidance on when and what form of mandates should be imposed, it is not practicable to devise *ex ante* rules that dictate the specific circumstances that should trigger mandates. As previously discussed, the specific attributes of a firm that generates policing agency costs are hard to identify *ex ante*. Thus, individual prosecutors inevitably must be given *some* discretion to determine whether policing agency costs were present at the time of the crime and are likely to continue in the future, using information obtained during the investigation about the causes of the crime, the effectiveness of the firm's compliance program in detecting and responding to the crime, the attitude of management, and the firm's decisions regarding self-reporting and cooperation, as well as information about post-crime changes to the firm's structure. Nevertheless, prosecutors can be provided better guidance because it is possible to identify circumstances where mandates are unlikely to be necessary. We discuss three such circumstances.

First, mandates generally should *not* be imposed if an individual or a privately-held corporate shareholder owns a stake in the firm sufficiently high to enable them to control the board (a "controlling shareholder"). Controlling shareholders generally have the incentives and the authority to ensure that the firm adopts the policing measures, including appropriate meta-policing measures, that serve shareholders' interests. Enforcement authorities thus can induce the desired corporate policing through duty-based liability enforced by adequate monetary sanctions imposed on the firm.¹⁰⁵

To be sure, even firms with controlling shareholders may commit corporate crimes and engage in inadequate policing. For these firms, however, policing is likely to be inadequate for

¹⁰⁵ Cf. James B. Jacobs and Ronald Goldstock, *Monitors and IPSIGS: Emergence of a New Criminal Justice Role*, 43 CRIM. L. BULL. 217 (2007) (discussing the rise of private monitors that firms can hire voluntarily to enhance compliance).

reasons other than policing agency costs. Potential reasons include insufficient corporate financial incentives to undertake effective policing,¹⁰⁶ insufficient information about effective policing, and asset insufficiency.¹⁰⁷ These problems can be addressed through a combination of information and corporate and individual liability structured to ensure that the firm is better off *ex ante* if it adopts optimal policing. PDA mandates are neither an optimal substitute nor a proper complement to this regime in this situation.

Thus, for example, we are skeptical whether the PDA mandates imposed on the Las Vegas Sands Casino are justified. It is unlikely that the firm's failure to adequately monitor gamblers is attributable to policing agency costs given that the casino has a controlling family group (the Adelson family) that owns 53% of the firm.¹⁰⁸ With these ownership stakes, monetary sanctions imposed on the firm can provide proper incentives for the Adelson family to ensure that the Las Vegas Sands undertakes the required policing measures.¹⁰⁹

In addition, PDA mandates are questionable when top managers proactively responded to suspected wrongdoing by taking reasonable and good faith measures to investigate the wrongdoing, report it to the enforcement authorities, and cooperate in their investigation. These actions suggest that top managers do not have the hear-no-evil, see-no-evil attitude that is the hallmark of policing agency costs. To be sure, even if the firm and its managers investigated, self-reported, and cooperated, policing agency costs could conceivably affect other elements of corporate policing, such as the firm's compliance program. Conceivably, managers investigated, self-reported and cooperated only because the evidence of wrongdoing was staring them in the

¹⁰⁶ See Arlen, *supra* note 16 (showing that the Organizational Sentencing Guidelines do not provide large firms with adequate incentives to self-report or adopt expensive compliance programs).

¹⁰⁷ Policing may also be inadequate if the controlling shareholder directly commits and benefits from the crime. Such situations are best addressed through personal liability for the underlying crime on the controlling shareholder.

¹⁰⁸ Similarly, we are skeptical that the mandates imposed on RAE Systems were justified. Top management owned approximately 34% of the firm and one manager alone owned 26.4%.

When we look forward to the forthcoming resolution of the Wal-Mart case, we note that, whether or not the firm paid bribes to Mexican government officials to speed store expansions in violation of the Foreign Corrupt Practices Act, see Aruna Viswanatha and Devlin Barrett, *Wal-Mart Bribery Probe Finds Few Signs of Major Misconduct in Mexico*, Wall St. J. (Oct. 19, 2015), the CEO arguably should not have delegated the investigation to people within the firm's Mexican subsidiary. Evidence of wide spread bribery in India, *id.*, also suggests policing deficiencies in that division. Yet these policing deficiencies are unlikely to be attributable to policing agency costs. The Walton family controls about 45-50% of the company's stock, <http://fortune.com/2015/04/10/walmart-waltons-billions>; <https://finance.yahoo.com/q/mh?s=WMT+Major+Holders> and has family members on the board involved in management. Indeed, there is reason to believe that a family member was aware of the conduct. Instead of PDA mandates, prosecutors should impose sufficient corporate (and potentially individual liability) to demonstrate to the Walton family that Wal-Mart will be healthier financially if it adopts a proper compliance program and acts promptly to deter bribery than if it does not. The firm could reasonably subject to external reporting obligations going forward to heighten the effectiveness to the threat of future sanctions, but mandates imposing internal governance reforms should not be needed if monetary sanctions are properly implemented.

¹⁰⁹ In addition, managers with a controlling interest have job security, access to significant compensation, and insulation from external interference as a result of their ownership interest, and thus are unlikely to obtain private benefits from inducing deficient policing. See *supra* Section IV.B. (discussing the private benefits to non-controlling managers of deficient policing).

face, and would have been happier if the compliance program had never uncovered such evidence. However, where the company acted reasonably and in good faith once evidence of wrongdoing emerged, it is equally, if not more, likely that any deficiency in *ex ante* compliance is *not* attributable to policing agency costs. Management, for example, may have instituted a deficient compliance program because they concluded in good faith either that the compliance program was effective¹¹⁰ or that the cost of effective compliance *to the firm* exceeded its benefit given expected sanctions. Both of these problems are better addressed through clearer *ex ante* compliance duties and adequate monetary sanctions for breach.

Accordingly, we are skeptical whether the PDA mandates imposed on Johnson & Johnson (J&J) for FCPA violations were justified. In that case, prosecutors determined that the firm engaged in voluntary and timely self-reporting and fully cooperated. In addition, prosecutors concluded that, while J&J had an effective compliance program, the legal problems arose from insufficient application of the J&J compliance program to its acquired subsidiaries.¹¹¹ Yet prosecutors imposed extensive policing mandates through the PDA—mandates that went beyond the requirements under the Organizational Sentencing Guidelines or the DOJ’s own FCPA guidance.¹¹² These mandates included appointing a Chief Compliance Officer with significant FCPA experience who shall report directly to the Audit Committee of the board; identifying at least five operating companies that are at high risk for corruption and conducting FCPA audits of these companies at least once every three years; and engaging in thorough FCPA diligence of all sales intermediaries as well as of any firm J&J plans to acquire. Given management’s response to the wrongdoing once it was detected, these extensive PDA mandates do not appear to be justified.

Finally, PDA mandates are not justified unless prosecutors detect policing agency costs that are likely to affect the firm’s *future* policing efforts. It is generally reasonable to assume that firms that had deficient policing in the past as a result of policing agency costs will continue to be plagued by policing agency costs in the future. But this presumption does not hold for firms that underwent a transformation following the violation that directly affected its policing agency

¹¹⁰ This is particularly likely in firms with isolated wrongdoing—suggesting the compliance program may in fact be effective.

¹¹¹ Johnson and Johnson Deferred Prosecution Agreement, p. 2-3 (2011) <http://www.justice.gov/sites/default/files/criminal-fraud/legacy/2011/04/27/04-08-11depu-dpa.pdf>. The Johnson & Johnson PDA states that the firm reported “a majority” of the misconduct. The mandates could be justified if prosecutors found that managers knowingly failed to report all the misconduct it detected as a result of policing agency costs. Were this the case, prosecutors could enhance corporate governance by so informing shareholders. The PDA on ABB Ltd (2010) also imposed compliance mandates on a firm that self-reported. Other PDAs impose monitors on firms that self-reported.

¹¹² *Id.* at Appendix D (Enhanced Compliance Obligations). Johnson & Johnson is not the only case where mandates were imposed on firms described in the PDA as having self-reported the wrong. Many of PDAs imposing mandates on firms that self-reported involve foreign bribery. It is possible that some of these firms had high policing agency costs and undertook incomplete or delayed self-reporting. Yet a number of these cases imposed a mandate on the firm or its controlled subsidiary even though the firm self-reported and the wrongdoing only occurred in a single country or was otherwise isolated. Isolated wrongdoing would appear to be consistent with the firm having an effective compliance program that failed in one area. It is hard to see the justification for imposing a mandate instead of (or in addition to) enhanced sanctions on firms that self-report isolated wrongdoing.

cost problem. Thus, when the firm was acquired by another firm, there is usually less reason to believe that pre-acquisition policing agency costs will persist post-acquisition. Lesser changes, such as replacement of top management or significant changes in compensation policy, also may ameliorate the firm's policing agency costs, depending on the source of the original problem. For example, if a firm's policing agency costs were attributable to a CEO who was particularly averse to interference by the compliance department, a replacement of the CEO may substantially reduce policing agency costs.¹¹³ In these situations, past defects on their own are unlikely to justify PDA mandates.

Accordingly, we are skeptical whether the PDA mandates imposed on Massey Energy following an explosion at one of its coal mines are justified.¹¹⁴ Massey was acquired by Alpha Natural Resources (Alpha) after the accident and before the PDA was imposed.¹¹⁵ In addition, Massey's CEO and President had left the company and the Massey Officer who replaced him as CEO was only going to have an advisory role after the merger.¹¹⁶ Even though the deficient policing prior to the accident may have been due to policing agency costs, given these changes, the PDA mandate imposed on Massey would be justified only if prosecutors had evidence that *Alpha* suffered from significant policing agency costs.¹¹⁷ However, it is unlikely that the

¹¹³ 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 PDAs reveals that many firms with detected wrongdoing replace management; firms with detected wrongdoing implicating contracting parties often hire outsiders to replace existing managers doubtless to signal 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 19, Section 2 (discussing the factors influencing the reputational penalty for corporate crime). In this case, going forward the firm may not be subject to the level of policing agency costs that caused the initial breach, and thus intervention may not be needed.

¹¹⁴ Policing mandates included provisions governing the frequency of and information to be collected during safety compliance visits at each underground mine; and internal and external reporting requirements following those visits, in addition to multiple other requirements. Prevention mandates included a mandate to spend at least \$80,000 per year on safety remedial measures for not less than two years and to undertake specific safety measures, including launching a new "state of the art safety training facility in the Julian, West Virginia area that includes lab space of at least 96,000 square feet; purchasing specific amounts of monitoring equipment and mine escape equipment, Massey Non-Prosecution Agreement. http://www.gibsondunn.com/publications/Documents/AlphaResources_NPA.pdf.

¹¹⁵ Mario Parker and Zachary R. Milder, *Alpha Natural Agrees to Buy Massey Energy for \$7.1 Billion*, BLOOMBERG BUSINESS (Jan. 29, 2011) <http://www.bloomberg.com/news/articles/2011-01-29/alpha-natural-agrees-to-buy-massey-energy-for-8-5-billion-in-cash-stock>. The NPA was signed Dec. 6, 2011. http://www.gibsondunn.com/publications/Documents/AlphaResources_NPA.pdf.

¹¹⁶ <http://www.npr.org/sections/thetwo-way/2011/06/01/136862836/in-about-face-massey-coo-chris-adkins-will-not-stay-after-merger>.

¹¹⁷ Prosecutors may have imposed policing mandates, instead of imposing the enhanced monetary sanctions for Massey's policing breaches, because Alpha Natural Resources did not commit those breaches. The DOJ should adopt a policy against this because it allows firms with detected wrongdoing to insulate shareholders by simply selling the firm. Alpha Natural Resources would have paid less for Massey—to Massey's managers' and shareholders' detriment—if it was confident it would have to pay large predictable monetary sanctions for Massey's crime and policing failures. Moreover, the PDA policing mandates are not the only questionable feature of this PDA, which also requires Alpha Natural Resources to contribute \$48 million to a trust to be used to fund research and development studies on mine health and safety by nonprofits and academic institutions.

prosecutors had obtained significant information about Alpha in its investigations of events that largely, if not entirely, preceded Massey's acquisition by Alpha.

B. WHAT TYPE OF MANDATES

The policing agency cost justification for PDA mandates also places limitations on the type of mandates that should be imposed. Mandates should be designed to induce optimal policing in a firm burdened by policing agency costs. This goal has several implications.

First, mandates should address the underlying problem: the presence of policing agency costs. As discussed above, mandates can do so in two ways: by imposing specific policing duties or by imposing meta-policing duties that shift authority or oversight over policing to persons inside or outside the firm who are not subject to significant policing agency costs. Mandates that contain neither of these measures are likely to be ineffective in addressing policing agency costs. Thus, we would not regard PDA mandates that merely require the firm to adopt a compliance program that satisfies the Organizational Sentencing Guidelines as justified. Such mandates are neither sufficiently specific as to what policing duties a firm must undertake nor provide for effective meta-policing. Similarly, PDAs that impose general policing duties supplemented by no more than a duty to make an annual self-report to prosecutors are suspect. Prosecutors receiving nothing more than an annual report prepared by the firm often are unlikely to provide effective oversight over compliance because they do not have sufficient industry expertise, time, or incentive to determine whether the firm has in fact adopted and is implementing an effective policing regime.¹¹⁸

Second, PDA mandates should generally be targeted at reducing *policing* agency costs, rather than at improving corporate governance more generally. PDA mandates create an inevitable risk that prosecutors will err when imposing internal reforms. The risk of error is lower, and may be worth incurring, when mandates relate directly to policing measures. After all, prosecutors have some general enforcement and firm-specific expertise that should enable them to identify the policing deficiencies within a firm and the policing and meta-policing mandates that could address the agency costs that led to the deficient policing. By contrast, prosecutors rarely have the requisite information or expertise to identify desirable corporate governance reforms more generally.¹¹⁹

¹¹⁸ In addition, Assistant U.S. Attorneys regularly obtain new employment during the pendency of a PDA; their replacements have their own cases to attend to and are unlikely to actively oversee compliance with past PDAs.

¹¹⁹ Indeed, experts in corporate governance do not agree on what corporate governance reforms are optimal. E.g., Roberta Romano, *Quack Corporate Governance*, 28 REGULATION 36 (2005) (finding that empirical evidence does not support many governance reforms adopted by Sarbanes Oxley); Sanjai Bhagat, Brian Bolton, and Roberta Romano, *The Promise and Peril of Government Indices*, 108 COLUM. L. REV. 1803 (2008) (finding that leading indices of good corporate governance are not good predictors of performance).

These considerations lead us to be skeptical that a free-standing, PDA-imposed mandate to separate the Chairman of the Board and the CEO is justified.¹²⁰ Corporate governance experts do not agree on whether and when it is desirable to separate these positions.¹²¹ In addition, institutional shareholders can readily determine whether a firm has adopted this reform and exert substantial pressure on boards to separate these positions when they deem it important to do so.¹²² Finally, the benefits from such a separation in reducing policing agency costs often will be incidental relative to their more fundamental impact on overall corporate governance. Nevertheless, a PDA-imposed mandate to separate the Chairman of the Board and the CEO may be a justified mandate, coupled with provisions shifting responsibility for corporate policing to the Chairman. 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.¹²³

C. SUMMARY OF REFORMS

Our analysis thus reveals that DOJ policy and prosecutors' enforcement practice should be reformed along three dimensions: first, the general standard for imposing policing mandates; second, the criteria that determine when mandates are imposed; and third, the type of mandates imposed.

Most importantly, current DOJ policy encouraging prosecutors to impose policing mandates on any firm with detected wrongdoing and a deficient compliance program should be revised. Mandates should be imposed only if the prosecutor has evidence to conclude that the inadequate policing was due to substantial policing agency costs and that, absent intervention, such agency costs will result in inadequate policing in the future.

In addition, prosecutors should be given guidance on factors that generally indicate that policing failures are not due to policing agency costs or will not persist in the future. These factors include the company having a controlling shareholder, the company having taken reasonable good faith steps in investigating, self-reporting, and cooperating with prosecutors with respect to the wrongdoing, or the company having gone through a transformation post-crime, such as through an acquisition of the firm, that affected its policing agency costs.

¹²⁰ Similarly, our analysis calls into question the mandate imposed on Friedman's Inc. requiring it to have both a nominations committee and compensation committee, absent evidence that the deficient policing was tied to policing agency costs arising from a compensation structure that the imposed nominations committee and compensation committee would alleviate.

¹²¹ See Price Waterhouse Coopers, Center for Board Governance, Key Issues: CEO and Board Chair Roles, available at <http://www.pwc.com/us/en/corporate-governance/board-leadership.jhtml> (stating that there are compelling arguments in favor and against separation).

¹²² Shareholders can, and often do, file precatory resolutions under Rule 14a-8 to separate the CEO and chairman positions. Firms often implement resolutions that receive majority shareholder support. See Marcel Kahan & Edward Rock, *Embattled CEOs*, 88 TEXAS L. REV. 987 (2010). Yet nevertheless not all firms with strong institutional shareholders have adopted these measures.

¹²³ Where policing agency costs at the CEO-level are serious, however, an independent risk management/compliance committee which must report externally would appear to be a more targeted solution that allows shareholders to retain a CEO-Chairman where this is optimal for other reasons.

Moreover, mandates must address the underlying policing agency cost problem. To do so, they should consist of specific, detailed policing duties or meta-policing measures. Mandates that contain neither of these provisions are likely to be ineffective in addressing policing agency costs. Duties that go beyond these measures are likely to do little to reduce policing agency costs and may be socially costly.

Finally, given that prosecutors imposing mandates act as quasi-regulators, it would appear appropriate for the DOJ to obtain, make available, and study data on the mandates imposed, and to study firms subject to mandates over time, to determine which mandates are most effective.

VI. CONCLUSION

Federal prosecutors overseeing corporate criminal enforcement increasingly have stepped out of the courtroom and are making structural corporate reform decisions—decisions that are more normally the province of management, Congress, or civil regulators. In so doing, prosecutors have transformed their relationship with corporate wrongdoers, assuming the role of firm-specific regulators. The mandates they impose can be very consequential, for example, altering a firm's internal governance or imposing hundreds of millions of dollars in additional compliance costs.

DOJ policy encourages prosecutors to impose PDA mandates on firms with detected wrongdoing and inadequate compliance. We find that PDA mandates can be justified. Yet our analysis reveals that the DOJ's broad embrace of PDA mandates is not warranted. Generally, proper incentives for firms to police wrongdoing should be supplied through harm-contingent liability or *ex ante* regulations that impose both upfront policing duties and proper sanctions on firms that violate their duties. PDA mandates are justified, in our view, only when a firm failed to take proper policing measures due to policing agency costs. Policing agency costs arise when managers derive personal benefits if the firm does not adopt the policing measures that maximize the firm's profits. In the presence of policing agency costs, penalties imposed *on the firm* may not induce firms to adopt optimal policing measures. Our analysis has shown that PDA mandates can reduce this problem.

Our conclusion that mandates are justified by policing agency costs places constraints on the type of mandates that should be imposed. In particular, we can identify situations where mandates presumptively should not be imposed, notwithstanding deficient policing, because it is unlikely that deficient policing is attributable to policing agency costs that will persist. Thus, PDA policing mandates generally are not justified when an individual or family-owned corporation owns a high stake in the firm; when top managers, reasonably and in good faith, investigated the wrongdoing, reported it to the enforcement authorities, and cooperated in the investigation; and when the firm, after the wrongdoing, underwent a transformative change that affected its policing agency cost structure.

In addition, in order to be justified, PDA mandates must be designed to effectively address policing agency costs. The only justifiable policing mandates, in our assessment, are mandates that impose specific policing duties and mandates that impose meta-policing duties.

PDA mandates that merely restate the vague requirement to adopt a policing program that satisfies the Organizational Sentencing Guidelines or that are directed to improving corporate governance more generally, as is the case for some PDA mandates, are not justified. Such mandates are not likely to be cost-effective in reducing policing agency costs.

We thus call on the DOJ to reform its current practices to ensure the proper use of mandates. In so doing, we disagree with those who suggest that the DOJ should abandon PDAs altogether on principle.¹²⁴ PDA mandates can be desirable to address policing agency costs – a problem that often cannot be effectively handled by more generally applicable criminal liability or regulations – but mandates must be imposed more selectively than they presently are and must be structured to address these costs.

¹²⁴ See Uhlmann, *supra* note 9.