

Corporate Criminal Enforcement in the United States: Using Negotiated Settlements to Turn Corporate Criminals In to Corporate Cops

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Abstract

Corporate criminal enforcement in the United States differs from other countries in three ways. First, the United States can impose criminal liability on corporations in a broader range of cases than other countries. Second, almost all corporate criminal resolutions involving large firms take the form of negotiated settlements. Third, the United States grants prosecutors both more choices and more discretion when resolving criminal cases: prosecutors can enter into guilty pleas or pre-trial diversion agreements (deferred and non-prosecution agreements). This chapter shows how granting prosecutors discretion to negotiate criminal settlements and use these alternative forms of criminal resolution can help governments deter corporate crime by inducing corporations to self-report and cooperate. It also identifies what features are needed in order for such a regime to promote deterrence. Finally, it identifies problems with the current U.S. approach that other countries considering employing such measures would do well to avoid.

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Corporate crimes occur all too often, causing serious harm to countries' economies and in some cases to individual welfare. To protect its citizens and promote economic growth, legislatures and enforcement authorities need to adopt laws designed to deter corporate crime. Legislation that both creates an appropriately structured corporate liability regime and provides for negotiated settlements is an essential part of achieving this goal.

Negotiated settlements with large corporations enhance governments' ability to deter corporate crime for two reasons. First, most governments (including large developed economies) have limited resources available to devote to corporate criminal enforcement. When enforcement agencies are required to bring all cases to trial, then enforcement authorities must be given considerably more resources to expend on enforcement. In addition, the risk of corporate crime is likely to be higher and economic welfare is likely to be lower. There are two reasons for this. The first is most obvious. Trials are time-consuming and expensive. In addition, they divert the time and attention of the judge and the prosecutorial team for an extended period, reducing their ability to pursue other cases. Requiring that all cases go to trial thus can reduce the deterrent effect of corporate criminal sanctions by reducing the probability that firms are sanctioned. Trials are also costly for the affected corporations. Enabling a speedier resolution—through a process that permits settlements in conformity with the rule of law (see Arlen 2016)—can both benefit firms and enhance deterrence by enabling enforcement officials to resolve cases more expeditiously. The benefits are particularly great in the case of corporate criminal actions because the cases are often complex, and firms tend to expend considerable resources on litigation. Forcing a trial imposes enormous costs on all concerned for an uncertain benefit relative to settlement.

There is a second reason to favour negotiated settlements, one that is particular to corporate criminal liability.¹ Negotiated settlements are likely the most effective way to implement the type of multi-tiered corporate liability regime that is needed in order to effectively deter misconduct by publicly held firms and other firms whose owners are not directly involved in management. Corporate liability can best deter corporate crime by inducing firms to take effective steps to monitor and detect misconduct, investigate suspicious activities, self-report any violations detected, and fully cooperate with authorities to bring wrongdoers to justice (hereinafter corporate policing) (see Arlen 2012). To do this, corporate liability for misconduct must be less severe if the firm self-reported and cooperated than if it did not (Arlen and Kraakman 1997). As criminal law tends to impose ruinous collateral sanctions, governments seeking to induce firms to take actions that increase their likelihood of being sanctioned—such as self-reporting and cooperation—generally must employ alternatives to formal conviction—such as deferred and non-prosecution agreements (hereinafter DPAs)—to sanction firms that take these beneficial actions. A system that alters the form of corporate liability in return for self-reporting and/or cooperation is often best accomplished

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¹ The chapter focuses on corporate enforcement against publicly held firms and other large firms where the owner is not directly involved in running the firm.

through negotiated settlements because these facilitate an on-going real time exchange between the firm and the prosecutor about the scope of self-reporting and the level of cooperation required and the likely benefits to the firm. Because negotiated settlements permit a this type of more nuanced approach to corporate criminal resolutions, negotiated settlements are more effective vehicles for deterring corporate crime.

Corporate policing is important because most government enforcement authorities cannot threaten wrongdoers with a material risk of being punished unless authorities are able to persuade firms to help them detect misconduct and identify and sanction individual wrongdoers (Arlen 1994; Arlen and Kraakman 1997). Corporate misconduct can be very profitable. Accordingly, potential wrongdoers will regularly violate the law—notwithstanding a theoretical risk of sanction—so long as they believe they are likely to avoid detection and sanction. In most countries, this expectation appears reasonable. Government enforcement authorities do not have sufficient resources to detect and sanction more than a fraction of the corporate crimes committed. Moreover, in many countries, prosecutors face legal impediments to holding firms legally responsible for their employees' misconduct. Accordingly, in order to deter corporate crime, enforcement authorities need to enlist the aid of the person in the best position to detect misconduct and obtain actionable evidence: the corporation (Arlen 2012; see Arlen and Kraakman 1997). In the case of non-owner managed firms (e.g., publicly held firms), the government can structure corporate liability to simultaneously ensure firms do not benefit from misconduct, while also incentivizing them to detect, self-report, and cooperate (Arlen 2012; Arlen and Kraakman 1997). To do this, firms must be subject to legal duties to both comply with the law and engage in effective policing (compliance, self-reporting and cooperation). Corporate liability must be imposed for all misconduct. Yet corporate liability must be materially enhanced—through the imposition of formal conviction, high fines, and mandates—for those firms that *both* violate the law and fail to adhere to their policing duties. Firms that engage in effective policing should be rewarded through a less severe form of liability, such as a civil sanction or an alternative form of criminal settlement (such as a deferred prosecution agreement, as discussed below). As the policing determination is fact-specific, and the choice of settlement form (plea versus DPA) can affect the firm's willingness to fully investigate and cooperate, prosecutors need to be granted considerable (but guided) discretion over criminal settlement determinations. This is best accomplished through negotiated settlements.

To identify both the benefits of this approach, and potential pitfalls to be avoided, it is instructive to consider the United States, which has a unique approach to corporate criminal liability. The United States has adopted an approach to corporate criminal liability that permits both negotiated settlements and corporate criminal resolutions through conviction, deferred prosecution agreements, or non-prosecution agreements. Some government agencies can also impose significant civil penalties on firms. Corporate criminal and civil enforcement in the U.S. is completely dominated by criminal settlements. Almost all of these occur through negotiated settlements. These settlements may take the form of a traditional guilty plea, in which the firm is formally convicted, and a judge imposes sanctions (such as criminal fines) in court. But they also regularly—in fact for parent corporations usually (Alexander and Cohen 2015)—occur through alternative forms of criminal settlements. These include both deferred and non-prosecution agreements, where the firm enters into a criminal settlement and is punished, but not formally convicted. The firm does not plead guilty through diversion agreements, and in fact in some agreements there is no judicial oversight.

This chapter demonstrates how granting prosecutors discretion to negotiate criminal settlements and use these alternative forms of criminal resolution enhances deterrence. It also identifies problems with the U.S. approach that other countries considering employing such measures would do well to avoid. The chapter proceeds as follows. Section 2 summarizes the U.S. approach to corporate criminal liability. Section 3 explains how the ability to choose between a guilty plea and a PDA improves deterrence. Section 4 identifies problems with the existing procedures employed to govern the use of pleas and PDAs. Section 5 concludes.

2. U.S. Approach to Corporate Criminal Liability

In the United States, corporations can be held criminally liable² for all crimes committed by employees in the scope of employment with any intent to benefit the firm (Arlen 2012). The scope of U.S. liability is broader than that imposed by other countries. Liability extends to crimes by low-level employees.³ Firms face criminal liability even if the firm had an effective compliance program and the employee violated orders.⁴ In fact, under U.S. law a corporation can be convicted for a crime committed by a low-level employee, notwithstanding an effective compliance program, even if the firm self-reported and even if the firm cooperated.⁵

In the case of publicly held firms, the vast majority—indeed almost all—convictions occur through guilty pleas—i.e., negotiated settlements (Alexander and Cohen 2015; Alexander et al 1999). Both prosecutors and firms favour guilty pleas for many reasons. Given the broad scope of corporate liability, firms often have little to gain from going to trial since the firm’s liability usually follows automatically from evidence that an employee violated the law. In addition, both firms and prosecutors have much to gain from a speedy resolution. The prosecutor benefits from the ability to conserve enforcement resources which can be used on the next case—including proceeding against the individuals responsible for the crime. In addition, speedy resolution may enable the government to assist victims, to the extent that the sanction includes a restitution payment. Finally, a more rapid resolution can give the public more confidence that even powerful wrongdoers will be punished.

Whether convicted through a plea or following a trial, convicted firms can be subject to very large total sanctions that can reach into the hundreds of millions or even billions of dollars (see Alexander and Cohen 2015, providing empirical evidence; Alexander, et. al 1999, same). Moreover, in the U.S. many convictions carry with them the threat of collateral consequences: administrative sanctions that can result in a firm being debarred from doing business with an important federal

² 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.

³ *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).

⁴ *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).

⁵ Under the Organizational Sentencing Guidelines, a corporation that had an effective compliance program, self-reported, and cooperated is eligible for a reduced fine. United State Sentencing Commission, Chapter 8, Sentencing of Organizations, §8C2.5 (hereinafter Organizational Sentencing Guidelines). Yet the mitigation granted to larger firms is too low to incentivize firms to undertake effective compliance or self-reporting (Arlen 2012b). Moreover, convicted firms remain subject to the collateral penalties triggered by indictment or conviction, such as debarment, that can discourage corporate policing.

agency, such as Health and Human Services. These collateral sanctions can have ruinous consequences for a firm. For example, a pharmaceutical firm convicted of health care fraud would risk being debarred from doing business with Medicare, which funds the health care for citizens over 65 (the primary customers for many drugs). As a result of the threat of large fines and collateral sanctions, many firms in the U.S. resist being formally convicted.

U.S. prosecutors can now resolve criminal cases through means other than conviction. Prosecutors have one of two options: declination (where no sanction is imposed at all) and pre-trial diversion agreements (PDAs). All pre-trial diversion agreements are negotiated settlements. PDAs can take one of two forms: a deferred prosecution agreement (DPA) or a non-prosecution agreement (NPA). Under a DPA, the prosecutor files charges but agrees not to seek conviction. Under a NPA, the prosecutor agrees not to file formal charges against the firm.⁶ Both types of PDAs enable prosecutors to sanction the firm without triggering the collateral consequences of a formal conviction, such as debarment or delicensing.⁷

While firms avoid the threat of collateral consequences, PDAs are anything but a “get out of jail free” card. Although the firm is not convicted, prosecutors entering into DPAs do file formal charges. In addition, a firm entering into a PDA generally signs a statement of facts admitting to the wrong. The firm agrees that if it breaches the agreement, the prosecutor can proceed to trial, and use its admissions against it in court. In addition, most PDAs require firms to pay fines and other monetary penalties (such as criminal restitution). These penalties can be substantial. For example, Arlen and Kahan (2017) found that the average fine imposed through PDAs was \$31.3 million and the average total sanction imposed on the whole corporate group through (or enforced by) PDAs was \$171.3 million during the period 2010 through 2014. Sanctions on some firms are much larger. Indeed, many of the larger total monetary sanctions were imposed through PDAs. Firms also agree to cooperate with prosecutors, which includes investigating wrongdoing. These investigations can be detailed and very costly.

Finally, most PDAs impose mandates on firms requiring the firm to take actions that the prosecutor concludes will deter crime (Alexander and Cohen 2015; Arlen and Kahan 2017). The majority of PDAs impose mandates that require the firm to adopt an effective compliance program. Many mandates go beyond this and specify the features that the compliance program should have. 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. Other PDAs include mandates enhancing internal and external oversight of a firm’s efforts to comply with the law (Arlen and Kahan 2017). 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, the establishment of new board or senior management committees, 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

⁶ NPAs are expressed in the form of a letter, often not filed in court (Garrett 2007, p. 928).

⁷ See United States Attorney’s Manual, Principles of Federal Prosecution of Business Organizations, § 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 (Alexander and Arlen forthcoming 2018).

require firms to hire an outside monitor with authority to audit the firm to ensure its compliance with the duties imposed by the agreement. Some monitors have been given authority to seek evidence of additional wrongdoing (Arlen and Kahan 2017).

PDAAs have dramatically transformed U.S. enforcement practice. The increased use of PDAAs coincides with an increase in total criminal settlements per year against publicly held firms. They also appear to be partially responsible for the apparent increase in firms' willingness to investigate and cooperate by providing their investigations to enforcement authorities. Additionally, PDAAs seem to contribute—albeit less dramatically—to corporate self-reporting, particularly in the context of FCPA violations.

A striking feature of PDAAs is they were introduced and embraced by U.S. prosecutors without any formal statutory or regulatory action by either Congress or any regulatory agency, respectively.⁸ Instead, reform of the U.S. approach to corporate criminal liability was initiated by a memo to U.S. prosecutors written by then-Deputy Attorney General Eric Holder. The apparent purpose of the Holder memo was to encourage prosecutors to adjust their enforcement practice to recognize that corporate crimes are committed by individual employees. The Holder memo indicated that prosecutors should ensure that responsible individuals were held liable. It also encouraged prosecutors to use their discretion to grant leniency to firms under appropriate circumstances given that shareholders bear the cost of corporate penalties but usually have no role in crimes committed at professionally managed firms. The Holder memo provided a list of considerations for prosecutors to take into account. Five of these factors assumed particular importance: whether the firm had an effective compliance program; whether the firm self-reported the misconduct; whether the firm fully cooperated with prosecutors by investigating and providing information to prosecutors; and whether the firm voluntarily adopted needed reforms post-detection.⁹

In 2003, then-Deputy Attorney General Larry Thompson ushered in the modern approach to corporate criminal enforcement by issuing a memo that simultaneously embraced and modified the approach of the Holder memo.¹⁰ Thompson instructed prosecutors to pay particular attention to compliance—both whether firms had effective compliance at the time of the crime and ensuring that those that did not subsequently reformed their compliance programs. The Thompson memo directed prosecutors to consider pre-trial diversion agreements as an alternative to either conviction or full leniency. Following the Thompson memo, prosecutors in the criminal division of the Department of Justice and in the leading U.S. Attorneys' offices embraced the use of DPAs and NPAs for many, if not most, crimes involving large publicly held firms (see Arlen 2012; see also Alexander and Cohen 2015, noting the disproportionate use of PDAAs for parent corporations).¹¹

⁸ By contrast, in the U.K. DPAs were introduced by statute.

⁹ 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).

¹⁰ 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].

¹¹ PDAAs were used before the Thompson memo. Nevertheless, the 2003 Thompson memo was the first official endorsement of these agreements, and dramatically increased their use. In the entire period prior to 2002, prosecutors negotiated only 18 PDAAs (Garrett 2007). By contrast, they entered into at least 267 PDAAs from 2004 through 2014 (Arlen and Kahan 2017).

The Thompson memo set forth criteria that prosecutors should consider when deciding whether to employ a PDA. These criteria were revised several times—most recently in the fall of 2015—and are now set forth as a list of ten criteria in the U.S. Attorney’s Manual. Since 2003, prosecutors have embraced the use of PDAs (both deferred and non-prosecution agreements), which enable them to both insulate firms from the collateral consequences of conviction while also imposing monetary sanctions and mandates (Arlen and Kahan 2017).

Although the U.S. Attorney’s Manual lists ten criteria, prosecutors have complete discretion as to which factors to emphasize and also what factors to consider beyond the ten listed in the USAM (Arlen 2016). Nevertheless, three appear to be most relevant. The first is whether the firm self-reported the misconduct. Firms that self-report and fully cooperate are potentially eligible for a declination, if the misconduct is isolated; otherwise, many receive an NPA or DPA with materially reduced sanctions. In the case of firms that did not self-report, the next most important factor appears to be whether conviction would potentially subject the firm to collateral sanctions. If so, then the firm is highly likely to get a DPA unless the firm failed to fully cooperate with federal authorities, as in the case of Credit Suisse or BNP Paribas. When conviction would not result in collateral consequences and the firm did not self-report, then the choice of settlement resolution depends on a variety of factors, including strategic considerations. Thus, it is likely that firms are more likely to obtain a DPA when their cooperation confers a material benefit on the prosecutor and the DPA would not subject the prosecutor to public outrage. As a result, common factors influencing the decision include the importance of the matter to the prosecutor, the completeness of the firm’s voluntary cooperation, the quality of the firm’s voluntary reforms, whether the firm was previously sanctioned, and the identity of the prosecuting office (specifically, whether the office regularly undertakes corporate criminal resolutions with large firms) (see Alexander and Arlen forthcoming, discussing prosecutors’ incentives).

As noted previously, prosecutors resolving a case through a PDA nevertheless can take additional actions to enhance deterrence, in the form of mandates. These mandates include both internal reforms and, in about one-third of the cases, a requirement that the firm accept and pay for an external monitor (Arlen and Kahan 2017, identifying the deterrence justification for mandates and issues with existing practice).

3. Justifications for Enabling Prosecutors to Enter into Pre-trial Diversion Agreements

Federal prosecutors’ use of pre-trial diversion agreements has been controversial in the United States. Some politicians, academics, and media commentators have challenged their use positing that there is no reason why corporations that committed a crime should be allowed to avoid conviction. Yet in the case of publicly held (and other professionally managed) firms, this argument is misplaced. Indeed, effective deterrence of corporate crime depends on the combination of a broad baseline rule governing corporate liability and a set of predictable guidelines that enable prosecutors to employ alternatives to conviction for firms that have helped detect or sanction misconduct (Arlen 1994; Arlen and Kraakman 1997; Arlen 2012a). Pre-trial diversion agreements are a way to achieve this goal.

A. Central Purposes of Corporate Criminal Liability for Professionally-Managed Firms

The central purpose of corporate criminal (and enhanced administrative) liability for professionally-managed firms (such as publicly held firms) is to deter corporate misconduct. Deterrence is the paramount goal that should not be sacrificed for other considerations, such as

punitive retribution. Effective deterrence reduces future harm from both the defendant corporation and the many other firms influenced by effective enforcement. Retribution, by contrast, is not well effectuated by corporate liability imposed on publicly held firms. Corporate liability ultimately falls on a firm's shareholders. Yet the shareholders of professionally managed firms play no role in causing crime and do not have sufficient management power to prevent misconduct (Arlen 2012a; Arlen and Kahan 2017).¹² Of course, the threat of liability can cause shareholders to put pressure on management to deter misconduct, as well as provide more direct incentives to management through their stock ownership. Yet this does not provide a retributory justification for corporate liability because corporate liability is imposed even when shareholders had evidence that there was a reason for them to intervene. As corporate liability generally falls on non-culpable shareholders, premising corporate criminal liability on retributive goals is inapposite.

This presents the question of how corporate liability contributes to deterrence. The answer is, indirectly. Corporate liability imposed on professionally managed firms does not deter by imposing costs directly on those responsible for the crime. Liability falls on shareholders (including senior management). But the shareholders did not commit the crime. They did not even intervene to cause it. They were at home, or at work, doing something else altogether. Instead, crimes by professionally-managed firms are committed by employees—and often by employees who are not members of the senior management team. This is most obviously the case with foreign corruption, which tends to involve bribe payments made by employees negotiating contracts or delivering goods overseas. Individuals who commit business crimes do not tend to do so in the heat of passion or as a result of some other irrational impulse (Soltes 2016).¹³ Economic theory suggests employees commit corporate crimes when they decide it is in their best interests to do so (Arlen 1994; see Becker 1968). They may do so because the benefits (such as job retention or a bonus) are salient and they under-estimate the expected costs. Nevertheless, employees make a rational decision to commit crimes, often motivated by a combination of self-interest and the desire to benefit the “home team” (their firm). Of particular importance, employees who commit corporate crimes tend to have time to consider their actions. They often need to plan. As a result, they can be deterred through interventions that either make misconduct more difficult or that enhance—and make more salient—the expected personal cost of corporate crime (see Arlen and Kraakman 1997).

The United States tends to focus its deterrence efforts on imposing enormous criminal sanctions—imposing longer prison sentences than other countries. Yet, we know from studies about human decision-making that people tend to ignore threats that they do not expect to materialize. People often discount low probability events to zero. In the cases of corporate crime, this tendency can be exacerbated by what is known as egocentric biases: people's tendency to conclude that they are above average. So just as 90 percent of people believe that they are above average drivers—which of course is impossible—it is likely that 90 percent of corporate criminals believe that they are cleverer than average, and are the ones who are unlikely to get caught (see generally Arlen 1998, discussing behavioural biases; Arlen and Talley 2008, same).

¹² For example, under Delaware law (which governs the majority of U.S. publicly held firms), the power to manage the firm is vested in the board of directors, not the shareholders. Delaware General Corporation Law 141(a). Shareholders can vote for the board of directors, but in most firms they cannot even vote to nominate which candidates are put before them for election. They have no genuine control over the firm.

¹³ There are crimes that are not rational: street crimes, a drug addict who commits a crime is probably not rational, a spouse who shoots another spouse because they see them having an affair.

To observe these tendencies, one only needs to take a drive along any large highway. Drivers regularly exceed the speed limit—often by wide margins—unless they expect there is a reasonable likelihood of getting caught. For example, one observes drivers slowing down when they see police cars on the road, when they know they are near a “speed trap,” or it is a holiday that prompts more traffic stops by the police. Even when the sanction for speeding remains constant, behavior changes because the threat of sanction has increased.

As a result, if enforcement officials want to deter crime, they must implement measures that increase the probability that misconduct is detected and employees are sanctioned. Additionally, we must incentivize corporations to make this risk salient. Finally, it is important to make misconduct less profitable for employees by reducing their personal benefit.

Unfortunately, the government lacks the resources to obtain the evidence needed to identify and convict individuals, if the government is required to rely on its own resources. But the firm is able to obtain this information, both in the course of its regular operations (for example, through its compliance department) and once misconduct is detected (see Arlen and Kraakman 1997; Arlen 2012a). As a result, the best way to detect and disincentivize misconduct is to induce firms to intervene on the side of the government.

Corporations are the only parties that can directly intervene to reduce the benefit to employees of misconduct. Most corporate crimes—such as corruption, securities fraud, and off-label marketing—do not benefit employees directly. Instead, the crime directly benefits the firm. Employees benefit indirectly to the extent that increased corporate success translates into more secure employment, a promotion, or a bonus. Thus, employees who commit corporate crimes are often motivated by a desire to obtain a benefit—enhanced job security, promotion, or financial reward—that results from a compensation and promotion policy under the firm’s control (see Arlen and Kraakman 1997). They also may be motivated by a desire to serve the “home team,” especially if the firm has a culture that prizes financial outcomes at all cost (see Soltes 2016, exploring the causes of business crime). Corporations can therefore directly intervene to reduce the benefit of crime by reforming both their promotion and compensation policies (Arlen and Kraakman 1997) and their internal cultures (Arlen 2012a).

In the United States we recently witnessed a clear example of a firm whose compensation and promotion policy induced its employees to engage in misconduct—Wells Fargo. It appears that employees at Wells Fargo were told they were required to meet very high targets on the number of accounts customers were signed up for. Faced with the threat of termination for failing to meet their numbers, a great number of employees signed customers up for new accounts without the customers’ consent. This is not an unfamiliar pattern. In the FCPA context, employees often bribe foreign officials because almost all their compensation depends on the delivery of goods overseas—deliveries that would be unlikely to clear customs in the absence of bribes. The firm could have deterred bribery by informing employees that they will not lose their bonus if the only reason they failed to finalize a deal is that they refused to act unlawfully. Instead, employees regularly face an all-or-nothing choice: get the deal done or lose your compensation (and perhaps your job). In this scenario, the cost of failing to close the deal falls on the employees, creating an overwhelming temptation to pay the bribe.

In addition, enforcement authorities can and should incentivize firms to detect, investigate and report misconduct (Arlen and Kraakman 1997; see Arlen 1994). Enforcement authorities need firms to engage in such policing efforts because corporations are far more effective at detecting and

investigating misconduct than is the government (Arlen and Kraakman 1997; Arlen 2012a). Research has shown that government regulators usually are not the first to detect misconduct (Dyck et al. 2010). Corporations, by contrast, are well positioned to monitor for misconduct. They can more cost-effectively monitor for misconduct for four primary reasons. First, corporations obtain many benefits for exerting oversight over employees, benefits that go beyond deterring criminal misconduct and reducing liability. Second, they are better positioned than is the government to exert oversight even absent probable cause to suspect misconduct. Additionally, they can better identify which of their activities present the greatest risks, making detection more efficient. And finally, corporations are better able to conduct the investigations needed to ascertain whether suspicious activity in fact violated the law and to identify the people responsible for it—both those who engaged in the act and those who might have condoned or encouraged it (Arlen 1994; Arlen and Kraakman 1997; Arlen 2012a).

One might wonder why corporate self-reporting is important given that the firm could just intervene to fire wrongdoers. There are two reasons. First, employees are not adequately deterred from many crimes by the threat of termination alone. In fact, the threat of termination is often what incentivizes misconduct. This is because employees are motivated to engage in misconduct when the firm employs compensation and promotion policies that impose specific performance benchmarks that the employee may not be able to meet without violating the law. We have seen this most recently with Wells Fargo. There also is theory and evidence that most securities frauds (intentionally misleading statements) can be attributed to job retention concerns (Arlen and Carney 1992). Employees who expect to be fired for underperforming if they do not violate the law will not be deterred from misconduct by the threat of detection and retaliation alone, if the chances of being caught and fired are less than the chances of being fired for underperforming. Second, some crimes are sufficiently lucrative that the mere threat of job loss is not a sufficiently high sanction to ensure that the “crime does not pay.” A more substantial threat is needed—such as the risk of imprisonment or long term debarment.

As a result, governments that want to effectively deter corporate crime should provide firms with strong incentives to undertake corporate policing (Arlen and Kraakman 1997). This includes adopting compliance programs that not only deter misconduct but also detect any crimes that do occur (Arlen 1994). Prosecutors also need to induce firms to investigate suspicions, and report any detected problems to government authorities—providing these authorities evidence on both the nature and scope of the misconduct and on which individuals are responsible for the crime (Arlen and Kraakman 1997; see Arlen 2012a).

Of course, corporations are managed to make profits. As a result, they will not undertake these actions unless they benefit from doing so. The most effective way to ensure that corporations police effectively is to both hold them liable for their employees’ crimes and structure liability so that firms are better off if they adopt an effective compliance program (Arlen and Kraakman 1997; Arlen 2012a). By rewarding corporations that detect misconduct, self-report, and fully cooperate in order to ensure that wrongdoing and the individual wrongdoers are sanctioned, enforcement agencies can motivate corporations to become corporate cops instead of complicit criminals with those that committed the crime.

Thus, we see that in order to deter corporate crime, it is important to hold corporations liable not only for senior manager misconduct but also for crimes committed by regular employees, since the firm ultimately controls the incentives that lead to employee criminal activity. However,

liability must be structured so that firms not only want to deter crime, but also want to help the government detect and sanction misconduct. This latter goal has important implications for the structure of corporate liability and helps explain why the U.S. implemented negotiated settlements (Arlen 2012a; see Arlen and Kraakman 1997). Because negotiated settlements enable prosecutors to grant more exacting forms of leniency to firms that implement effective compliance programs, self-report, and/or cooperate, negotiated settlements can be a better vehicle for creating the nuanced incentive structure required to properly motivate corporations.

B. Perverse Effects of Strict Corporate Liability for Employees' or Managers' Misconduct

Many countries hold corporations strictly criminally liable for wrongdoing by either all employees or by senior managers. U.S. law imposes broad liability: holding firms liable for crimes by any employee committed in the scope of employment with any intent to benefit the firm. Many other countries hold firms strictly liable for misconduct but only if committed by senior managers who are the brains (or managing mind) of the firm. Finally, some countries impose liability on corporations for their employees' crimes unless the firm had an effective compliance program. None of these approaches will cause firms to undertake effective corporate policing, which includes self-reporting and providing full cooperation by disclosing facts learned through the firm's own internal investigation.

Countries that hold firms strictly liable for crimes committed by employees or managers undermine their ability to deter corporate misconduct. This form of liability places a cost on corporate policing, instead of encouraging it (Arlen 1994; Arlen and Kraakman 1997).

Corporations held liable for all employee misconduct—and subject to a fixed sanction of F (equal to the harm caused)—can have strong incentives to intervene to deter crime by altering corporate compensation and promotion policies. They also are incentivized to adopt compliance measures designed to make crime harder to commit (Arlen 1994; Arlen and Kraakman 1997). However, this corporate liability rule does not give firms adequate incentives to undertake measures that help the firm detect and report wrongdoing. Indeed, liability discourages corporate policing.

Upon careful reflection, the reason is intuitively apparent. Firms that expect to be convicted for their managers' crimes are caught on the horns of a dilemma. They can intervene to detect and report wrongdoing, and thereby deter employees (who now are more afraid of being caught). This is the deterrent effect of corporate policing. But when firms are held strictly liable for employees' or managers' crimes, this deterrent effect comes at a cost: the liability enhancement effect. Corporations that undertake effective policing know they will not deter all wrongdoing. To the extent crimes occur, corporate policing will increase the probability that employees are sanctioned as well as the probability that the firm is sanctioned as well. Thus, when firms are held strictly liable for their employees' or managers' misconduct, firms are discouraged from monitoring, self-reporting, and fully cooperating because these actions will ultimately increase their liability.

To illustrate this, consider a firm that has detected misconduct and now must decide whether to self-report and fully cooperate. Reporting and cooperating (by providing strong evidence about the crime and the underlying misconduct) will help the government deter crime by enabling the government to both punish the individual responsible and send a strong message to others contemplating misconduct. But if the firm expects to be convicted for its employees' crimes, then reporting and cooperating can only harm the firm. If the firm reports and cooperates, the

government will seek to hold the firm liable, imposing the appropriate sanction (e.g., \$100 million). If the firm does not report, the firm's expected liability is much lower. True, there is a chance that the government will detect the crime and hold the firm liable (for the same sanction, \$100 million). Yet, unlike when the firm self-report, liability is far from guaranteed. Indeed, the likelihood of liability when the firm does not self-report often will be substantially less than the risk of liability if it does report because government enforcement authorities usually are not able to detect most corporate crimes on their own. And, even if they do, often they cannot easily get the evidence they need to obtain a conviction unless the firm cooperates. As a result, the firm's expected sanction if it reports is \$100 million (in our example) whereas its expected sanction if it does not report is $(P)(\$100 \text{ million})$, where P , the probability of detection/sanction, is much less than one. It is easy to see that not reporting is the wiser course of conduct.

Strict corporate liability not only deters firms from self-reporting, but it also disables them from deterring employee misconduct by threatening to detect them and self-report (Arlen and Kraakman 1997). Firms can deter misconduct when they can credibly threaten that detected misconduct will be reported to the authorities for punishment. Of course, employees understand that threats are cheap talk. Employees will decide whether or not to believe the threat based on whether they think the firm, having detected wrongdoing, benefits from self-reporting. Employees understand that firms facing the threat of criminal liability for reported misconduct will not self-report detected crimes that otherwise could remain hidden; they only believe threats when firms are better off self-reporting. As such, in a strict liability regime, firms are disarmed of a tool that otherwise could be used to effectively deter crime. Corporate liability must therefore be structured to ensure that firms are better off when they self-report than when they do not—or in turn are worse off when they do not self-report than when they do self-report.

C. How to Structure Corporate Liability

Accordingly, governments seeking to deter corporate crime must structure corporate liability (criminal, civil, and administrative) to serve three goals. First, they must ensure that crime does not pay, as otherwise firms can benefit from compensation policies that incentivize misconduct. Second, corporate liability (civil, criminal, and PDAs) must provide firms with an incentive (i) to adopt optimal measures that detect wrongdoing, (ii) investigate suspected misconduct, (iii) self-report detected misconduct to the authorities, and (iv) fully cooperate to bring individual wrongdoers to justice (Arlen and Kraakman 1997; see Arlen 2012a). Third, corporate liability must be structured so that firms that do plan to adopt effective compliance, self-report, and cooperate retain incentives to take other actions to deter crime, such as compensation and promotion policy reform.

In order to achieve these goals, corporate liability for criminal misconduct must have a multi-tiered structure to enable prosecutors to impose substantially different sanctions on firms that fail to comply with their policing duties. The most severe sanctions should be reserved for corporations that detected misconduct, failed to report detected misconduct, did not have an effective compliance program, and did not fully cooperate to provide evidence against all the individuals responsible for the crime (Arlen and Kraakman 1997; Arlen 201a).

To induce corporate policing, the optimal approach would be to impose a legal duty on firms to adopt effective compliance, self-report detected misconduct, and fully cooperate (hereinafter policing duties). Firms that breach all of these duties should face seriously enhanced sanctions—ideally imposed through formal conviction. The enhanced sanction should be sufficiently large that,

ex ante (when a firm does not know whether misconduct will be detected), a firm has lower expected sanctions if it self-reports and cooperates (thereby guaranteeing detection) than if it does not. Accordingly, if a firm that has detected misconduct faces a 20 percent chance that the government will detect and sanction the crime should the firm fail to self-report, then sanction imposed on the firm if it fails to self-report must be at least five times as great as the sanction imposed if the firm does self-report. A particularly effective way to implement such a scheme is to reserve corporate conviction—whether following a trial or guilty plea—for firms that either detected misconduct and failed to self-report or failed to detect and then also failed to cooperate once the government detected misconduct.

By contrast, firms that significantly aid the government's enforcement efforts by either self-reporting or fully cooperating (providing strong actionable evidence against all individuals responsible) should not be formally convicted. A predictable policy against convicting firms that help the government can provide a strong incentive to firms to take the steps needed to deter crime. Firms that self-report and cooperate should likewise pay lower penalties.

One effective way to implement a policy of rewarding self-reporting and cooperation is to reserve DPAs and NPAs for firms that self-report detected misconduct and cooperate. Enforcement authorities can further refine the incentives they provide by announcing that certain actions (self-reporting before a risk of detection and full cooperation) not only lead to a DPA with lower sanctions, but also will enable the firm to avoid having a monitor imposed. Correspondingly, enforcement agencies can signal that other actions (failing to self-report detected misconduct) will subject the firm to high sanctions and a monitor, even if a firm's other efforts (an adequate compliance program for instance) justify the use of a DPA.

What is crucial is that the government must ensure that firms that self-report are much better off than those that detect, fail to self-report, but then provide valuable cooperation should the government later detect. The government can only do this by clearly announcing both the benefits to self-reporting and the negative consequences of failing to self-report. In so doing, it's important to bear in mind that the government often cannot simply say that failure to self-report will lead to automatic conviction, because often prosecutors not only need self-reporting, they also need cooperation. Thus, prosecutors need to be able to provide incentives to firms to cooperate even if, at an earlier stage, management detected the misconduct and failed to self-report. Granting a DPA to a firm that fully cooperates can incentivize cooperation. Combining the DPA with compliance reforms and enhanced oversight (e.g., a monitor) for firms that detected misconduct, failed to self-report, and retained the responsible managers will provide strong incentives to both firms and managers to self-report (Arlen 2012a; see Arlen and Kraakman 1997).

Although firms that satisfy all policing duties should escape criminal sanction, they still should be held liable for detected misconduct if they profited from it or it caused serious harm. This liability could take the form of restitution or remediation imposed through either an NPA or government-imposed civil or administrative sanctions. The monetary penalty must remove the benefit to the firm of wrongdoing and be sufficiently large to motivate the firm to want to deter wrongdoing through measures that go beyond compliance programs, including compensation and promotion policy reform. This liability is needed because otherwise firms could adopt compensation systems that encourage crime, and then avoid sanction by self-reporting any misconduct they happen to detect while retaining the full benefit of the crime. (Arlen and Kahan 2017).

There are many ways to implement an effective regime. A system that both enables prosecutors to choose between formal conviction, a DPA, and an NPA, while providing clear guidelines to firms and prosecutors on the effect that self-reporting, compliance, and cooperation will have on the choice of settlement form, is only one of many possibilities. What is likely is that even if the regime is adopted by the legislature instead of by prosecutors—as in the U.S.—prosecutors will need discretion (chastened by oversight (Arlen 2016)) to determine whether the firm has satisfied the criteria needed to trigger the use of one settlement resolution or the other, and should be allowed to resolve cases through negotiation instead of having to take all cases to trial.

In the United States, prosecutors not only use criminal settlements (pleas, DPAs, and NPAs) to impose monetary penalties, they also use them to impose mandates (as discussed in the appendix). These mandates include mandated compliance program reforms and monitors.

When used under appropriate circumstances, mandates can play an important role in the effort to deter corporate crime. Moreover, because the circumstances that justify mandates are limited, and require firm-specific analysis by prosecutors, prosecutors inevitably will need to exercise discretion in determining whether mandates should be imposed and what form they should take (Arlen and Kahan 2017)—though the discretion should not be broad as it is currently in the United States (Arlen 2016).

Corporate reform mandates are justified, but only in one particular circumstance: when enforcement officials have clear evidence that corporate monetary sanctions alone cannot induce the firm to adopt effective compliance, self-report, and cooperate because the managers are not making policing decisions in the firm's best interests because they benefit personally from suboptimal policing (Arlen and Kahan 2017). Corporate reform mandates are justified only in this limited circumstance because when managers make policing decisions to maximize corporate profits then managers can be incentivized to undertake effective policing through properly structure corporate liability with monetary sanctions (such as described above). Indeed, monetary penalties are superior to mandates because they impose a direct and immediate cost on firms that failed to take appropriate steps. Mandates are only needed when senior managers gain private benefits from deficient policing, either because they benefit from the crime or benefit from deficient oversight. In this case, enforcement officials must intervene through mandates to ensure that oversight ultimately resides with an actor other than the senior management (Arlen and Kahan 2017).

D. Why Effective Compliance Should Not Insulate Firms from Liability

The conclusion that corporate liability is needed to induce firms to self-report and fully cooperate, and also to encourage firms to undertake other measures to deter misconduct, reveals the problems with adopting a corporate liability rule predicated liability entirely on the existence of an effective compliance program—insulating firms that adopted an effective compliance program.

There are two reasons why effective compliance programs alone should be insufficient to negate liability. First, it is too easy for firms to set up systems that appear to be effective but are not. As a result, granting a compliance defence presents two serious risks. Either prosecutors give firms credit for appearances, thus enabling many to avoid liability based on paper compliance programs that is poorly implemented, or they will implement a presumption that the firm's must have had ineffective compliance if a crime occurred. Neither of these approaches will induce firms to adopt effective compliance programs.

Second, and more important, even when prosecutors can determine the effectiveness of a firm's compliance program, granting a full compliance defence to all corporate liability undermines deterrence. A compliance defence only provides incentives for firms to undertake one of the many actions needed in order to effectively deter corporate crime. This is a problem because compliance programs—even good ones—do not deter all crime. Thus, we need to induce firms to employ these other tools to deter crime. For example, we need to induce firms to reform compensation, promotion, and retention policies to ensure that they encourage productivity without also encouraging misconduct. We also need corporations to self-report all detected misconduct and to fully cooperate in investigating the wrong (including providing materials to the government).¹⁴ Regimes that insulate firms from liability if they have an effective compliance program do not provide corporations with needed incentives to take these other actions to deter crime because a firm that is not liable for corporate crime has little to no reason to spend resources to deter it. In effect these regimes say to firms: “If you have a great compliance program, you have satisfied your obligations. You need not worry about any incentives you provide employees to commit crimes. And you have no reason to self-report or otherwise assist the government’s investigations.”

4. Negotiated Resolutions With Constrained and Targeted Discretion

The preceding analysis reveals why governments seeking to deter corporate crime cannot rely on simple corporate liability regimes in which criminal resolutions take one form and are predicted on one simple fact: whether the crime occurred or whether the firm had a compliance program. A more nuanced approach is needed as to the structure of liability and the type of sanctions imposed—including fines, restitution, and mandates.

The U.S. system—with its heavy reliance on negotiated settlements—shares many of the features of the deterrence regime described above. Yet there are important differences between the U.S. approach and an approach that can best deter corporate crime (e.g., Arlen 2012; Arlen 2016; Arlen and Kahan 2017). Specifically, governments can most effectively deter corporate crime by adopting *ex ante* standards (through statutes or regulations) imposing duties on corporations to (1) adopt an effective compliance program, (2) self-report detected wrongdoing, and (3) fully cooperate. These duties must be enforced by pre-announced and predictable sanctions. The pre-announced duties and rules may be implemented through negotiated settlements. But prosecutors must be given clear guidelines governing what enhancements should be imposed on firms that failed to self-report, failed to cooperate, or that adopted genuinely ineffective compliance programs.

A central deficiency in the U.S. approach is that the Department of Justice has not provided prosecutors with clear guidelines that lead to predictable resolutions that predicate the choice of criminal resolution on the quality of corporate policing.¹⁵ Instead, the DOJ grants prosecutors enormous discretion to decide whether to pursue a conviction or instead use a DPA or NPA.

¹⁴ Firms can investigate more efficiently than the government can. A firm has access to employees’ emails, to the firm’s own records on payments, and can send its investigators to the firm’s operations throughout the world to interview employees without jurisdictional concerns. We need firms to undertake these measures.

¹⁵ The Fraud Section of the Department of Justice has taken steps to reduce, albeit not eliminate, this problem. The Fraud Section announced a Pilot Program that provides greater clarity to firms (and prosecutors) about the potential effect of self-reporting and cooperating versus cooperating alone. Senior Fraud Section officials also regularly give speeches that provide additional information about the offices’ approach. Finally, the Fraud Section hired a compliance consultant, Hui Chen, to provide expert expertise to prosecutors when evaluating firms’ compliance programs.

Prosecutors are told to make this decision based on a list of ten factors, but this list is not exclusive. The US Attorney's Manual explicitly tells prosecutors that they can consider other factors that they deem appropriate. Moreover, while corporate policing—compliance, self-reporting, and cooperation—are included in the ten factors, there are numerous other considerations. These include the magnitude of the crime, past misconduct, and collateral consequences. As a result, a firm cannot predict with confidence how it will be treated by a prosecutor should it self-report misconduct because prosecutors have full discretion to decide which of the ten factors matters the most. The resulting lack of predictability is especially high for firms reporting misconduct to prosecutors who do not have a track record dealing with corporate crime cases. In turn, a large firm that would face serious collateral consequences if convicted can be very confident of avoiding conviction, even if it detects misconduct and fails to self-report, as long as it fully cooperates if detected. This is because collateral consequences appear to trigger a *de facto* presumption against conviction of firms that agree to fully cooperate once detected. As a result, the existing U.S. approach to adjusting corporate liability for effective policing does not provide the clear *ex ante* rewards for corporate policing needed to deter corporate misconduct effectively.¹⁶

In addition, prosecutors are given insufficient and incorrect guidance on when and what mandates are appropriate. They are encouraged to impose mandates whenever the firm lacks an effective compliance program and face little constraint when choosing among the types of mandates available. Indeed, they are not even constrained by judicial oversight when imposing mandates through PDAs. Yet mandates are only appropriate in a much more limited circumstance—when prosecutors have evidence that managements' policing decisions are distorted by agency costs. In such circumstances, prosecutors should rely on specific mandates or mandates enhancing internal and external oversight of policing, instead of the general vague compliance mandates they tend to impose (see Arlen and Kahan 2017, critiquing existing U.S. policy towards mandates).

Finally, until recently, historically there was too little oversight of whether prosecutors were using corporate liability to pursue the ultimate objective: imposing liability on the individuals ultimately responsible for misconduct (Arlen 1994; see Arlen and Carney 1992). This is important because prosecutors who are not repeat-players against corporations may be tempted (and appear to have been tempted) to accept a deal that insulates individuals from prosecution in return for a potentially headline grabbing corporate conviction. This has improved since the promulgation of a memo by then-Deputy Attorney General Sally Quillian Yates (the Yates memo), which calls on prosecutors to pursue individuals and increases oversight of their decisions on this matter. Yet the actual impact on individual liability remains to be seen.

These three problems all stem from a more general concern. The U.S. led the way in adopting a regime that *could* be used to effectively deter corporate crime, but did so by emphasizing the prosecutor's right to assert discretion. The DOJ did not provide strong guidance on the policy

¹⁶ This degree of discretion also is not consistent with a commitment to the Rule of Law (Arlen 2016). Nevertheless, allowing judicial review would not suffice to remedy this problem in the U.S. because judicial review simply substitutes one level of excessive discretion for another (by the judge) unless the state provides rules and standards governing both the decision to convict and the appropriate sanction enhancements for violations of policing duties. In the U.S. these enhancements are contained in the U.S. Sentencing Guidelines, but the Guidelines are not binding. Moreover, the Guidelines were not well-designed to induce corporate compliance, self-reporting and cooperation (Arlen 2012b) and therefore prosecutors consistently deviate from the Guidelines to promote the public interest.

considerations that should drive prosecutors' determinations. Prosecutors have not been clearly directed to focus on deterrence as the primary goal of corporate liability. Nor have they been instructed about the weight to be put on self-reporting and full cooperation in determining the form of resolution. Indeed, the DOJ has not adequately counselled prosecutors to recognize that their decisions they make in an individual case can affect their fellow prosecutors' ability to induce corporations to self-report and cooperate in future cases. As a result of its failure to take a more regulatory, incentive-oriented, approach to corporate criminal liability, the Department of Justice has undermined prosecutors' ability to achieve the most important benefits of negotiated criminal settlements with multi-tiered corporate liability. Instead, the decisions by many offices lack the predictability and clear purpose needed to send the right message to firms on how to deter misconduct. The potential benefits of negotiated settlements remains present, but are not being fully realized as a result of the failure to provide adequate guidance, rules, and oversight.

5. Conclusion

It is tempting for legislatures and government enforcement authorities to eschew both negotiated settlements and pre-trial diversion agreements to avoid any public opprobrium for going “soft” on corporate crime. Yet in fact, both negotiated settlements and the use of alternatives to formal conviction are important tools to be used to deter crime when structured to enhance the threat of criminal liability.

Absent these tools, individual corporate wrongdoers face little risk of criminal sanction because they are unlikely to be caught and even less likely to be sanctioned. When prosecutors must detect and investigate every case on their own, and bring each case to trial, few crimes are detected, even fewer are fully investigated, and even fewer actions can be brought. Additionally, firms have little or no reason to step into the fray to assist enforcement authorities.

Negotiated settlements that include a choice between pleas and PDAs can change the legal landscape in a way that makes corporate criminal sanctions *more* of an effective threat, and not less. When properly employed, these measures can provide firms with much needed incentives to promote legal compliance and assist government enforcement. Corporations can do this by adopting effective compliance programs, investigating misconduct, self-reporting and cooperating to identify the individuals responsible for the wrong, and providing the evidence needed to bring them to justice. When firms are on the same side as the government, employees are less likely to violate the law because all crimes would face a genuine risk of detection and criminal sanction.

The U.S. experience provides an illustrative example of how these approaches can be used to induce firms to enhance compliance, cooperate, and in some cases, self-report. It also provides examples of structural problems to avoid—and that can be avoided in systems likely to adopt these measures through more formal processes. Countries have much to gain from negotiated settlements and PDAs if properly employed.

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