

The Compliance Function

Jennifer Arlen *

Abstract

This Chapter identifies the features of the corporate compliance function and the steps countries should take to induce companies to implement effective compliance. The compliance function is comprised of the set of corporate inventions that deter corporate misconduct. Using empirical psychology, this Chapter shows that important aspects of corporate compliance reside outside a company's compliance program as typically designed. For example, the compliance function includes the company's compensation, promotion and retention policies and its approach to self-reporting misconduct to, and fully cooperating with, enforcement authorities. Countries cannot induce effective compliance through regulatory mandates alone because optimal compliance varies too widely across firms and is not readily assessable by either enforcement officials or courts. Thus countries must instead incentivize corporations to implement effective compliance functions holding them criminally liable for their employees' misconduct. Corporate liability must be structured to remove their expected profit from corporate crime and induce them to detect and self-report misconduct and fully cooperate. In addition, directors and officers must be subject to explicit properly-tailored duties to promote effective compliance enforced through liability for bad faith breach and clawbacks.

1. Introduction

Countries cannot deter employees from committing deliberate corporate misconduct¹ unless they induce corporations to both curtail the actions they act that promote misconduct and actively seek to deter it, both directly and indirectly by helping enforcement authorities to detect and investigate misconduct. Countries employ individual criminal liability to deter organizational misconduct through both the disincentives produced by the threat of criminal sanctions² and the moral suasion produced by criminal law's expression that the unlawful conduct violates social and ethical norms.³ Companies significantly impact criminal law's ability to deter through either of

* Norma Z. Paige Professor of Law and Faculty Director of the Program on Corporate Compliance and Enforcement, NYU School of Law. I would like to thank Miriam Baer, Yuval Feldman, Jill Fisch, Jeffrey Gordon, Kathryn Reimann, and the participants at the Conference on The Oxford Handbook on Corporate Governance for their thoughtful comments.

¹ Employees commit a corporate crime when they commit an act that violates the criminal law with the requisite mens rea for the crime, if one of the employee's goals was to benefit the firm. Thus, bribery designed to obtain a contract for the firm is corporate misconduct, even if the employee was primarily motivated by the bonus that would result from her actions. By contrast, an employee who misappropriates the firm's material nonpublic information to trade stocks solely for her own behalf engages in white collar crime but not corporate misconduct. In this case, the firm is the victim not the perpetrator.

² E.g., Jennifer Arlen & Reinier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. Rev. 687 (1997); Jennifer Arlen, *Corporate Criminal Liability: Theory and Evidence*, in RESEARCH HANDBOOK ON THE ECONOMICS OF CRIMINAL LAW, 144 (Keith N. Hylton & Alon Harel, eds., 2012).

³ The rich literature on the expressive role of law includes BENJAMIN V. ROOIJ & ADAM FINE, *THE BEHAVIORAL CODE: THE HIDDEN WAYS THE LAW MAKES US BETTER . . . OR WORSE* (2021); YUVAL FELDMAN, *THE LAW OF GOOD PEOPLE: CHALLENGING STATES' ABILITY TO REGULATE HUMAN BEHAVIOR* (2018); Jennifer Arlen & Lewis Kornhauser, *Battle for our Souls: A Psychological Justification for Corporate and Individual Liability for Organizational Misconduct*, 2023 ILL. L. REV. 673 (2023); Robert Cooter, *Expressive Law and Economics*, 27 J. LEGAL STUD. 585 (1998); Kenneth G. Dau-Schmidt, *An Economic Analysis of the Criminal Law as a Preference-Shaping Policy*, 1990 DUKE L.J. 1, 38 (1990); Dan M. Kahan, *Social Influence, Social Meaning, and Deterrence*, 83 VA. L. REV. 349 (1997); Richard H. McAdams, *An Attitudinal Theory of Expressive Law*, 79 OR. L. REV. 339 (2000); see also Kenworthy Bilz & Janice Nadler, *Law, Moral Attitudes, and Behavioral Change*, in THE OXFORD HANDBOOK OF BEHAVIORAL ECONOMICS AND THE LAW 241 (Eyal Zamir & Doron Teichman eds., 2014).

these channels. Corporate compensation, promotion and retention policies generally determine employees' incentives to commit corporate crime.⁴ Corporations also significantly impact employees' expected cost of crime through their internal messaging to employees and their substantial impact on employees' threat of criminal sanction through their efforts to detect and investigate misconduct and their willingness to self-report it to and cooperate with enforcement authorities.⁵ Corporate intervention also is vital to the criminal law's ability to deter through expressive channels—through its ability to cause employees to experience guilt and shame over engaging in corporate misconduct.⁶ Companies largely determine the salience and effectiveness of the criminal law's expressive message through their control over their employees' decision-making environment and their impact on the salience of the threat of criminal sanctions both internally and by detecting, self-reporting and cooperating.⁷ The extensive set of interventions that a company can take to deter (or induce) misconduct⁸ comprise its compliance function.⁹

Companies generally will not adopt an effective compliance function absent legal intervention that incentivize them to do so because compliance is costly and many companies profit from their employees' crimes. Countries cannot induce effective compliance by simply adopting regulations requiring it, however. Instead, countries must incentivize companies to take effective steps to deter employee misconduct, including by detecting, self-reporting and fully cooperating, by imposing liability on them designed to deter misconduct and induce self-reporting and full cooperation. They also must impose duties on directors to obtain evidence about, and investigation, material misconduct in order to motivate them to adopt an effective compliance functions.¹⁰

This Chapter identifies the features of corporate compliance and shows why corporate and director liability is vital to the effort to induce companies to implement an effective compliance function. This Chapter first employs empirical psychology to identify the many ways that companies affect their employees' likelihood of complying with the law, for good or for ill, either knowingly or inadvertently.¹¹ While analysis of corporate compliance tends to focus on the

⁴ Arlen, *supra* note 2; Arlen & Kornhasuer, *supra* note 3; see also Jennifer Arlen & William Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 ILL. L. REV. 691 (1992) (managers commit fraud on the market securities fraud when they fear termination).

⁵ Arlen, *supra* note 2; Arlen & Kraakman, *supra* note 2.

⁶ Arlen & Kornhasuer, *supra* note 3.

⁷ *Id.*

⁸ This Chapter uses the term deterrence to refer to any intervention designed to reduce the likelihood that a person knowingly violates the law, including interventions commonly referred to as prevention measures.

⁹ An organization's compliance function is composed of the myriad of measures the organization takes to deter its employees (and other agents) from violating the law, and to detect, investigate, and remediate any violations that do occur. See, e.g., Geoffrey Parsons Miller, *The Compliance Function: An Overview*, 981, THE OXFORD HANDBOOK OF CORPORATE LAW AND GOVERNANCE (Jeffrey Gordon & Wolf-Georg Ringe (2018); see Miriam Hechler Baer, *Governing Corporate Compliance*, 50 B.C. L. Rev 949, 954 (2009); Donald Langevoort, *Monitoring: The Behavioral Economics of Corporate Compliance with Law*, COLUMBIA BUS L REV 71 (2002); see also Francesco Centonze, *The Imperfect Science: Structural Limits of Corporate Compliance and Co-Regulation*, 45 in CORPORATE COMPLIANCE ON A GLOBAL SCALE: LEGITIMACY AND EFFECTIVENESS (Stefano Manacorda & Francesco Centonze eds. 2021); Geoffrey P. Miller, *An Economic Analysis of Effective Compliance Programs*, in RESEARCH HANDBOOK ON CORPORATE CRIME AND FINANCIAL MISDEALING (Jennifer Arlen ed., 2018).

For a discussion of the difference between the compliance function and a compliance program see *Compliance*, §§ 5.01-5.06, in PRINCIPLES OF THE LAW OF COMPLIANCE AND ENFORCEMENT FOR ORGANIZATIONAL MISCONDUCT (2023) (Amer. L. Inst. 2023).

¹⁰ See Arlen & Kornhauser, *supra* note 3.

¹¹ This Chapter is focused on misconduct by and compliance within large companies, such as multi-national publicly held companies.

company policies, procedures, and training that constitute a company's "compliance program," analysis employing empirical studies of human decision-making reveals that most of the ways that companies undermine or enhance the law's ability to deter employee misconduct lie outside the compliance program, and rely on the same channels as the criminal law: financial incentives and social and ethical norms favoring compliance.¹² Companies alter both employees' incentives and the salience of norms favoring compliance through how they structure their compensation, promotion and retention policies.¹³ They also can deter through both incentives and expressed norms by helping enforcement authorities detect and punish misconduct.¹⁴ Finally, they can alter the way they structure their employees' jobs to undermine or enhance or weaken the salience and impact of the law's social and ethical norms against legal violations.¹⁵ These interventions, that reach deep within and throughout the firm, combine to constitute the firm's compliance function.

This Chapter next explicates why countries cannot rely on regulatory injunctions alone to induce effective compliance but instead must impose criminal liability on companies for their employees' misconduct.¹⁶ Companies cannot be relied on to adopt effective compliance functions absent legal intervention. Compliance is costly. In addition, effective compliance functions entail interventions throughout the firm that often involve trade-offs between compliance and productivity. Effective compliance also increases the risk of misconduct being detected and publicly disclosed, which can harm the firms in a variety of ways absent properly structured legal interventions.¹⁷ Nor can countries induce effective compliance through regulatory mandates alone because the features of an effective compliance function vary substantially across companies.¹⁸ Moreover, neither enforcement authorities nor regulators have sufficient information to effectively distinguish an effective compliance function from one which may appear effective but is not.

Instead, countries need to adopt legal rules designed to incentivize effective compliance, including detection, self-reporting and full cooperation. To achieve this goal, companies should be held liable for all knowing and intentional corporate misconduct committed by *all* employees—

¹² See Arlen & Kornhauser, *supra* note 3; see also U.S. Dep't of Justice, Criminal Division, Evaluation of Corporate Compliance Programs (March 2023) (identifying the listed considerations as part of effective compliance and explicitly recognizing that the appropriate risk-adjusted approach varies significantly across firms).

¹³ See, e.g., Arlen & Kraakman, *supra* note 2; Arlen & Kornhauser, *supra* note 3; see also Arlen, *supra* note 2, at 167–84 (companies largely determine employees' benefit from corporate misconduct through their control over compensation, promotion and retention policies).

¹⁴ *Id.* (discussing corporate policing measures that enhance employees' risk from and expected cost of criminal sanction); see Arlen & Kornhauser, *supra* note 3.

¹⁵ Arlen & Kornhauser, *supra* note 3; see also MAX H. BAZERMAN & ANN E. TENBRUNSEL, BLIND SPOTS: WHY WE FAIL TO DO WHAT'S RIGHT AND WHAT TO DO ABOUT IT, Chap. 6 (2011); Donald Langevoort, *Cultures of Compliance*, 54 AM. CRIM. L. REV. 933 (2017); FELDMAN, *supra* note 3, at 168–89; Donald Langevoort, *Behavioral Ethics, Behavioral Compliance*, in RESEARCH HANDBOOK ON CORPORATE CRIME AND FINANCIAL MISDEALING 1, 8 (Jennifer Arlen ed., 2018). Other articles that explore the implications for corporate liability or corporate law of insights from empirical psychology about the root causes of corporate misconduct include Yuval Feldman, Adi Libson, Gideon Parchomovsky, *Corporate Law for Good People*, 115 NW. L. REV. 1125 (2021).

¹⁶ Arlen & Kornhauser, *supra* note 3.

¹⁷ See Arlen & Kraakman, *supra* note 2; Arlen & Kornhauser, *supra* note 3; see also Cindy R. Alexander & Jennifer Arlen, *Does Conviction Matter? The Reputational and Collateral Effects of Corporate Crime*, in RESEARCH HANDBOOK ON CORPORATE CRIME AND FINANCIAL MISDEALING 87 (Jennifer Arlen ed., 2018) (discussing reputational penalties for organizational misconduct).

¹⁸ Regulatory mandates can be optimal in specific circumstances—such as the requirement that public companies obtain an external audit of their financial statements. But countries cannot rely on regulatory mandates to ensure that companies take all the actions needed to implement effective compliance.

even lower-level employees—on behalf of the firm.¹⁹ Expected sanctions should eliminate companies' expected benefit from misconduct and provide them with a strong financial motivation to adopt the measures they conclude are most effective.²⁰ In addition, to enable criminal law to deter employees through incentives and expressive channels, corporate liability needs to be structured to induce companies to help enforcement authorities detect, investigate and pursue individual wrongdoers.²¹ Thus, corporate liability must be structured so that companies that self-report to, and fully cooperate with, enforcement authorities predictably fare better than those that do not.²² Countries also should increase wrongdoers' and companies' risk of detection by adopting laws that protect and reward employees who report misconduct.²³

Corporate criminal liability alone is not enough, however, for two reasons. First, corporate liability tends to under-deter because most countries under invest in corporate enforcement.²⁴ As a result, companies often expect to benefit from corporate crime. Second, directors and officers can benefit personally from either misconduct or weak compliance even when the firm does not.²⁵ Accordingly, countries seeking to induce effective compliance thus also must target duties and liability, and incentives), directly at directors and officers. This Chapter discusses director and officer liability must be narrowly tailored, but must include more specific duties on directors to obtain information about misconduct than those originally articulated by the Delaware courts in *In re Caremark International*.²⁶

Finally, the Chapter examines how organizations and government authorities can best assess the effectiveness of a company's compliance function.²⁷ Recognition that the compliance function reaches deep into the firm necessitates focus on the "outputs" of compliance, rather than its procedural inputs. Tests of effectiveness should focus on the compliance function has reduced illegal or unethical behavior, as evidenced by data from the firm's internal reporting system, customer complaints, monitoring, and human resources.

This Chapter proceeds as follows. Section 2 presents evidence on the ways the law can deter individuals from committing crimes and identifies the ways in which organizations can and do structure their internal operations to promote or deter misconduct. Section 3 explains why and how corporate criminal liability is needed to induce firms to adopt effective compliance functions

¹⁹ Arlen & Kornhauser, *supra* note 3; Arlen & Kraakman, *supra* note 2.

²⁰ *Id.*

²¹ See Arlen & Kornhauser, *supra* note 3; see also Arlen & Kraakman, *supra* note 2. This discussion focuses on companies other than owner-managed closely-held firms. For a discussion of why corporate liability is unlikely to be effective at inducing self-reporting and cooperation by these firms see Arlen, *supra* note 2, at 157-58.

²² Arlen & Kornhauser, *supra* note 3; Arlen & Kraakman, *supra* note 2.

²³ See Jennifer Arlen, *The Promise and Perils of Introducing Deferred Prosecution Agreements Outside the U.S.*, in NEGOTIATED SETTLEMENTS IN BRIBERY CASES 175 (Abiola Makinwa & Tina Söreide eds., 2020).

²⁴ See Jennifer Arlen, *Evolution of Director Oversight Duties and Liability under Caremark: Using Information-Acquisition Duties in the Public Interest*, RESEARCH HANDBOOK ON CORPORATE LIABILITY (Martin Petrin & Christian Witting eds., forthcoming 2023); see also Jennifer Arlen, *Countering Capture: A Political Theory of Corporate Criminal Liability*, 47 J. CORP. LAW 862 (2022) (discussing how corporations use their political influence to promote under-resourcing of federal enforcement); Daniel Richman, *Federal Criminal Law, Congressional Delegation, and Enforcement Discretion*, 46 UCLA L. REV. 757, 760-83 (1998) (discussing why Congress prefers to reduce corporate liability by targeting enforcement as opposed to narrowing corporate liability); Daniel C. Richman, *Corporate Headhunting*, 8 HARV. L. & POL'Y REV. 265, 273-74 (2014) (Congress made public statements post-financial crisis favoring corporate enforcement and then refused to appropriate promised funding for corporate criminal enforcement).

²⁵ See *infra* Section 4.

²⁶ *In re Caremark Int'l*, 698 A.2d 959 (Del. Ch. 1996); see *infra* Section 4.

²⁷ See *infra* Section 5.

and how it should be structured. Section 4 shows why achieving effective compliance also requires that duties and liability be imposed on directors and officers. Section 5 discusses the challenge and appropriate focus of efforts to assess the effectiveness of a company's compliance function.

2. The Compliance Function: Its Essential Role to Deterrence and Its Components

This Section identifies the goals and components of the compliance function. It first explains why society cannot rely entirely on the threat of criminal sanctions for individual wrongdoers to deter corporate crime, but instead also needs to induce companies to intervene to deter their employees' organizational misconduct.²⁸ The Section then identifies the ways in which companies intervene to induce or deter misconduct through their impact on employees' expected sanctions and responsiveness to the law's injunctive norms. These activities combine to constitute a company's compliance function.

2.1. Why Society Cannot Rely Entirely on the Threat of Individual Criminal Sanctions

Employees (including officers and directors) directly commit—and control whether the corporation commits—organizational misconduct. Although, by definition, organizational misconduct is designed to benefit the firm,²⁹ individual employees generally are motivated to commit it to obtain a personal benefit (e.g., a bonus or promotion)³⁰ or avoid a cost, such as termination for poor performance.³¹

Countries rely on the threat of individual criminal sanctions to deter employees from committing corporate misconduct. Criminal sanctions can deter in two ways. Criminal sanctions can disincentivize crime if employees face a material and salient³² threat of punishment whose expected cost³³ exceeds employees' expected benefit from misconduct.³⁴ In addition, a salient criminal injunction and enforcement can deter by expressing society's condemnation of the prohibited conduct by causing employees to experience strong guilt or shame over violating the law, under the right circumstances.³⁵

²⁸ This Chapter defines organizational misconduct as misconduct for which the company can be held criminally liable under federal law. Thus, it constitutes criminal conduct by an employee of the firm (at any level) committed within the scope of employment with some intent to benefit the firm. See, e.g., ALI, *Principles of Corporate Criminal, Civil and Administrative Enforcement Against Corporations and Individuals for Organizational Misconduct*, in PRINCIPLES OF THE LAW OF COMPLIANCE AND ENFORCEMENT FOR ORGANIZATIONAL MISCONDUCT (2023) (hereinafter *Principles of Corporate Enforcement*).

²⁹ See *supra* note 28.

³⁰ See, e.g., Jonathan Macey, *Agency Theory and the Criminal Liability of Corporations*, 71 B.U. L. Rev. 315 (1991); Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. Legal Stud. 833, 846 (1994); A. Mitchell Polinsky & Steven Shavell, *Should Employees Be Subject to Fines and Imprisonment Given the Existence of Corporate Liability?*, 13 INT'L REV. L. & ECON. 239 (1993).

In some countries, employees may develop such a strong sense of duty to their employer that they commit misconduct solely to benefit the firm and their fellow employees, even when they are unlikely to personally benefit.

³¹ See Arlen & Carney, *supra* note 4 (managers commit fraud on the market securities fraud when they fear termination).

³² For a discussion of why the sanction must be salient see, e.g., Arlen & Kornhauser, *supra* note 3; Feldman, *supra* note 3.

³³ The expected sanction is defined as the probability of sanction multiplied by the cost of punishment (pF).

³⁴ See Gary S. Becker, *Crime and Punishment: An Economic Approach*, 76 J. POLIT. ECON. 169 (1968).

³⁵ See, e.g., Cooter, *supra* note 3; Dau-Schmidt, *supra* note 3, at 38; Kahan, *supra* note 3; McAdams, *supra* note 3; see also Bilz & Nadler, *supra* note 3.

Yet society cannot rely *solely* on criminal sanctions to optimally deter organizational misconduct through either the incentives or expressive messages produced by criminal sanctions because neither is reliably effective unless the state is able to induce corporations to intervene.

2.1.1. Deterrence Through Incentives and the Under-detection and Enforcement Problem

Corporate criminal liability cannot reliably deter by increasing the cost of misconduct because, absent corporate intervention, employees contemplating misconduct usually face such a small likelihood of being detected and punished that it is not material; employees thus do not even consider the risk when contemplating misconduct.³⁶ The risk of detection is small, absent corporate intervention, because organizational misconduct is difficult to detect because it mimics ordinary legal business transactions. The evidence also is hidden in financial documents or complex transactions and may reside across multiple countries.³⁷ It also is notoriously difficult to establish the knowledge and intent for a criminal conviction for most important corporate crimes.³⁸ The government cannot optimally and reliably solve this problem on its own for two reasons. First, corporations consistently wield considerable political power which they leverage to ensure that criminal and civil corporate enforcement is under-resourced.³⁹ Second, the government is not in the best position to detect and investigate misconduct. Companies are better able to detect and investigate their employees' misconduct, at lower cost, than is the government. They know more about their own operations and risk,⁴⁰ can engage in on-going monitoring of their employees, have on-going access to their own documentary and digital evidence, and are better able to investigate misconduct than are U.S. government authorities should potential misconduct be detected.⁴¹

Thus, to cost-effectively deter by disincentivizing misconduct, the government needs corporations to actively detect and investigate misconduct,⁴² and then self-report it to the government and provide enforcement authorities with the evidence they obtained about the scope of the misconduct and the role of the individuals responsible for it (hereinafter, "full cooperation").⁴³ In light of the under-detection problem, society also can enhance deterrence by inducing companies to intervene to reduce employees' benefit from misconduct—a benefit that companies control.⁴⁴

³⁶ See Arlen & Kornhauser, *supra* note 3; Arlen & Kraakman, *supra* note 2; see also EUGENE SOLTES, WHY THEY DO IT: INSIDE THE MIND OF THE WHITE-COLLAR CRIMINAL (2016) (interviewed white collar criminals consistently did not focus on consequences when violating the law).

³⁷ See Jennifer Arlen & Samuel W. Buell, *The Law of Corporate Investigations and the Global Expansion of Corporate Criminal Enforcement*, 93 S. CAL. L. REV. 697 (2020).

³⁸ See Arlen & Kornhauser, *supra* note 3; Arlen & Kraakman, *supra* note 2.

³⁹ See Arlen, *Countering Capture*, *supra* note 24.

⁴⁰ See Arlen & Kraakman, *supra* note 2; Arlen, *supra* note 2.

⁴¹ See Arlen & Buell, *supra* note 37 (under U.S. law companies can investigate more effectively than the government).

⁴² See Arlen & Kraakman, *supra* note 2; Arlen, *supra* note 2.

⁴³ See Arlen & Kraakman, *supra* note 2. Corporations fully cooperate with authorities by investigating misconduct and sharing both the underlying relevant documentary and digital evidence, and also their central findings about what happened and which employees are culpable. An important goal is to identify individuals responsible for the misconduct and share evidence relevant to their culpability. U.S. Dep't of Justice, Justice Manual, *Principles of Federal Prosecution of Business Organizations*, at §9-28.720, 9-47.120.3(b) (defining cooperation); §9-28.800 (Comment B) (discussing federal law).

⁴⁴ See Arlen & Kraakman, *supra* note 2; Arlen, *supra* note 2, at 144.

2.1.2. *Impediments to Deterrence of Organizational Misconduct Through Expressive Law*

Of course, corporate intervention to enhance the employees' expected cost from criminal sanctions would not be needed if criminal law could adequately deter through its other pathway: its ability to express social and moral opprobrium over the prohibited conduct. Evidence that people want to perceive themselves to be, and to have others perceive them to be, ethical has led many to conclude that the criminal law can potentially deter by expressing society's condemnation of those who engaged in prohibited conduct,⁴⁵ even absent a material threat of enforcement.⁴⁶

Yet criminal law cannot reliably deter organizational misconduct through expressive channels unless society is able to induce corporations to intervene to amplify and support the law's expressive message and reduce employees' motivations and justifications for corporate misconduct.⁴⁷ Criminal law's expressive exhortations alone are not sufficient for three reasons. First, people are not reliably primarily motivated to make ethical choices when they can benefit substantially from violating a norm, especially if the injunctive norm is not salient.⁴⁸ Second, employees regularly can benefit materially from organizational misconduct; organizational misconduct also incurs in circumstances that both offer other-regarding justifications for the misconduct and mute the salience of the law's injunctive norm.⁴⁹ Corporations can intervene to effectuate criminal law's expressive voice because they control both employees' motivations to engage in misconduct and the features of their decision-making environment that enhance or weaken the salience to employees of the law's expressed injunctive norm.⁵⁰

2.1.2.1. *Pursuit of Self-Interest While Maintaining Positive Self-Image*

Although there is little doubt that people do have social and other-regarding preferences and want to perceive themselves to be ethical and to have others perceive them to be ethical, these social and other-regarding preferences do not ensure that they in fact make ethical and law-abiding choices when presented with opportunities to profit from legal or ethical violations because human decision-making is structured to favor self-interest.⁵¹

People are not only motivated to be ethical. They also want to promote their financial self-interest. Moreover, many, if not most, people are primarily motivated by self-interest and will make the self-interested choice if they can do so without having to perceive themselves to be immoral.⁵² This primary motivation leads even "good people" to violate the law because people's decision-making processes are structured to enable them to pursue their self-interest without any

⁴⁵ See citations *supra* note 3.

⁴⁶ See Cass R. Sunstein, *On the Expressive Function of Law*, 144 U. PA. L. REV. 2021, 2022 (1996); Cass R. Sunstein, *Social Norms and Social Roles*, 96 COLUM. L. REV. 903, 914 (1996); but see Kahan, *supra* note 3; Arlen & Kornhauser, *supra* note 3.

⁴⁷ Arlen & Kornhauser, *supra* note 3.

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ See, e.g., Arlen & Kornhauser, *supra* note 3; see also FELDMAN, *supra* note 3; Langevoort, *Cultures of Compliance*, *supra* note 15, at 951; BAZERMAN & TENBRUNSEL, *supra* note 15.

⁵² See BAZERMAN & TENBRUNSEL, *supra* note 15, at 35–36. People have both their "wants" and their sense of what they should do. In a conflict between the "want self" and the "should self," the want self tends to dominate. People's "should self" reasserts itself after the decision to search for arguments that justify the choice, including by reframing it to appear other-regarding. See *id.* at 66–69.

threat to their self-perception that they are, and would be perceived by others to be under most of the conditions common to organizational misconduct.⁵³

Extensive empirical evidence reveals that people rely on intuitive, nonconscious decision-making processes to make most decisions, even when they think they engaged in active deliberation.⁵⁴ Intuition determines the initial presumptive choice; subsequently people deliberate to finalize the choice. But the intuitive processes that determined the initial choice distort both the information that reaches the deliberative processes and the weight various factors receive in the deliberative processes by highlighting information that supports the presumptive choice and muting information and the weight given to factors that undercut that choice.⁵⁵

This dominant role of intuitive processes matters because most people's intuitive choices tend to favor egoistic self-interest, if they can do so without material damage to their own self-image and their sense of others' perception of them.⁵⁶ Moreover, people's intuitive decision-making processes are structured to enable them to pursue self-interest without damaging their sense of being ethical. To do so, people engage in "motivated reasoning." When faced with a decision involving a choice between self-interest and ethics, people instinctively tend to favor the self-interested choice and then undertake a biased assessment of the pros and cons of this choice designed to identify arguments in its favor (including ethical ones) and suppress conscious recognition of arguments against it. This bias can render people "morally blind" to concerns that would interfere with their pursuit of self-interest, allowing them to favor self-interest without recognizing that they are unethical.⁵⁷

Whether motivated reasoning will indeed enable criminal conduct depends on both the magnitude of the benefit to the decision-maker from misconduct, the nature of the harm (whether it is to an identifiable person who is proximate to the actor or a stranger who is distant in time, space or socially), and whether the person operates in a decision-making environment that mutes other-regarding concerns or instead regularly highlights the importance of complying with the legal injunction in question. Thus, most people would eschew an offer to murder someone for hire even if they were well paid. The guilt and shame triggered by the thought of violating the legal, social and moral norm suffices to deter. But for many other forms of misconduct the legal injunction does not have the requisite moral salience to deter.⁵⁸

2.1.2.2. The Difficulty of Using Expressive Channels to Deter Organizational Misconduct

The literature has identified features about the misconduct and the actors' decision-making environment that either enhance or undermine deterrence of organizational misconduct through

⁵³ For a discussion of this literature see generally Arlen & Kornhauser, *supra* note 3; see also FELDMAN, *supra* note 3 Langevoort, *Cultures of Compliance*, *supra* note 15, at 951; BAZERMAN & TENBRUNSEL, *supra* note 15, at 35–36; see also DAN ARIELY, *THE (HONEST) TRUTH ABOUT DISHONESTY HOW WE LIE TO EVERYONE—ESPECIALLY OURSELVES* (2012); Don A. Moore, Lloyd Tanlu & Max H. Bazerman, *Conflict of Interest and the Intrusion of Bias*, 5 JUDGMENT & DECISION MAKING 37, 47 (2010) (finding that people truly believe their own biased judgements and thus fail to recognize that their behavior is unethical).

⁵⁴ See DANIEL KAHNEMAN, *THINKING, FAST AND SLOW* 225 (2013); Colin F. Camerer, George Loewenstein & Drazen Prelec, *Neuroeconomics: How Neuroscience Can Inform Economics*, 43 J. ECON. LIT. 9, 9–11 (2005).

⁵⁵ See citations *supra* note 53.

⁵⁶ See *supra* note 52.

⁵⁷ See generally Arlen & Kornhauser, *supra* note 3, at (providing extensive citations to the evidence); BAZERMAN & TENBRUNSEL, *supra* note 15, at 48–50, 69; FELDMAN, *supra* note 3, at 3, 35; cf. SOLTES, *supra* note 36 (interviewed white collar criminals consistently did not focused on consequences when violating the law).

⁵⁸ See Arlen & Kornhauser, *supra* note 3.

expressive channels, including⁵⁹ (1) employees' knowledge of the law, the salience of the legal norm at the moment of choice, and the clarity of the law's injunction; (2) whether the local environment treats the legal injunction as legitimate and proscriptive; (3) the nature of the harm associated with breach (e.g., physical harm to identified person vs. a risk of harm to unidentified statistical persons);⁶⁰ (4) the degree to which employees benefit financially from the misconduct;⁶¹ (5) the degree to which the corporate culture provides employees with an other-regarding justification for the misconduct by priming them with the importance of working together towards the common goal of profit;⁶² (6) whether employees' assigned tasks are narrowly defined to target attention on specific profit-producing outcomes; (7) the cognitive load under which employees operate (e.g., time pressure, assignment of multiple challenging tasks);⁶³ and (8) whether employees act within a decision-making environment that spreads responsibility, thereby muting their own perceived guilt or shame over misconduct that occurs.⁶⁴

The character of most organizational misconduct tends to undermine the law's ability to deter by expressing society's condemnation of the misconduct, absent corporate intervention.⁶⁵ Most corporate criminal laws do not on their own create or enhance salient ethical or moral norms. They often do not enjoin actions that are commonly viewed as immoral; they also do not express injunctions that are taught or affirmed by leading social institutions, such as schools. In addition, they guard against harms that are not salient—harms to strangers who are socially and geographically distant from the actor. Moreover, employees who commit corporate crimes often can protect their self-image as an other-regarding person by embracing the view that they are violating the law to help others who are important to them—either the firm or their fellow employees. This unselfish “other-regarding” justification can enable them to be morally blind to the illegal and unethical nature of their actions.⁶⁶ Finally, expressive law regularly is ineffective at deterring organizational misconduct because it depends on employees experiencing anticipated guilt and shame over engaging in misconduct. Yet employees engaging in organizational misconduct often do not experience guilt or shame because they act within a group-setting which dissipates their perceived responsibility for any misconduct, thereby negating the essential trigger for guilt and shame.⁶⁷

⁵⁹ For an full discussion of why each of these factors affects employees' proclivity towards misconduct see Arlen & Kornhauser, *supra* note 3, 695-718; see also BAZERMAN & TENBRUNSEL, *supra* note 15, Chap. 6; FELDMAN, *supra* note 3; Langevoort, *Cultures of Compliance*, *supra* note 15, at 953; Yuval Feldman & Yotam Kaplan, *Behavioral Ethics in Compliance*, in THE CAMBRIDGE HANDBOOK OF COMPLIANCE (Benjamin van Rooij & D. Daniel Sokol eds. 2021); Benjamin van Rooij & D. Daniel Sokol, *Introduction: Compliance as the Interaction between Rules and Behavior*, in THE CAMBRIDGE HANDBOOK OF COMPLIANCE (Benjamin van Rooij & D. Daniel Sokol eds. 2021).

⁶⁰ Intentional harm to identifiable victims is more salient than probabilistic harm to unidentified people, especially if they are socially, geographically or temporally distant from the decision-maker. See generally Arlen & Kornhauser, *supra* note 3 (discussing this literature).

⁶¹ See Arlen & Kornhauser, *supra* note 3.

⁶² Arlen & Kornhauser, *supra* note 3; see Feldman et. al, *supra* note 15, at 1166; see also Blake E. Ashforth & Anand Vikas, *The Normalization of Corruption in Organizations*, 25 RESCH. ORG. BEHAV. 1, 42 (2003) (employees are more likely to commit corporate misconduct when they can justify it as promoting the firm's welfare).

⁶³ See generally Todd Haugh, *Nudging Corporate Compliance*, 54 AMER. BUS. L. J. 683, 708 (2017); Langevoort, *Cultures of Compliance*, *supra* note 15, at 953.

⁶⁴ See Arlen & Kornhauser, *supra* note 3; see also Samuel Buell, *The Blaming Function of Entity Criminal Liability*, 81 IND. L. J. 473, 495-96 (2006) (people are more likely to stray when they are in a group).

⁶⁵ See Arlen & Kornhauser, *supra* note 3, at 706-706 (for further elaboration).

⁶⁶ See *id.*

⁶⁷ See *id.*; see also Buell, *supra* note 64, at 495-96 (people are more likely to stray when they are in a group).

Thus, the law cannot reliably deter organizational misconduct through expressive channels unless it also can find ways to reduce employees' financial benefits from, and their other-regarding justifications for, misconduct, and can enhance the salience and impact of the law's expressive message condemning the misconduct. To achieve these goals, society needs to induce companies to intervene because companies control employees' expected benefit from misconduct, their perception of what benefits the firm and their fellow employees, and the relative salience of ethical versus profit concerns in their daily lives.⁶⁸

2.2. *The Features of an Effective Compliance Function*

Accordingly, the preceding analysis reveals that in order to deter either through the incentives provided by the threat of criminal sanctions or the law's expressive messages, society needs to induce companies to undertake a series of actions designed to deter their employees from engaging in organizational misconduct. These corporate interventions that are needed to deter misconduct combine to comprise a company's compliance function.⁶⁹ Most of them fall outside the formal policies, monitoring, and internal controls that are conventionally viewed as defining a company's compliance program.

Specifically, in order to enable the law to deter effectively through the threat of criminal sanctions companies need to intervene to (1) reduce employees' expected benefit from misconduct (for example by reforming the company's compensation, promotion and retention practices), (2) increase their direct cost and difficulty of engaging in misconduct (for example through internal controls that disable a single employee from committing the crime), and (3) increase wrongful employees' anticipated threat of criminal sanction by actively seeking to detect, investigate and self-report misconduct, and by fully cooperating with enforcement authorities by turning over evidence against wrongful employees.⁷⁰

In turn, in order for the law to deter through its expressive pathways society needs to induce companies to support the law's expressive voice. Companies control most of the features of an employees' decision-making environment that impact whether employees are motivated to comply with the law or to violate it.⁷¹ The steps corporations can take to enhance the effectiveness of expressive law constitute components of the firm's compliance function.⁷²

First, companies substantially determine their employee's awareness and comprehension of the law's prohibiting organizational misconduct. The legal system itself does not seek to inform or train employees; instead it relies on companies to train employees in the relevant law and to

⁶⁸ See Arlen & Kornhauser, *supra* note 3.

⁶⁹ See *supra* note 9 (defining the compliance function); see also Hui Chen, *The Use and Measurement of Compliance Programs in Legal and Regulatory Domains*, 25, in MEASURING COMPLIANCE: ASSESSING CORPORATE CRIME AND MISCONDUCT PREVENTION (Melissa Rorie & Benjamin van Rooij ed., 2022) (corporate compliance has three goals: (1) prevention, (2) detection, and (3) remediation); Eugene Soltes, *Evaluating the Effectiveness Corporate Compliance Programs: Establishing a Model for Prosecutors, Courts, and Firms*, 14 J. L. & Bus. 966, 978 (2018) (compliance is expected to achieve three objectives: (1) prevention; (2) detection and investigation; and (3) adopting policies and practices that align corporate behavior with applicable laws and regulations).

⁷⁰ See Arlen & Kornhauser, *supra* note 3; see also Arlen & Kraakman, *supra* note 2 (discussing the importance of corporate prevention, including compensation and promotion policy reform, and corporate policing).

⁷¹ See Arlen & Kornhauser, *supra* note 3, at 706-18; see also BAZERMAN & TENBRUNSEL, *supra* note 15, at Ch. 6.

⁷² See, e.g., Arlen & Kornhauser, *supra* note 3 (providing a detailed discussion of such measures); see also Langevoort, *Cultures of Compliance*, *supra* note 15, at 952-968 (discussing how companies can create a culture that strengthens or weakens people's tendencies to favor self-interest over ethics); FELDMAN, *supra* note 3; BAZERMAN & TENBRUNSEL, *supra* note 15. For a model principals of corporate compliance see Amer. L. Inst., *Compliance*, *supra* note .

inform them of what actions they need to take in order to comply with the law.⁷³ Companies' expositions and explanations of these requirements also can enhance the law's perceived legitimacy. Companies also determine the salience of the legal norm. To establish a salient injunctive norm, the norm must be regularly reinforced during employees' everyday working lives. Companies thus must ensure that line managers and communications to employees from senior management regularly reaffirm the importance of compliance—and the legitimacy of the social aims the law seeks to serve; the firm should also treat legal compliance as an important metric to be taken into account in making compensation, promotion, and retention decisions.⁷⁴

Second, because self-interest tends to undermine compliance with social norms, companies also should intervene to enhance employees' self-interest in compliance and reduce their financial incentives to either engage in misconduct or look the other way when their co-workers violate the law, to reduce both their direct profit from misconduct and their inclination to employee motivated reasoning to justify misconduct.⁷⁵ Companies can do this by adjusting their compensation, promotion and retention policies to reduce the impact of short-run financial returns and to increase the negative impact of misconduct.⁷⁶ Companies can do this in multiple ways: (1) performance measures that incorporate employees' contributions to compliance and ethics; (2) compensation tied to long-run, and not short-run, measures of performance with set asides that are lost should misconduct be detected; (3) active and consistent efforts to detect and sanction employees who engage in misconduct; and (4) visible and affirmative rewards to employees who detect, internally report, and help terminate misconduct.⁷⁷

Third, companies also can substantially impact employees' ability to justify corporate crime on prosocial grounds as a way to benefit their co-workers and the firm.⁷⁸ Companies can do so through compensation policy reform and also by ensuring the exhortations to promote compliance reach employees with the same salience and frequency as their calls to boost productivity and financial returns.⁷⁹ Employees also need to see corporate speech reflected in corporate actions. They thus need to see that those who re-commit to legal compliance fare better than those who boost profits through illegal or unethical conduct.⁸⁰

⁷³ See Arlen & Kornhauser, *supra* note 3.

⁷⁴ *Id.*

⁷⁵ *Id.*

⁷⁶ Companies whose managers predicate performance reviews solely on objective measures of productivity undermine deterrence through expressive law by enhancing the salience of financial returns, thereby sending ethical concerns into the shadows. See, e.g., Arlen & Kraakman, *supra* note 2; Arlen & Kornhauser, *supra* note 3; ALI, *Compliance*, *supra* note 9, at § 5.05, cmt m (firms should reduce incentives to engage in misconduct and enhance employees' incentives to comply with the law); § 5.07, cmt b (incentive compensation programs can increase the risk of misconduct); § 5.16 (compliance should be taken into account in setting compensation).

Indeed, company's regular exhortations to enhance performance promotes misconduct through the very pathways expressive law seeks to leverage—people's tendency to defer to instructions from and the expectations of those in authority. See Robert B. Cialdini & Noah J. Goldstein, *Social Influence: Compliance and Conformity*, 55 ANN. REV. PSYCHOLOGY 591, 596 (2004); Blake E. Ashforth & Vikas Anand, *The Normalization of Corruption in Organizations*, in RESEARCH IN ORGANIZATIONAL BEHAVIOR 1, 7 (B. M. Staw & R. M. Kramer eds., 2003) (noting how subordinates follow their supervisors' instructions even if it would lead to an unethical or illegal act).

⁷⁷ See Arlen & Kornhauser, *supra* note 3.

⁷⁸ Arlen & Kornhauser, *supra* note 3.

⁷⁹ Arlen & Kornhauser, *supra* note 3.

⁸⁰ *Id.*; ALI, *Compliance*, *supra* note 9, at § 5.05, cmt e (the compliance function cannot succeed until employees are incentivized to comply and disciplined for violations); see also Eugene Soltes, *Unsubstantiated Allegations and Organizational Culture*, 43 SEATTLE U. L. REV. 413, 430–34 (2020) (finding that employees in units with unaddressed ethical allegations are less likely to internally report misconduct and, potentially, more likely to engage in it).

Fourth, companies can enhance ethics by structuring assignments to ensure that (1) employees' manuals and instructions expressly include compliance in addition to other goals; (2) teams always include a person in authority who is explicitly responsible for the team's compliance; and (3) employees are not placed under pressure to achieve narrow aims that could lead them to violate the law.⁸¹ To avoid the dispersion of responsibility, companies also should clearly delineate the lines of responsibility for compliance within each team, explicitly provide that each employee is expected to speak up when they see others potentially violate the law, and ensure supervisors (both senior and line managers) regularly communicate to employees about disciplinary measures imposed on those who neglected their compliance obligations.⁸²

Finally, companies can—and indeed must—enhance deterrence through expressive law by actively intervening to help the government detect, investigate and sanction individual wrongdoers.⁸³ Regular and reliable enforcement is important to the law's ability to express (and render salient) society's condemnation of criminal conduct; it also helps mute employees' egoistic motivation to commit crime through its threat of criminal sanctions.⁸⁴ Corporate intervention is needed to produce an adequate threat of enforcement because the government cannot reliably produce an adequate threat of individual enforcement on its own.⁸⁵ As previously explained, the government needs companies to invest in effective detection (including internal reporting systems),⁸⁶ investigations, and to self-report to and fully cooperate with federal authorities.⁸⁷ To be effective, corporate efforts to detect and investigate must be proactive and must be pursued with the same level of rigor at all levels of the company—enforcement that turns a blind eye to rule-bending by senior or highly profitable employees undermines the legitimacy of the entire regime.

Finally, to create the internal culture needed to support deterrence through expressive law, companies also need to determine the root causes of the misconduct and remediate them, including by penalizing, and where appropriate, firing supervisors who induce, condone or fail to terminate misconduct.⁸⁸ Remediating the root causes of misconduct also includes recouping costs of the wrongdoing from those responsible, fairly addressing demonstrable harm to stakeholders (as for

⁸¹ See Arlen & Kornhauser, *supra* note 3; BAZERMAN & TENBRUNSEL, *supra* note 15, at 107–08 (People given one-dimensional goals tend to be extrinsically motivated to achieve that goal, rather than intrinsically motivated to do what is right).

⁸² See Arlen & Kornhauser, *supra* note 3, at (discussing how responsibility sharing undermines expressive law and the steps companies accordingly can take to enhance or undermine the law's ability to deter through expressive channels).

⁸³ See Arlen & Kornhauser, *supra* note 3.

⁸⁴ For a discussion of these and other reasons enforcement against individual wrongdoers is needed to deter through expressive law see Arlen & Kornhauser, *supra* note 3; see also Kahan, *supra* note 3, at 351, 363, 380; Raymond Paternoster, et al., *Perceived Risk and Social Control: Do Sanctions Really Deter?*, 17 L. & SOC. REV. 457, 472 (1983) (perceived punishment is a significant predictor of an act's perceived morality); FELDMAN, *supra* note 3, at 153–54, 169; but see Sunstein, *supra* note.

⁸⁵ See *supra* text accompanying notes x-y; Arlen & Kraakman, *supra* note 2; Arlen & Kornhauser, *supra* note 3; see also Arlen & Buell, *supra* note 37, at 713-727 (discussing companies' comparative advantage in investigating over the government stemming from laws governing corporate investigations).

⁸⁶ Arlen & Kornhauser, *supra* note 3. Companies can enhance detection in a variety of ways including effectively-designed whistleblower hotline programs, monitoring, data analytics, AI (both to detect crime and to audit the firm's deterrence systems), employee communications, and appropriately resourced and trained internal investigations teams.

⁸⁷ See *id.*; cf. Eugene Soltes, *The Frequency of Corporate Misconduct: Public Enforcement Versus Private Reality*, 26 J. FIN. CRIME 923, 923-35 (2019) (presenting evidence that companies' internal reporting systems detected hundreds more instances of misconduct than the government).

⁸⁸ See Arlen & Kornhauser, *supra* note 3; see also ALI, *Compliance*, in PRINCIPLES OF THE LAW OF COMPLIANCE AND ENFORCEMENT FOR ORGANIZATIONAL MISCONDUCT, §§ 5 (discussing the importance of internal discipline and root cause analysis), §§ 6.XXX (same) (2023).

example, a harmed customer or co-worker) and taking effective steps to prevent this same type of misconduct from recurring in the future. This may include adjustment to a company's assessment of a particular risk of non-compliance. A company that can be seen to learn from its mistakes and commit to continually enhancing its commitment to preserving its reputation for adherence to the law further enhances the legitimacy of both expressive law and internal enforcement mechanisms.

All of these interventions—including companies' investments in detection and investigation and its policies and practices regarding self-reporting, cooperation, and remediation—constitute vital components of companies' compliance functions.⁸⁹

2.3. Implications for Corporations' Compliance Functions

Accordingly, effective corporate functions necessarily touch most aspects of companies' internal operations and extend far beyond the standard "compliance program"—which consists largely of the firm's ethical and compliance policies, the internal control procedures, employee training, and the establishment, implementation and initial response to the firm's internal reporting system.⁹⁰ It implicates the company's compensation, promotion and retention policies and practices, line managers relationships with and messaging to employees, the firm's internal disciplinary practices regarding both classic business crime but also other violations (such as sexual harassment),⁹¹ how jobs are defined and structured, the efficacy of its detection and investigation systems (including whether compliance has recourse to adequate data analytics based on information drawn from internal reports, monitoring, customer complaints, and human resources), and the company's approach to self-reporting, cooperation and remediation with respect to detected misconduct.⁹²

Each of these interventions involves trade-offs between profit and deterrence and the optimal approach varies across industries, across firms, and may even vary across units within a firm. Achieving the right balance requires a detailed understanding of the firm—and its individual subunits. The government cannot readily identify, from the outside, the set of compliance measures that reliably and optimally deters misconduct across all firms or even all firms in an industry. Companies generally must determine for themselves how best to deter misconduct while also promoting productivity.

2.3.1. Is Corporate Compliance Really Needed?

Before addressing the steps society needs to take to induce firms to implement an effective compliance function, it is important to address why firms cannot optimally deter through far simpler interventions such as (1) a contractual prohibition on misconduct, or (2) terminating or imposing financial sanctions on employees who violate the law.

Interestingly, the answer to both questions roots lessons from economic theories explaining why entrepreneurs form firms and hire employees, instead of obtaining the goods and services they need from outsiders. Entrepreneurs bring economic activities within a firm when they cannot optimally achieve their goals through contracts and markets, usually as a result of imperfect information that precludes them from obtaining their desired results through either contractual injunctions or through sole reliance on financial incentives. Thus, companies corporations' internal

⁸⁹ See Arlen & Kornhauser, *supra* note 3; see also Chen, *supra* note 69 (identifying detection as an important goal of compliance); Soltes, *supra* note 69 (same).

⁹⁰ See, e.g., Arlen & Kornhauser, *supra* note 3; see also ALI, *Compliance*, *supra* note 88, at Chapter 5.

⁹¹ See Soltes, *supra* note 69.

⁹² See Arlen & Kornhauser, *supra* note 3.

operations are characterized by costly and imperfect information, contractual incompleteness, and imperfect control.⁹³

Nor can firms adequately deter employees solely through the threat of financial sanctions and termination. Employees who engage in misconduct often obtain expected benefits over time that exceed the financial penalty that could practicably be imposed on them should they be detected. Employees also often cannot be deterred from misconduct by the threat of termination. First, firms often profit from misconduct; thus, unless corporate liability ensures that firms do not benefit from misconduct companies may retain employees who commit profitable crimes.⁹⁴ In addition, the threat of termination should misconduct be detected will not deter employees who commit profit-enhancing misconduct to avoid a higher risk of termination if they do not commit misconduct because they or the firm are in a last period.⁹⁵ The threat of termination also will not deter employees who expect to use the results produced by the crime to obtain a better job at another firm, as firms with detected misconduct may be disinclined to report it to other companies.⁹⁶

Accordingly, to deter misconduct companies must employ a host of measures, as detailed above, including compensation reform; monitoring; internal controls; corporate detection, investigation, and cooperation; and reforms to companies' internal operations designed to create a culture with a salient norm favoring compliance with the law and ethical norms.⁹⁷

3. How to Incentivize Companies to Adopt Effective Compliance Functions

Although countries need companies to adopt effective compliance functions in order to optimally deter corporate crime, companies generally will not do so unless countries implement laws that incentivize them to do so.⁹⁸ First, absent laws imposing liability on them, companies have little reason to implement effective compliance functions to deter misconduct from which they earn substantial profits.⁹⁹ Second, implementing effective compliance also is costly. Some compliance measures impose direct costs on the firms, such as policies, training, and corporate investigations. Others impose indirect costs, such as reforms to compensation and promotion policies that may reduce the firm's ability to induce employees to pursue corporate profits. Finally, some impose costs indirectly through either the legal system or corporate reputation, such as investments in self-reporting and full cooperation that can impose costs on the firm if their positive impact on the likelihood misconduct is detected¹⁰⁰ increasing the firm's expected damage costs

⁹³ See, e.g., Armen Alchian & Harold Demsetz, *Production, Information Costs, and Economic Organization*, 62 AMER. ECON. REV. 777 (1972); Harold Demsetz, *The Theory of the Firm Revisited*, 171, in *THE NATURE OF THE FIRM: ORIGINS, EVOLUTION AND DEVELOPMENT* (Oliver E. Williamson and Sidney G. Winter ed, 1991); Sherwin Rosen, *Transactions Costs and the Internal Labor Market*, Chapter 6, in *THE NATURE OF THE FIRM: ORIGINS, EVOLUTION AND DEVELOPMENT* (Oliver E. Williamson and Sidney G. Winter ed, 1991).

⁹⁴ See Arlen, *supra* note 2 [hylton], 167–84; see also PAUL MILGROM & JOHN ROBERTS, *ECONOMICS, ORGANIZATION, & MANAGEMENT* Chap. 8 (1991)(explaining why high powered incentives often are inefficient).

⁹⁵ See Arlen & Carney, *supra* note 4.

⁹⁶ See Arlen, *supra* note 2, at 167–84.

⁹⁷ See Section 2.3; cf. Bengt Holmstrom, *The Firm as a Subeconomy*, 15 J. LAW, ECON., & ORGAN. 74 (1999) (discussing how imperfect information and contracting necessitates firms employing a host of mechanisms, in addition to high-powered incentives, to induce employees to take desired actions).

⁹⁸ This discussion assumes that companies face substantial market pressures to focus on profits and thus will not simply adopt an optimal compliance function in an effort to benefit society if doing so would harm the company's financial welfare.

⁹⁹ See Arlen, *supra* note 24 (explaining why companies can expect to profit from corporate crime in more detail).

¹⁰⁰ See Arlen, *supra* note 30[perverse].

from either criminal or civil sanctions¹⁰¹ or reputational damage.¹⁰² Accordingly, societies need to adopt laws designed to motivate companies to adopt an effective compliance function.¹⁰³ Legal interventions need to ensure that companies are better off when they deter misconduct; thus they cannot be allowed to retain profits from it. In addition, the law needs to incentivize companies to detect and investigate organizational misconduct and self-report and cooperate with authorities by providing evidence against individual wrongdoers.¹⁰⁴

This Section explains why the optimal approach to inducing effective compliance is to impose corporate criminal and civil liability on companies for their employees' knowing or intentional misconduct. It shows that the optimal form of liability is *respondeat superior* for misconduct by all employees combined with an enforcement policy that motivates companies to detect, self-report and fully cooperate, and remediate by providing substantial and predictable benefits only to companies that do so in the form of preferable forms of nontrial resolutions, lower sanctions, and no compliance monitor.¹⁰⁵ It then discusses other interventions (including direct regulation) that can potentially enhance, but not substitute for, corporate liability.

3.1. Corporate Liability for Misconduct

Corporate misconduct tends to boost companies' profits. Thus, in order to incentivize them to spend resources to deter it, governments need to hold them criminally liable¹⁰⁶ for all knowing and intentional corporate misconduct by all of their employees¹⁰⁷—even lower-level ones—and subject to penalties designed to eliminate companies' expected profit from crimes.¹⁰⁸ Liability structured to ensure companies do not profit from crime—and in fact can be harmed by it¹⁰⁹—should motivate them to deter misconduct and induce them to reform their compensation and promotions policies and other operations to avoid inducing employee misconduct, whether intentionally or not.¹¹⁰

¹⁰¹ See Arlen & Kraakman, *supra* note 2.

¹⁰² For a discussion of when companies can expect to incur costs from reputational damage as a result of public revelation of corporate crime see, e.g., Jonathan M. Karpoff & John R. Lott, Jr., *The Reputational Penalty Firms Bear from Committing Criminal Fraud*, 36 J. L. & ECON. 757 (1993); Alexander & Arlen, *supra* note 17 (discussing reputation and large publicly held firms); see also Arlen, *supra* note 2 (finding expected reputational from corporate crime helps justify corporate liability that rewards self-reporting and cooperation).

¹⁰³ Arlen & Kornhauser, *supra* note 3.

¹⁰⁴ Arlen & Kornhauser, *supra* note 3; see, e.g., Arlen & Kraakman, *supra* note 2.

¹⁰⁵ For a more extensive discussion of why this is the optimal approach see Arlen & Kornhauser, *supra* note 3; Arlen, *supra* note 2; see also Arlen & Kraakman, *supra* note 2 compare with Polinsky & Shavell, *supra* note 30. For a discussion of additional measures needed to deter see Arlen, *supra* note 23[tina]; Arlen, Caremark, *supra* note 24.

¹⁰⁶ For a discussion of why federal authorities need to impose criminal liability see Arlen, *Countering Capture*, *supra* note 24.

¹⁰⁷ This chapter focuses on employee misconduct. For a discussion of inefficiencies produced by the independent contractor rule see Jennifer Arlen & W. Bentley MacLeod, *Beyond Master-Servant: A Critique of Vicarious Liability*, Chapter 4 in *EXPLORING TORT LAW* (M. Stuart Madden ed., 2005).

¹⁰⁸ See, e.g., Arlen & Kornhauser, *supra* note 3; Arlen & Kraakman, *supra* note 2, at 742; see also Arlen, *supra* note 2, at 168-70 (explaining why corporations must be held liable even when individuals also are held liable); Kornhauser, at 1359.

¹⁰⁹ Given the high cost of corporate investigations and defense, companies facing expected sanctions equal to their expected profit from misconduct are worse off when employees commit crimes and thus should be motivated to deter it, even when crime would otherwise be profitable.

¹¹⁰ See, e.g., Arlen & Kornhauser, *supra* note 3.

Optimal deterrence requires that countries also induce companies to actively seek to detect, investigate, self-report and fully cooperate, however.¹¹¹ In order to do this, they cannot rely on a pure *respondeat superior* liability because this liability rule deters corporations from such activities for fear of increasing their own expected liability for any misconduct the firm is not otherwise able to deter.¹¹² The problem is particularly acute in the case of self-reporting: once the firm detects misconduct, silence is the best option for companies whose liability is governed by *respondeat superior* because self-reporting would cause the firm to be held automatically criminally liable.¹¹³

Accordingly, in order to induce companies to detect, self-report and fully cooperate, countries must adopt laws or enforcement policies that ensure that companies that self-report, fully cooperate, and remediate a corporate criminal resolution fare much better than those that do not.¹¹⁴ Countries can most effectively do this by adopting laws or enforcement policies under which prosecutors seek to convict companies with material knowing or intention misconduct unless the company self-reported or fully cooperated. Companies that self-report and/or fully cooperate thus should be required to pay far lower penalties than those that did not. But in addition, companies that self-reported or fully cooperated—and only those companies—should be presumptively able to resolve a case involving knowing or material misconduct without being formally convicted, for example by entering into a deferred prosecution agreement (DPA), a non-prosecution agreement (NPA), or a declination following disgorgement of all the profits from the offense.¹¹⁵ Enforcement authorities need to offer companies that self-report or fully cooperate a form of criminal resolutions other than conviction because a corporate felony conviction regularly triggers ruinous consequences from collateral consequences—e.g., debarment, exclusion or delicensing—either in the United States or abroad.¹¹⁶ Companies will not self-report undetected misconduct or provide prosecutors with evidence they could not otherwise obtain unless they can be confident that their

¹¹¹ At present, corporate self-reporting, investigation and full cooperation is important to deterrence even with respect to highly regulated companies and those with external gatekeepers, such as auditors. Neither of these institutions do and can be relied on to detect all material misconduct. Even highly-regulated companies do not always adhere to their legal duties to self-report. Regulatory oversight also does not ensure misconduct is detected because regulators are woefully under-funded and can be plagued by conflicts of interest arising from the revolving door. *See, e.g.,* Arlen, *Countering Capture*, *supra* note 24. Finally, gatekeepers, such as accountants and credit-rating agencies, are plagued by conflicts of interest that undermine their effectiveness because they selected and paid by the companies they are supposed to oversee; they also often lack the motivation to undertake the critical assessment of information firm's provide them needed to reliably detect most material misconduct. *See, e.g.,* JOHN C. COFFEE, GATEKEEPERS: THE PROFESSIONS AND CORPORATE GOVERNANCE (2006); BETHANY MCLEAN & JOE NOCERA, ALL THE DEVILS ARE HERE: THE HIDDEN HISTORY OF THE FINANCIAL CRISIS (2011).

¹¹² *See* Arlen, *supra* note 30[Perverse] (detection); Arlen & Kraakman, *supra* note 2 (self-reporting and cooperation); Arlen, *supra* note 2 [hylton] (showing that strict respondeat superior cannot provide optimal incentives to prevent misconduct, reduce activity levels, and detect and self-report it).

This problem arises because even a firm with an optimal compliance function—one that one would reasonably deem to be “effective”—cannot reliably deter all misconduct.

¹¹³ *See* Arlen & Kraakman, *supra* note 2.

¹¹⁴ *See, e.g.,* Arlen & Kraakman, *supra* note 2; Arlen & Kornhauser, *supra* note 3; Arlen, *supra* note 2, at 145; ALI, *Principles of Corporate Enforcement*, *supra* note 28.

¹¹⁵ Under a DPA, the prosecutor files charges but agrees to dismiss the charges, without conviction, if the corporation complies with the terms of the agreement. Under an NPA, the prosecutor agrees not to file charges against the firm if the corporation fulfills the bargain. *See* SAMUEL W. BUELL, CAPITAL OFFENSES: BUSINESS CRIME AND PUNISHMENT IN AMERICA'S CORPORATE AGE (W.W. Norton & Co. 2016); Brandon L. Garrett, *Structural Reform Prosecution*, 93 VA. L. REV. 853, 893–902 (2007).

¹¹⁶ *E.g.,* ALI, *Principles of Corporate Enforcement*, *supra* note 28; *see also* Arlen & Alexander, *supra* note 17, at Section 5 (discussing federal law on exclusion).

efforts will not leave them debarred, excluded or delicensed. To motivate self-reporting and full cooperation, companies that neither self-report nor *fully* cooperate should face conviction.¹¹⁷ Individual wrongdoers also should face conviction.¹¹⁸

3.1.1. Why Companies Should Not Have a Compliance Defense

Maintenance of an effective compliance program should not be a defense to liability,¹¹⁹ although it should affect sanctions and prosecutors' inclination to mandate compliance program reforms.¹²⁰ Granting companies a compliance defense undermines deterrence for multiple reasons. First, enforcement authorities cannot reliably determine whether a firm's compliance function is effective. Effective compliance requires interventions throughout and across the firm, entailing trade-offs between productivity and deterrence whose optimal resolution requires access to information about the firm that enforcement officials will not have. Moreover the optimal set of compliance interventions will vary across firms, precluding the government from adopting rules that simply mandate effective compliance.¹²¹ Thus, a compliance defense could induce companies to implement measures that enforcement officials appear to prefer even though they are not optimal. Moreover, to the extent it allows companies to escape liability without having implemented the full set of optimal measures, it would eliminate their incentives to implement fully effective compliance because once they satisfy the compliance defense they retain the profit of—and thus the incentive to encourage—their employees' misconduct.¹²² Finally, a compliance defense would undermine deterrence by enabling companies with detect misconduct to avoid liability even if they do not self-report and cooperate—unless effective compliance is defined to require these activities.¹²³

Although companies should not be able to rely on effective compliance to avoid corporate liability, the policy set forth above of rewarding self-reporting and full cooperation should provide companies with substantial incentives to implement an effective compliance function.¹²⁴ First, it ensures they forfeit the profit from misconduct, thereby encouraging companies to deter it. Second, this policy provides strong incentives for companies to deter and investigate misconduct. A company's ability to self-report and cooperate depends on its ability to monitor, detect, and investigate, which are essential features of effective compliance.¹²⁵

¹¹⁷ For an example of how to structure enforcement policy to optimally deter see ALI, *Principles of Corporate Enforcement*, *supra* note 28; see also Arlen, *supra* note 23[tina].

¹¹⁸ See Arlen, *supra* note 30 [perverse]; Arlen & Kraakman, *supra* note 2; Arlen & Kornhauser, *supra* note 3.

¹¹⁹ See Arlen & Kornhauser, *supra* note 3, at 718-719; Jennifer Arlen, *Corporate Criminal Enforcement in the United States: Using Negotiated Settlements to Turn Potential Corporate Criminals into Corporate Cops*, in CRIMINALITA D'IMPRESA E GIUSTIZIA NEGOZIATA: ESPERIENZE A CONFRONTO 91, 91-112 (Stefano Manacorda and F. Centonze eds., 2018).

¹²⁰ See Jennifer Arlen & Marcel Kahan, *Corporate Governance Regulation Through Non-Prosecution*, 84 U. CHI. L. REV. 323 (2017).

¹²¹ See Arlen & Kornhauser, *supra* note 3, at 718-19; Prosecutors' difficulties in assessing compliance no doubt partly explains their tendency to measure compliance effective based on "inputs"—such as training—rather than genuinely testing whether the firm's compliance function reliably deters, detects and investigates misconduct. E.g., Chen, *supra* note 69; Soltes, *supra* note 69; Brandon L. Garrett & Gregory Mitchell, *Testing Compliance*, 83 L. & Contemp. Prob. 47 (2020).

¹²² Arlen, *supra* note 119, at 91-112; Arlen & Kornhauser, *supra* note 3, at 718-719.

¹²³ Arlen, *supra* note 122; Arlen & Kornhauser, *supra* note 3.

¹²⁴ See ALI, *Principles of Corporate Enforcement*, *supra* note 28.

¹²⁵ A compliance function is unlikely to be effective if it does not reliably detect misconduct or detects it but fails to effectively investigate it. It also is less effective—and far less beneficial to society—if it detects misconduct but the company fails to self-report or fully cooperate—as the latter are needed for prosecutors to ensure the company

3.1.1. U.S. Federal Corporate Liability and Corporate Enforcement Federal Policy

U.S. federal law and policy on corporate criminal liability and enforcement is consistent with the approach set forth above in multiple ways. Under federal law, companies are criminally liable for all crimes committed in the scope of employment by all employees (even low level employees) provided the employee was acting with some intent to benefit the firm. The firm is liable even if the employees was not following orders and regardless of whether it adopted and maintained an effective compliance program.¹²⁶ No matter what the company does subsequently, including self-reporting and fully cooperating, companies are expected to disgorge their profit from misconduct to ensure they do not benefit from—and thus are not incentivized to induce—misconduct.

To incentivize self-reporting and cooperation, the DOJ has adopted a formal policy under which companies can avoid a guilty plea in most cases involving material organizational criminal misconduct, and instead resolve a case involving organizational misconduct through a DPA, NPA or declination (following disgorgement), by self-reporting, fully cooperating and remediating;¹²⁷ these actions also materially reduce the fine imposed.¹²⁸ By contrast, under current DOJ policy companies that neither self-report nor fully cooperated are unlikely to be offered a DPA, NPA, or declination for material misconduct, even if they offer to settle without a trial or remediated by adopting an effective compliance program.¹²⁹

terminates and remediates the full range of misconduct and that individual wrongdoers are appropriately punished. can assess these facets of the compliance program.

¹²⁶ See generally *Justice Manual*, *supra* note 43, at §9-28.800 (Comment B) (discussing federal law).

¹²⁷ See *Justice Manual*, *supra* note 43, at §9-28.900 (discussing the implications of self-reporting, full cooperation and remediation absent aggravating circumstances, such as criminal conduct that raises national security concerns); see Deputy Attorney General Lisa Monaco, *Remarks on Corporate Criminal Enforcement*, COMPLIANCE & ENFORCEMENT BLOG (Sept. 15, 2022).

Indeed, in the case of FCPA violations, companies that self-reported, fully cooperated, and remediated are presumptively eligible for a declination provided they disgorge their benefit from the misconduct, absent aggravating circumstances. *Justice Manual*, *supra* note 43, at §9-47.120. Companies that self-report, fully cooperate and remediate but are unable to obtain a declination due to aggravating circumstances can expect to be able to enter into a DPA or NPA; they also can expect a fine that is 50% below the minimum sanction recommended by the Sentencing Guidelines (unless the company is a recidivist). *Id.*

¹²⁸ *Id.* The U.S. Sentencing Guidelines also entitle companies to fine mitigation for self-report and cooperation. Companies also can get fine mitigation for effective compliance, subject to multiple restrictions. U.S. Sentencing Guidelines Governing Sentencing of Organizations, §8C2.2 (f) (g). Yet the Organizational Guidelines did little (if anything) to induce either self-reporting and cooperation or genuinely effective compliance because companies that self-reported still faced conviction and the amount of fine mitigation was not sufficient. See Arlen, *supra* note 2 [Hylton] (evidence shows little self-reporting following the adoption of the Organizational Sentencing Guidelines); see also See Jennifer Arlen, *The Failure of the Organizational Sentencing Guidelines*, 66 UNIVERSITY OF MIAMI LAW REVIEW 321 (2012) (showing that the USSG provide insufficient incentives for large firms to self-report and cooperate).

¹²⁹ See Monaco, *supra* note 127 (self-reporting is the “the clearest path for a company to avoid an indictment or guilty plea); Principles of Federal Prosecution of Business Organizations, *supra* note, at §9-28.800 (the existing of a compliance program is not sufficient, in and of itself, to justify not charging the firm). Indeed, failure to fully cooperate may well induce prosecutors to pursue formal conviction. cf. Veronica Root Martinez, *The Government’s Prioritization of Information over Sanction: Implications for Compliance*, 83 L. & CONTEMP. PROB. 85 (2020).

By contrast, some countries and U.S. states predicate corporate criminal liability on whether the company had an effective compliance program or whether the misconduct was committed by very senior managers. See generally ALI, *Principles of Corporate Enforcement*, *supra* note 28; Arlen, *supra* note 23, at 161 & 161 n. 17.

3.2. Importance of Whistleblower and Bounty Provisions

Corporate enforcement policies that offer materially better terms to companies that self-report cannot reliably induce corporate self-reporting unless either (1) companies are confident that they will suffer no costs should they self-report or (2) companies face a sufficiently high risk that the government will detect them even if they fail to self-report that they are better off deciding to self-report, even if doing so will subject them to some costs. At present, government enforcement authorities generally do not have sufficient resources to create the requisite risk of detection on their own. Consequently, absent a risk of detection from another source, companies regularly fail to self-report detected material misconduct because they expect not to be caught.¹³⁰ In such circumstances, companies regularly retain the profit from misconduct, and in turn the incentives to structure their internal operation to promote productivity at the expense of compliance.

Governments can best ameliorate their under-detection problem by providing incentives and protections to employees (and others) to report misconduct to government authorities.¹³¹ Employees are unlikely to reliably report corporate misconduct absent laws that prohibit companies from punishing them. reporting it.¹³²

To promote effective whistleblower reporting to the government, the law also needs to preclude companies from requiring employees sign agreements that bar them from disclosing illegal conduct to the government—including in confidentiality, non-disparagement, termination, or settlement agreements. Governments also should ban nondisclosure agreements relating to material violations of the law in legal settlements.¹³³ In addition, companies must be prohibited from retaliating against employees who report misconduct in good faith. Existing legal protections for whistleblowing employees do not go far enough. The Dodd-Frank Act¹³⁴ and the Sarbanes-Oxley Act of 2002 prohibit covered publicly-held companies from retaliating against employees who report certain types of misconduct or provide information to the government.¹³⁵ Public companies that require employees to sign confidentiality agreements, non-disparagement agreements, and nondisclosure agreements must include in those agreements express language stating that any disclosure prohibitions do not apply to reporting misconduct to the SEC.¹³⁶ These

¹³⁰ Arlen, *Caremark*, *supra* note 24. For evidence that firms detect substantial amounts of misconduct that they do not self-report see Soltes, *supra* note 87; Arlen & Kahan, *supra* note 120.

¹³¹ E.g., Arlen, *supra* note 23[tina] (whistleblower bounties are vital to deterrence); Miller, *The Compliance Function*, *supra* note 9, at 995-97 (whistleblowers are key to compliance); see also ALI, *Principles of Corporate Enforcement*, *supra* note 28, at § 6.08 rep. note n, (discussing importance of protecting whistleblowers and whistleblower bounties); § 6.27; cf. Restatement of the Law, Employment Law, §§ 5.01–5.03 (AM. L. INST. 2015) (discussing principles for wrongful discharge).

¹³² See Arlen, *supra* note 23[tina].

¹³³ There is a trend towards adopting such laws. E.g., NY (precluding nondisclosure agreements in sexual harassment and assault cases).

¹³⁴ 15 U.S.C. § 78u-6(h)(1)(C). An individual who reports internally to his or her firm, and then later reports to the SEC, can qualify as a whistleblower if he or she reports within 120 days of reporting to the firm.

¹³⁵ 18 U.S.C. § 1514A (prohibiting retaliation by covered companies against employees who “provide[s] information . . . or otherwise assist[s] in an investigation regarding any conduct which the employee reasonably believes constitutes a violation” of certain delineated fraud statutes, any SEC rule or regulation, or “any provision of Federal law relating to fraud against shareholders.”).

¹³⁶ SEC Rule 21F-17. For a discussion of SEC cases sanctioning companies for “pretaliatory” contracts with employees, see ALI, *Principles of Corporate Enforcement*, *supra* note 28, at § 6.27 (discussing actions against KBR, Blackrock, and Homestead).

protections are limited, however, as they do not extend to all companies, all employees or all types of material corporate crime.

In addition, countries should adopt laws offering significant compensation to all employees who report evidence about previously undisclosed material organizational misconduct to enforcement authorities that results in an enforcement action. Employees need to receive compensation for two reasons. First, employee whistleblowers regularly suffer personally and financially even if the firm does not formally retaliate. In addition, bounties also can improve the quality of whistleblowing complaints by enabling whistleblowers to hire a lawyer to investigate and document the misconduct prior to reporting it to enforcement authorities.¹³⁷

Existing law in the U.S. offers bounties in a limited set of circumstances, but does not offer bounties to employees reporting most forms of misconduct.¹³⁸ Moreover, problems with both bounty systems undermine their effectiveness.¹³⁹ Finally, other countries rarely if ever offer bounties to whistleblowers and many do not offer effective protections either.¹⁴⁰ Countries committed to inducing companies to adopt effective compliance functions need to reform their whistleblower protections and bounty regimes.

3.3 Supplements to Liability for Misconduct

To deter effectively, governments cannot rely solely on corporate liability for misconduct to induce firms to adopt effective compliance functions because enforcement officials do not have sufficient resources to produce the requisite risk that corporate wrongdoing will be detected and sanctioned across all sectors of the economy. Countries can address the under-deterrence problem by supplementing corporate liability for misconduct with more direct government regulation of compliance. Such duties can be imposed at one of two points in time but must always be limited in their scope and thus cannot substitute for efforts to use corporate liability to induce effective compliance.

3.3.1. Direct Regulation of Compliance or Sanction for Compliance Failures

Government regulators also can enhance compliance by adopting rules that require companies in certain industries to adopt specific compliance measures to guard against specific types of crimes. They also can induce companies to adhere to these rules by monitoring their compliance and sanctioning those who fail to comply, even if no misconduct occurred. Yet governments cannot rely on direct regulation as the primary mechanism for inducing effective corporate compliance. Government authorities cannot dictate, *ex ante*, all the steps that firms should take to deter misconduct because the components of an effective compliance function reach throughout companies' operations, and involve trade-offs whose optimal resolutions vary widely across firms and industries.¹⁴¹ For example, it would not be optimal to regulate companies'

¹³⁷ See Arlen, *supra* note 23[tina].

¹³⁸ See David F. Engstrom, *Bounty Regimes*, p. 334 in RESEARCH HANDBOOK ON CORPORATE CRIME AND FINANCIAL MISDEALING (Jennifer Arlen ed., 2018) (discussing U.S. cash for information and bounty regimes).

¹³⁹ SEC whistleblowers can remain anonymous until the bounty is paid, but they cannot bring an action on their own. *Qui tam* relators by contrast can bring an action on their own in some circumstances but cannot remain anonymous, and can expect to suffer within the firm years before they obtain any recovery (if ever). See Engstrom, *supra* note 138 (describing the SEC's bounty for information system and *qui tam*); see also Miller, *supra* note 9, at 996-97. For a discussion of other problems see, e.g., Miriam Baer, *Reconceptualizing the Whistleblower's Dilemma*, 50 U.C. DAVIS L. REV. 2215 (2017).

¹⁴⁰ See Arlen, *supra* note 23[tina].

¹⁴¹ See, e.g., Arlen & Kahan, *supra* note 120; Arlen & Kornhauser, *supra* note 3. Consistent with this, the provisions on compliance programs in the Organizational Sentencing Guidelines and the Justice Manual contain broad standards

approaches to compensation, retention and promotion or the way companies structure the allocation of tasks within a firm or their corporate cultures.

Nevertheless, in some circumstances regulators may be able to identify specific measures that all firms of a particular type should take to guard against a particular type of risk. This is an effective solution when (1) the regulator can identify and articulate compliance measures that are optimal for all firms (or all firms in a particular category), (2) can reliably detect a breach even when no harm occurred, and (3) is better able to detect a compliance breach than an instance of organizational misconduct.¹⁴² For example, laws reasonably require public companies to adopt specific measures to promote accurate disclosures to shareholders and to exercise internal control over assets, including having audited financial statements, audit committees comprised of independent directors with financial expertise, and a system of internal controls that meets specific requirements.¹⁴³ Yet these regulations, while helpful, can only be optimally applied to a subset of firms; they also can only cover a small portion of the measures companies need to adopt in order to implement an effective compliance function because regulatory authorities lack the information needed to determine the optimal approach for all companies across the wide array of corporate decisions that comprise companies' compliance function. Thus, *ex ante* regulation and oversight does not eliminate a government's need to use the threat of corporate liability to incentivize companies to give greater weight to deterrence across the many features of companies' internal operations that affect employees' likelihood of engaging in corporate misconduct.¹⁴⁴

3.3.2. Mandated Compliance Reforms and Monitors

Although government *ex ante* regulation of the compliance function is, and should be, restricted to a relatively small number of interventions that are optimal for all firms in a particular category (e.g., publicly held), government authorities can optimally intervene to impose a broader set of mandated compliance duties on companies found to have engaged in organizational misconduct when the investigation into the misconduct and its root causes enables enforcement authorities to identify specific compliance function reforms that they are confident the company should implement and enforcement authorities have good reason to believe that they cannot rely on the threat of corporate liability to induce the board and management to implement an effective compliance function.¹⁴⁵

U.S. enforcement officials can, and regularly do, incorporate provisions into criminal and civil corporate resolutions that require companies to implement specific mandated reforms to their compliance function, including reforms to compensation policies and oversight of contracts with

(and in the case of the DOJ questions to ask) but do not prescribe specific measures. *E.g.*, Organizational Sentencing Guidelines, *supra* note; Justice Manual, *supra* note 43.

¹⁴² See Arlen & Kahan, *supra* note 120 (discussing regulation as a solution to compliance); see generally Steven Shavell, *Liability for Harm Versus Regulation of Safety*, 13 J. LEGAL STUD. 357 (1984).

¹⁴³ The accounting provisions of the FCPA hold issuers liable (strictly for civil liability; criminal requires knowledge) for failure to adopt books and records that reasonably characterize the transaction and effective internal controls over the firm's disposition of its assets. See § 13 (b)(2) of the Exchange Act (15 U.S.C. § 78m(b)(2)); These requirements encourage investment in processes but do little to incentivize internal reforms—for example to compensation—designed to reduce employees' incentives to commit misconduct.

¹⁴⁴ Proposals to improve regulation of compliance include Veronica Root Martinez, *Coordinating Compliance Incentives*, 102 CORNELL L. REV. 1003 (2017).

¹⁴⁵ See Arlen & Kahan, *supra* note 120.

third parties.¹⁴⁶ These mandated reforms regularly impose compliance duties on companies that go beyond those imposed by regulation.¹⁴⁷

Enforcement officials may have sufficient information to identity a broad set of compliance reforms that the company should take, even when regulators would not have sufficient information to determine whether to adopt a regulation mandating such reforms, because they will have more information after a crime has occurred and been investigated than regulators. They can identify specific deficiencies in the firm's internal operations that led to the misconduct and intervene to address those deficiencies. Moreover, unlike regulatory rule-making that must apply broadly to many firms, they only need to determine what measures are needed to optimally reform a specific company's compliance function.¹⁴⁸

Because management generally is better informed than enforcement officials about the best ways for the company to deter corporate misconduct, enforcement officials should only impose mandated reforms if they determine that they cannot rely on officers and the board to implement an effective compliance function.¹⁴⁹ When reforms are needed, they needed to be designed to be effective even when management resists implementing effective compliance. Accordingly, enforcement officials mandating reforms need to impose clear duties that are tailored to the root causes of the firms misconduct; the duties need to be sufficiently specific that enforcement officials can clearly determine when the firm is in breach.¹⁵⁰ Prosecutors should not impose broad vague standards—such as those in the Organizational Sentencing Guidelines¹⁵¹—that give managers full discretion to avoid implementing a genuinely effective compliance function.¹⁵²

Moreover, because mandated reforms are needed when management is not committed to effective compliance, mandates need to include “meta-policing measures” which provide independent oversight over management. In some cases, enforcement officials may be able to rely on independent directors or regulators. But often enforcement officials need to appoint an independent compliance monitor who has the expertise and authority to assess whether the company is adhering to its mandated compliance obligations and can report any deficiencies to enforcement officials.¹⁵³

Existing federal corporate enforcement officials currently have the authority to impose mandated compliance reforms and often do so.¹⁵⁴ Yet they do not always restrict their interventions to situations where management cannot be relied upon to reform the firm's compliance function.¹⁵⁵ Moreover, when reforms are needed they regularly fail to adopt specific

¹⁴⁶ See, e.g., *id.*; Garrett, *supra* note 115; Vikramaditya S. Khanna & Timothy L. Dickinson, *The Corporate Monitor: The New Corporate Czar*, 105 MICH. L. REV. 1713, 1724 (2007).

¹⁴⁷ See Arlen & Kahan, *supra* note 120; Jennifer Arlen, *Prosecuting Beyond the Rule of Law: Corporate Mandates Imposed Through Deferred Prosecution Agreements*, 8 J. LEGAL ANAL. 191 (2016); Garrett, *supra* note 115.

¹⁴⁸ See Arlen & Kahan, *supra* note 120.

¹⁴⁹ *Id.*

¹⁵⁰ *Id.*

¹⁵¹ Organizational Sentencing Guidelines, *supra* note , at § 8B2.1. The Organizational Sentencing Guidelines set forth broad standards and goals that neither provide adequate specificity to induce effective compliance by recalcitrant managers or cover all the features of firms' internal operations implicated in an effective compliance function.

¹⁵² See Arlen & Kahan, *supra* note 120.

¹⁵³ See Arlen & Kahan, *supra* note 120. Compliance monitors are paid by the firm but report to the prosecutor (or civil enforcement official). See *id.*; see generally Veronica Root Martinez, *Public Reporting of Monitorship Outcomes*, HARV. L. REV. (2023); Veronica Root Martinez, *Modern-Day Monitorships*, 33 YALE J. REG. 109 (2016). Civil enforcement authorities also impose monitors, though they use different terms to refer to them.

¹⁵⁴ E.g., Arlen & Kahan, *supra* note 120; Garrett, *supra* note 115.

¹⁵⁵ Arlen & Kahan, *supra* note 120.

reforms that would constrain management's discretion; instead, they regularly simply require firms to adhere to broad requirements set forth in the Organizational Sentencing Guidelines that neither articulate clear duties nor reach sufficiently far into the firm to induce effective compliance.¹⁵⁶ Mandated reforms also often are not accompanied by "meta-policing" provisions designed to ensure they are implemented.¹⁵⁷ Indeed, until recently the use of monitors has fallen, although recent reforms to federal practice suggest the DOJ may increase their use of them.¹⁵⁸

4. Inducing Officers and Directors to Implement an Effective Compliance Function

Corporate criminal and civil liability for organizational misconduct are essential to inducing companies to implement an effective compliance function. Yet by themselves they are not sufficient for two reasons.

Companies (and their directors and officers) often have strong financial incentives to favor productivity over compliance because misconduct remains profitable—notwithstanding the threat of corporate liability—because most corporate misconduct is neither detected nor sanctioned.¹⁵⁹ In addition, companies may fail to implement an effective compliance program, even when the firm does not profit from misconduct, when senior management or directors have personal reasons to favor weak compliance (i.e., agency costs).¹⁶⁰ Senior managers and directors may suffer from "hard" or "soft" agency costs. Directors' or officers' decisions are plagued by hard agency costs when they benefit personally from either corporate crime or weak internal controls.¹⁶¹ Directors decisions are plagued by "soft" agency costs when they have a non-financial reason not to assert the appropriate oversight over compliance. For example, directors may fail to exercise sufficient monitoring of the firm's compliance function and investigations to facilitate their personal working relationships with senior management who might be offended by oversight that suggests management cannot be assumed to do the right thing.¹⁶²

¹⁵⁶ *Id.*

¹⁵⁷ *Id.*

¹⁵⁸ See Monaco, *supra* note 127.

¹⁵⁹ Arlen, *Caremark*, *supra* note 24; John Armour, et al., *Taking Compliance Seriously*, 37 YALE J. REG. 1 (2020). Companies' expected profit from misconduct likely explains institutional shareholders lack of attention to improving companies' compliance functions. See Leo Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 BUS. LAW. 1, 13 (2010).

For evidence that firms detect substantial amounts of misconduct that they do not self-report see Soltes, *supra* note 87; Arlen & Kahan, *supra* note 120 (providing evidence on corporate DPAs and NPAs few of which entailed self-reported misconduct). For a discussion of the political forces that leave enforcement officials under-funded see, e.g., Arlen, *Countering Capture*, *supra* note 24 (discussing under-resourcing); Richman, *supra* note 24 (same).

¹⁶⁰ For a discussion of agency costs impacting compliance see, e.g., Arlen & Kahan, *supra* note 120; Arlen, *Caremark*, *supra* note 24; John C. Coffee, *Crime and the Corporation: Making the Punishment Fit the Corporation*, 47 J. CORP. L. 963 (2022); Miller, *supra* note 9; Leo E. Strine, Jr., et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO L. REV. 629, 648–55 (2010); see also Langevoort, *supra* note 15; Baer, *supra* note 8.

¹⁶¹ See, e.g., Arlen, *Caremark*, *supra* note 24 (discussing hard and soft agency costs).

¹⁶² *Id.*; see also Arlen & Carney, *supra* note 4 (discussing how corporate liability will not reliably induce senior management to detect and terminate securities fraud by others if they also would be harmed were the firm's true financial picture to become public); Arlen & Kahan, *supra* note 120; John Armour, et. al, *supra* note 159 (discussing how agency costs can lead firms not to adopt optimal compliance); Assaf Hamdani & Reinier Kraakman, *Rewarding Outside Directors*, 105 MICH. L. REV. 1677 (2007) (same).

Accordingly, to induce effective compliance, countries need to adopt legal rules that specifically target directors and officers. They need to reduce their personal benefit from misconduct and also increase their personal incentives to oversee compliance. While a full evaluation of potential solutions is beyond the scope of this chapter, the Section briefly discusses two potentially promising avenues for reducing the agency cost problem.¹⁶³

4.1. Director and Officer Liability

One way to induce directors and officers to ensure that the firm has an effective compliance function is to hold them civilly liable for harm to the company from compliance deficiencies under certain circumstances.¹⁶⁴ Liability must be carefully structured, however.

Directors and officers should not be held personally liability whenever employees commit corporate misconduct for two reasons. First, strict liability for corporate misconduct would induce directors and officers to devote excessive corporate resources to deterring misconduct because cost would be borne disproportionately by shareholders while they would disproportionately benefit.¹⁶⁵ Second, it would undermine a central goal of corporate liability by providing directors and officers with a personal financial incentive to reduce the likelihood that the company detects, self-reports and fully cooperates with respect to misconduct.

Nor should directors or officers be subject to negligence liability for their firm's failure to adopt an "effective" compliance function. Courts cannot reliably determine whether a company's compliance function is effective rendering this rule impracticable.¹⁶⁶ Moreover, the resulting uncertainty in the standard of care would induce directors and officers to over-invest corporate resources in compliance in an effort to avoid personal liability.¹⁶⁷ This approach also would distort their compliance decisions towards those features courts tend to focus on, even if they are not effective. Finally, it also would incentivize them to find subtle ways to undermine detection and self-reporting because detected misconduct increases their risk of a negligence action.

To design an optimal rule, legislatures and policy makers need to impose duties that are (1) targeted at the directorial interventions most needed to address both companies' excessive incentives to profit from misconduct and managerial agency costs, (2) entail decisions that outside directors can obtain sufficient information to make and courts can obtain sufficient information to reliably assess, (3) promote, rather than undermine, corporate liability in inducing detection, investigation, self-reporting and cooperation, and (4) do not impose on directors an excessive risk of liability that they cannot be confident of avoiding through good faith compliance with the duties imposed on them by courts. In addition, the duties should be structured to deter misconduct that imposes substantial harm on society, even if the firm could profit from it.¹⁶⁸

¹⁶³ For a more extensive discussion of director oversight liability see Arlen, *supra* note 24. A more detailed analysis of clawbacks and other measures is reserved for future analysis. Other efforts to address this issue include Hamdani & Kraakman, *supra* note 162.

¹⁶⁴ This is distinct from imposing liability on senior management for misconduct itself. For a discussion of why directors and senior management rarely are appropriately charged for organizational misconduct see Samuel Buell, *Criminally Bad Management*, ch. 3, in *THE RESEARCH HANDBOOK ON CORPORATE CRIME AND FINANCIAL MISDEALING*, (Jennifer Arlen ed., 2018).

¹⁶⁵ E.g., Arlen & Kornhauser, *supra* note 3, at 725-26; Arlen, *Caremark*, *supra* note 24; Hamdani & Kraakman, *supra* note 162.

¹⁶⁶ E.g., Arlen & Kornhauser, *supra* note 3, at 725-26; Arlen, *Caremark*, *supra* note 24.

¹⁶⁷ E.g., Arlen & Kornhauser, *supra* note 3, at 725-26; Arlen, *Caremark*, *supra* note 24.

¹⁶⁸ Arlen, *Caremark*, *supra* note 24.

While a full evaluation of the optimal rule to satisfy these goals beyond the scope of this Chapter,¹⁶⁹ it is possible to identify important features of such a rule. First, in order to address companies' (and in turn directors' and officers') suboptimal incentives to favor productivity over legal compliance,¹⁷⁰ the law should give directors and officers a personal incentive not to induce, and indeed to terminate, misconduct. Courts and legislatures can do this by imposing duties on directors and officers not to knowingly allow the firm to violate the law and to terminate legal violations when they are detected subject to the threat of personal liability should they fail to do so. This duty is specific. It also places limited demands on directors, officers and courts: they need to assess whether the firm violated the law and whether there is evidence directors or management was aware of the violation and failed to terminate it. Delaware corporate law currently imposes these duties enforced by the threat of personal liability for breach.¹⁷¹

Second, the law should increase directors' and officers' incentives to induce the company to detect and investigate misconduct. These actions are important because they deter misconduct by increasing employees' likelihood of detection and sanction (by the firm or otherwise); they reduce the expected duration of misconduct by triggering the previously articulated duty to terminate misconduct.¹⁷² Duties and liability should also be structured to reduce the likelihood that agency costs would impede corporate self-reporting and cooperation. To reduce agency costs, these duties and the threat of liability needs to be targeted at directors who have less to gain from enabling misconduct and also less to lose if it is detected (and appropriately addressed), as management is more likely to bear the reputational and legal consequences of detected misconduct. Managerial agency costs can be particularly great once potential misconduct is detected; officers may be overly inclined to structure investigations to avoid confirmation and revelation of material misconduct.¹⁷³

The law can address these concerns—while avoiding creating an excessive threat of liability—by focusing interventions on increase the likelihood that misconduct is detected, and channel information about material suspected misconduct and authority over the investigation to the board. Directors should be subject to duties to act in good faith to ensure that (1) the firm is seeking to detect material misconduct, (2) the firm has procedures to ensure that the board (or a specific committee of the board) is regularly informed about detected misconduct and potential compliance deficiencies and is informed immediately about certain types of suspected misconduct, (3) management in fact does inform them, fully and accurately, about material compliance

¹⁶⁹ A full assessment of optimal director and officer liability aimed at inducing effective compliance is beyond the scope of this Chapter. For an more complete discussion of this issue see Arlen, *Caremark*, *supra* note 24.

¹⁷⁰ See *supra* text accompanying note 159 (discussing companies excessive incentives to enable misconduct); Arlen, *Caremark*, *supra* note 24; see also Leo Strine, Jr., *One Fundamental Corporate Governance Question We Face: Can Corporations Be Managed for the Long Term Unless Their Powerful Electorates Also Act and Think Long Term?*, 66 BUS. LAW. 1, 13 (2010) (; indeed, companies' expected profit from misconduct likely explains why institutional shareholders generally do not exert their influence to improve corporate compliance).

Directors and officers can adopt structures that enable corporate misconduct, without facing a risk of personal criminal liability, as long as they do not do (or aid and abet) the requisite criminal acts themselves with the requisite *mens rea*. See Buell, *supra* note 164.

¹⁷¹ See, e.g., Arlen, *Caremark*, *supra* note 24; Leo E. Strine, Jr., et al., *Loyalty's Core Demand: The Defining Role of Good Faith in Corporation Law*, 98 GEO L. REV. 629, 648–55 (2010); *In re Massey Energy Company Derivative and Class Action*, C.A. No. 5430-VCS (Del. Ch. 2011) ('Delaware law does not charter law breakers. Delaware law allows corporations to pursue diverse means to make a profit, subject to a critical statutory floor, which is the requirement that Delaware corporations only pursue "lawful business" by "lawful acts"'); *Graham v. Allis-Chalmers Mfg. Co.*, 188 A.2d 125 (Del. 1963) (directors who are aware of misconduct must investigate it and terminate it).

¹⁷² See Arlen, *Caremark*, *supra* note 24.

¹⁷³ See *id.*

deficiencies and detected misconduct, and (4) the board (or relevant committee)—and not management—has primary authority over the firm’s response to detected misconduct, including the decisions to self-report and fully cooperate. director liability needs to be limited to deliberate bad faith breach to avoid subjecting directors to an excessive risk of court error. Because directors’ should not have their attention redirected from the firm’s financial welfare unless it is important, directors’ duty to acquire information should be limited to (1) periodic reporting from compliance during regular board (or committee) meetings about patterns and trends in detected misconduct and their implications for compliance program effectiveness and the firm’s legal and reputational risks and (2) immediate reporting of suspected detected misconduct that either (a) implicates senior management, (b) could materially harm the firm if revealed, or (c) presents a substantial risk of harm to society (should the suspicions prove to be correct).¹⁷⁴ To reduce the risk of excessive liability, directors should only be liable if they act in bad faith by knowingly failing to adhere to these duties.¹⁷⁵ To enable directors to predict which potential harms to society they should ensure they are informed about, courts initially can limit directors’ duties to be informed to situations which either (1) risk physical harm or death to substantial numbers of people and/or (2) involve legal obligations that both appear to be material to society and where the legislature has affirmed the importance of compliance by imposing a duty on the firm to report detected violations to authorities.¹⁷⁶

Duties to act in good faith to ensure that the firm detects misconduct, directs it to the board, and gives the board ultimate oversight over important investigations target incentives at the features of compliance where intervention by directors is most important and where directors (and courts) can obtain the information needed to assess their compliance with these duties. They also would not discourage corporate self-reporting as directors who learn about misconduct and investigate it do not risk liability for breach should the public learn about the misconduct.

Imposition of these duties does not ensure that all features of a firm’s compliance function are effective. But it does not appear possible to use directorial liability to so without giving directors excessive incentives to favor compliance over productivity. The duties articulated above should enhance deterrence by (1) channeling information about detected misconduct to independent directors who are obligated and motivated to terminate it; (2) producing information that increases the firm’s risk of detection, thereby increasing its incentive to deter; and (3) increasing individual employees’ threat of sanction by channeling information to independent directors who are more likely to self-report.¹⁷⁷

The approach articulated above is superior to the approach taken by the Delaware Chancery Court in *In re Caremark International*.¹⁷⁸ *Caremark* requires directors to adopt a system to ensure the firm’s compliance with the law but does not provide any more specific duties on them with respect to their obligations. Instead, they have full discretion over how the compliance function should be structured and what role the board should play, protected by the Business Judgement Rule.¹⁷⁹ As a result, *Caremark* was not effective at addressing the central agency costs plaguing corporate compliance because it gave directors full discretion to limit their intervention to ensuring that the firm adopted policies, procedures and training and overseeing the implementation of those

¹⁷⁴ See *id.*

¹⁷⁵ See *id.*

¹⁷⁶ See *id.*

¹⁷⁷ See Arlen, *Caremark*, *supra* note 24. For a discussion of why boards could improve their oversight of compliance by creating compliance committees see John Armour, *et al.*, *Board Compliance*, 104 MINN. L. REV. 1191 (2020).

¹⁷⁸ *In re Caremark Int’l*, 698 A.2d 959 (Del. Ch. 1996).

¹⁷⁹ *Id.*

measures.¹⁸⁰ It does not address agency costs by challenging information about detected misconduct and oversight of investigations to the board.¹⁸¹

Recently, Delaware courts appear to be moving towards the approach articulated above in a set of cases that impose duties on directors to ensure that they are informed about, and oversee the investigation into, misconduct that could substantially harm the firm if revealed.¹⁸² The Delaware court also appears to have imposed these duties with respect to misconduct that is material to society, as evidenced by its potential to cause serious harm to many people and the imposition of duties on the firm to report risk of violation.¹⁸³ The category appears to be misconduct that presents an existential threat to the firm or that risks substantial personal injury to victims.¹⁸⁴ The Delaware Chancery Court recently extended oversight duties to corporate officers as well.¹⁸⁵ To fully realize the potential deterrence benefits of these extended Caremark duties, Delaware should be more explicit about the obligation to oversee the firm's effort to detect misconduct and should more clearly specify the set of violations to which they apply.

4.2. Clawbacks

Enforcement officials also are seeking to enhance managers' incentives to deter misconduct by incentivizing companies to adopt and enforce broader clawback provisions targeted not only at wrongdoers but also at supervisors who encouraged, condoned, or failed to terminate misconduct. *If properly structured*, these could both remove managers' incentives to adopt internal structures that promote misconduct and potentially induce them to deter it.¹⁸⁶

Yet implementing an effective clawback program presents many challenges. While a full assessment of these is beyond the scope of this chapter, a few are worth noting. First, it is important to ensure that employees are confident that compensation will not be clawed back unfairly—they should either have participated in, condoned, or knowingly failed to terminate misconduct (when they could have) or should have received it unfairly. Second, clawback policies are best tied to deferred compensation as it is more practicable to clawback compensation that has not been awarded. Third, it is important to create strategic exclusions from clawback policies for employees who report misconduct to the government (but were not primarily responsible for it) in order to

¹⁸⁰ See, e.g., Jennifer Arlen, *The Story of Allis-Chalmers, Caremark, and Stone: Directors' Evolving Duty to Monitor*, 323, in *CORPORATE STORIES* (J. Mark Ramseyer ed., 2009) (criticizing *Caremark* on this basis); Arlen, *Caremark*, *supra* note 24, at n. 109; Miller, *supra* note 9, at 986; compare with Todd Haugh, *Caremark's Behavioral Legacy*, 90 *TEMPLE L. REV.* 611 (2018).

¹⁸¹ See Arlen, *Caremark*, *supra* note 24.

¹⁸² E.g., *Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019); *Chou*, No. CV 2019-0816-SG; *In re Clovis Oncology, Inc. Derivative Litig.*, No. CV 2017-0222-JRS (Del. Ch. Oct. 1, 2019); *In re Boeing Co. Derivative Litig.*, No. CV 2019-0907-MTZ, 2021 WL 4059934 (Del. Ch. Sept. 7, 2021); see also *Lebanon Cty. Employees' Ret. Fund v. AmerisourceBergen Corp.*, No. CV 2019-0527-JTL (Del. Ch. Jan. 13, 2020), *aff'd*, 243 A.3d 417 (Del. 2020).

¹⁸³ See, e.g., *Marchand v. Barnhill*, 212 A.3d 805 (Del. 2019); *Chou*, No. CV 2019-0816-SG; *In re Clovis Oncology, Inc. Derivative Litig.*, No. CV 2017-0222-JRS (Del. Ch. Oct. 1, 2019); *In re Boeing Co. Derivative Litig.*, No. CV 2019-0907-MTZ, 2021 WL 4059934 (Del. Ch. Sept. 7, 2021); *Lebanon Cty. Employees' Ret. Fund v. AmerisourceBergen Corp.*, No. CV 2019-0527-JTL (Del. Ch. Jan. 13, 2020), *aff'd*, 243 A.3d 417 (Del. 2020).

¹⁸⁴ *Teamsters Loc. 443 Health Servs. & Ins. Plan v. Chou*, No. 2019-0816-SG (Del. Ch. Aug. 24, 2020); see Arlen, *Caremark*, *supra* note 24 (discussing *Chou*).

¹⁸⁵ *In re McDonald's Corporation Stockholder Derivative Litigation*, C.A. 2021-0324-JTL. *Caremark* is not the only source of potential liability. For example, Sarbanes-Oxley imposes duties on senior managers of publicly held companies. See generally Miller, *supra* note 9, at 987-88. Yet these duties do not appear to have been a substantial source of liability or to have motivated officers to actively seek to detect, investigate or self-report misconduct.

¹⁸⁶ For an example of a clawback proposal see Armour, *et al.*, *supra* note 159; cf. Hamdani & Kraakman, *supra* note 162 (proposing the use of rewards for directors).

ensure that clawback policies do not discourage employees from reporting misconduct. Finally, the policy should be designed to address the time inconsistency problem: the fact that a board the policy that is optimal for a firm to announce *ex ante*

5. The Challenge of Determining When Compliance is Effective

One challenge to efforts to deter through the adoption of an effective compliance function is our nascent understanding of the underlying causes of corporate misconduct and what corporate interventions are most effective in deterring it.

To determine the important features of an effective compliance function, one must first identify the root causes of employee misconduct and how firms' internal operation induces or deters it. As previously discussed, behavioral scholarship has identified a host of corporate interventions needed to deter crime that include, but also extend well beyond, the measures conventionally associated with a corporate "compliance program": *e.g.*, risk assessment, internal controls, employee training, policies and procedures, monitoring, testing or audit, and an internal escalation process protected by anti-retaliation measures. The compliance function also includes measures such as reforms to employee compensation, promotion and disciplinary policies and practices; statements by managers (including line managers) about the firm's goals and expectations of employees; the structure of employees' jobs; corporate efforts to detect and investigate misconduct; and the firm's commitment to assisting enforcement authorities to detect and punish wrongdoers by self-reporting and "fully cooperating." The optimal set of interventions will vary across companies. Accordingly, to assess the effectiveness of a firm's compliance function neither companies nor firms can simply look at a check list of interventions; they also certainly cannot simply only at the existence and structure of the compliance program alone.

According, in addition to assessing whether any features of the company's operations are not appropriately designed to deter misconduct, both the firm and enforcement officials examining a firm with detected misconduct should assess whether the firm's compliance function is achieving the central goals of compliance: prevention, detection/investigation, and remediation of misconduct.¹⁸⁷ Specifically, they should obtain and analyze evidence on whether employees are engaging in misconduct or unethical behavior, perceive others to be, and experience the firm as an entity that is committed to compliance. Companies can obtain the information needed to make these assessments through (1) internal reporting hotlines; (2) decision advisory hotlines; (3) well-designed surveys given months after training to assess employees reactions to scenarios implicating choices between compliance and profits; (4) exit interviews; (5) adoption of an analytic detection system that incorporates data from internal hotlines, HR complaints about unethical behavior (including sexual harassment), consumer complaints, and (6) carefully calibrated performance indicators that can raise red flags about potential misconduct.¹⁸⁸ Advances in AI-assisted monitoring of performance and transaction data may also prove a boon to identifying "red flags" or anomalies in data that may be predictive of suspicious conduct. Firms also should audit their systems for detecting and investigating misconduct to determine whether those systems are working well. They can examine trends in detected misconduct, by subunit, over time; evidence on the types of misconduct that is evading detection by the firm but is detected by employees or the government; the audit exception rate; outcomes of investigations (including assessment of the Type 1 and Type 2 error at the escalation stage by employee), and what happens to employees

¹⁸⁷ See Chen, *supra* note 69; Soltes, *supra* note 69, at 973-74; see also Garrett & Mitchell, *supra* note 121.

¹⁸⁸ See, *e.g.*, Chen, *supra* note 69; Soltes, *supra* note 69, at 981-83, 992-74.

with detected misconduct (by seniority and productivity of employee, complicity, supervisor, and magnitude of the misconduct).¹⁸⁹ If employing a “three lines of defense” compliance risk management and escalation system, firms should also track and assess the degree to which the “first line” operating business detects and internally self-reports misconduct before “second line” (i.e., compliance or risk functions) monitoring activities detect it; and the extent to which “third line” audits of controls later identify both a failure of “first line” controls and escalations, as well as a lapse in “second line” monitoring of the same behavior is also a relevant data point for measuring of program health.

Although firms cannot genuinely determine that their compliance functions are effective without conducting this kind of rigorous analysis of whether the system is working—of whether it is deterring and shaping the culture—at present too few firms do not conduct this type of assessment, limiting their focus to a review of policies, procedures and training.¹⁹⁰ Outcome-based measures should also be favored by prosecutors when assessing effectiveness.¹⁹¹ It is hoped that increased focus by federal prosecutors on the “outputs” of compliance—on assessing effectiveness—will induce more firms to genuinely implement their own assessments.

6. Conclusion

Countries’ citizens benefit from corporations but also risk being substantially harmed by them. Governments thus must intervene to enjoin excessively harmful corporate activities and impose liability on individual wrongdoers. Yet governments cannot rely individual liability alone to deter, either through incentives or through the law’s ability to express social and moral condemnation of prohibited conduct. Companies hold the keys to countries’ ability to deter effectively through either channel. The compliance function is the mechanism through which companies can intervene to promote deterrence.

Scholars’ and policymakers’ understanding of the compliance function has evolved substantially from the early focus on corporate policies, procedures and training. Scholars, companies, and enforcement officials now understand that effective deterrence requires corporate interventions that reach throughout and across the firms, extending to features, like compensation and promotion, that traditionally were not considered features of corporate compliance. Most of the constitute features of corporate compliance present a trade-off between corporate profit and legal compliance, however. Governments thus must target criminal liability at firms for their employees’ misconduct to motivate them to deter it—rather than intentionally or unintentionally encourage it—and also to enhance deterrence by detecting, investigating and self-reporting misconduct and helping enforcement officials to sanction those responsible. In addition, governments must adopt laws—such as properly structured director and officer oversight liability and clawbacks—designed to motivate directors and officers to deter corporate misconduct and ameliorate corporate agency costs.

Scholars, policy makers and governments still have a lot to learn about how to design corporate interventions and legal institutions to deter misconduct effectively, and what information is most effective at assessing the effectiveness of corporate compliance. Scholars seeking to

¹⁸⁹ See Chen, *supra* note 69, at 41; see also Joseph E. Murphy, *Policies in Conflict: Undermining Corporate Self-Policing*, 69 RUT. U. L. REV. 421, 480 (2017) (when managers who break rules are rewarded and promoted, this tends to define the firm’s culture for employees).

¹⁹⁰ Soltes, *supra* note 69, at 971 (discussing data that only 70% of firms seek to measure compliance function effectiveness).

¹⁹¹ See, e.g., Chen, *supra* note 69 (critiquing the federal government’s approach to measuring compliance effectiveness); Garrett & Mitchell, *supra* note 121 (same).

address these issues have turned to both economic analysis and psychology to understand when and why people violate the law and how companies and the law can interact to dissuade them. The resulting insights into the implication of psychology for economic theories of deterrence and of self-interest and incentives for efforts to deter through social norms has potentially broad implications for many issues in corporate governance beyond compliance.