9-2009

Governing Corporate Compliance

Miriam H. Baer
miriam.baer@brooklaw.edu

Recommended Citation
50 B.C. L. Rev. 949 (2009)

GOVERNING CORPORATE COMPLIANCE

MIRIAM HECHLER BAER*

Abstract: In light of the financial meltdown of 2008, it is reasonable to question whether the prior decade's emphasis on corporate compliance—the internal programs that corporations adopt in order to educate employees, improve ethical norms, and detect and prevent violations of law—has been fruitful. This Article contends that the key problem with compliance is that we regulate it through an adversarial system that pits federal prosecutors against corporate defense counsel, fueling distrust between corporate entities and the government, and between the corporate employees and the internal monitors tasked with ensuring compliance. Despite this adversarial atmosphere, a number of scholars have suggested that corporate compliance is an example of a more collaborative regulatory approach known as "New Governance." This Article challenges that notion, arguing that the government's adversarial stance all but eliminates the experimental and collaborative approach championed by the New Governance movement. The Article further concludes that a New Governance model of compliance regulation is unlikely to take hold. Nevertheless, policymakers should consider New Governance's administrative stance in lieu of the more punitive, "war-driven" approach that adjudication usually encourages.

INTRODUCTION

It is an open question whether the corporate compliance industry, which includes lawyers, auditors, ethics officers, and other professionals who monitor firms, has achieved improvements in corporate culture commensurate with its costs.[1] The boards of Fortune 1000

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* Assistant Professor of Law, Brooklyn Law School; J.D. 1996, Harvard Law School; A.B. 1993, Princeton University; Assistant United States Attorney, Southern District of New York 1999–2004; and Assistant General Counsel for Compliance, Verizon, 2004–2005. The author gratefully thanks for helpful comments and suggestions: Bill Araiza, Sam Buell, Rachel Barkow, Cindy Estlund, Jim Fanto, Roberta Karmel, Donald Langevoort, Jim Park, Yane Svetiev, Dan Richman, David Zaring, and participants in the Washington University of St. Louis Corporate Regulation Workshop and the New York City Junior Faculty Colloquium. The author also thanks Dean Joan Wexler and Brooklyn Law School, whose summer research stipend supported this project.

[1] *See, e.g.*, Laurie Brannen, *Price of Sarbanes-Oxley Declines*, 12.5 BUS. FIN. 15, May 1, 2006, *available at* http://businessfinancemag.com/article/upfront-price-sarbanes-oxley-compliance-declines-0501 (citing 2006 survey of financial executives in which "85 percent of re-

companies approve eloquent codes of conduct, their corporate lawyers advise them on how best to structure their compliance programs, and thousands of compliance providers offer services guaranteed to promote adherence to legal obligations.[2] Yet a number of recent surveys suggest that far from disappearing, employee malfeasance—including the very types of wrongdoing that created the corporate crises at Enron and Worldcom—is on the rise.[3] Indeed, the latest crises in the corporate world—from the meltdown of the mortgage security market to the massive Ponzi scheme that Bernard Madoff orchestrated through his investment management business[4]—arguably came about because numerous people in varying positions of public and private power ignored internal company policies, twisted regulatory requirements, or perpetrated outright violations of the law.

As the federal government continues to sort out the various causes of the 2008 financial meltdown, it will likely identify employees or officers of large corporate entities who committed crimes, with or without the knowledge of their superiors or the people charged with monitoring them.[5] It is even more likely that as these individuals are

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spondents still don't believe that the benefits of compliance outweigh the costs, even though they recognize that investor confidence has risen").

[2] *See, e.g.*, Robert Lupone, Gen. Counsel, Siemens, Remarks at the Georgetown Journal of Legal Ethics Symposium: Corporate Compliance: The Role of Company Counsel (Oct. 4, 2007), *in* 21 GEO. J. LEGAL ETHICS 491, 526 (2008) (describing the sophisticated processes that aid the corporation in gathering information as follows: "We have audit departments, we have human resources departments, [and] we have our lawyers who are counseling our business operations day-to-day, often on site at the companies. We have compliance offices, we have compliance committees. We have regulatory affairs groups. We have compliance hotlines.").

[3] *See, e.g.*, ETHICS RES. CTR., NATIONAL BUSINESS ETHICS SURVEY, at v (2007) (concluding that despite increased attention to compliance programs and ethical training, "[e]thical misconduct in general is very high and back at pre-Enron levels" within national firms surveyed); KROLL GLOBAL FRAUD REPORT 6–7 (2008) (observing increases in overall incidence of corporate fraud and weakening internal controls among firms surveyed globally).

[4] *See* Diana B. Henriques, *Madoff Will Plead Guilty; Faces Life for Vast Swindle*, N.Y. TIMES, Mar. 11, 2009, at A1.

[5] *See generally* Eric Lichtblau, *FBI Looks Into 4 Firms at Center of the Storm*, N.Y. TIMES, Sept. 24, 2008, at C1 (describing how, following collapse of credit markets and announcement of government bailout, the FBI initiated investigation of possible criminal activity at Fannie Mae, Freddie Mac, Lehman Brothers, and the American International Group). In the wake of the collapse of Bear Stearns, the United States Attorney's Office for the Eastern District of New York indicted two former Bear Stearns hedge fund managers for misleading investors about the health of one of Bear's funds. Patricia Hurtado & David Scheer, *Former Bear Stearns Fund Managers Arrested by FBI*, BLOOMBERG.COM, June 19, 2008, *available at* http://www.bloomberg.com/apps/news?pid=20601087&sid=aZjI.EgNDuFQ. In September 2008, the same office indicted two Credit Suisse brokers for fraudulently selling auction-rate securities

tried in court and the internal workings of their respective organizations become public, spectators will blame those organizations and decry the failures of corporate "self-regulation," a nebulous term that refers not only to independent industry organizations that monitor firms, but also to the internal programs that corporations adopt in order to regulate their internal compliance programs.[6]

As was the case during the lead-up to the Sarbanes-Oxley bill in 2002, alongside calls for increased regulation and transparency, commentators likely will argue for stronger pressure on corporate entities to monitor their employees for violations of criminal law.[7] One can therefore assume that in addition to more up-front structural reforms, Congress likely will consider imposing harsher criminal and civil penalties for financial crimes, which federal prosecutors will duly threaten and impose on both entities and individual defendants.[8]

Notwithstanding the argument for greater transparency and structural reform within the financial world, the reflexive impulse to punish companies for the wrongdoing perpetrated by corporate officers and employees—however understandable the frustration that fuels it—is wrong. The problem is not one of too little or too lenient compliance regulation. To the contrary, public and private corporations are the subject of numerous statutes and regulatory regimes that directly and indirectly require them to adopt programs designed to ward off internal misconduct, and threaten highly punitive consequences for their

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backed by subprime mortgages. *See* Patricia Hurtado & David Scheer, *Ex-Credit Suisse Brokers Charged with Subprime Fraud*, BLOOMBERG.COM, Sept. 3, 2008, *available at* http://www.bloomberg.com/apps/news?pid=20601103&sid=aacj9vBCee8c&refer=news; *see also* Carl H. Loewenson, Jr., *Ethics of Internal Investigations*, 1679 PLI/CORP. 571, 577 (2008) (noting the "ever-increasing number of internal investigations being performed as a result of the subprime mortgage crisis").

6 *See, e.g.*, Miriam H. Baer, *Insuring Corporate Crime*, 83 IND. L.J. 1035, 1051, 1054 (2008); Editorial, *Going Soft on Corporate Crime*, N.Y. TIMES, Apr. 10, 2008, *available at* http://www.nytimes.com/2008/04/10/opinion/10thu2.html (arguing that corporate deferred prosecutions must not be applied in subprime mortgage investigations).

7 *See, e.g.*, Robert Ridge & McKenzie Baird, *The Pendulum Swings Back: Revisiting Corporate Criminality and the Rise of Deferred Prosecution Agreements*, 33 U. DAYTON L. REV. 187, 187 (2008) (observing calls for "criminal statutes specifically addressing mortgage fraud and predatory lending practices"); Chisun Lee, *Senators Propose to Expand Financial Fraud Laws*, PROPUBLICA, Feb. 11, 2009, *available at* http://www.propublica.org/article/senators-propose-to-expand-financial-fraud-laws.

8 *See, e.g.*, Posting of Joe Palazzolo to Blog of Legal Times, *Feds Set Sights on 'Gatekeepers' in Fraud Investigations*, http://legaltimes.typepad.com/blt/2009/02/feds-set-sights-on-gatekeepers-in-fraud-investigations.html (Feb. 11, 2009, 14:45 EST) (quoting Senator Patrick Leahy: "I want to see people prosecuted . . . . Frankly, I want to see them go to jail.").

failure to do so.[9] As a result, corporate compliance has evolved "into a universal corporate governance activity."[10]

Nor can the pervasiveness of wrongdoing within firms be attributed solely to the problem of "cosmetic compliance," whereby corporations implement programs solely for the sake of appearing, but not actually being, compliant.[11] The sheer size of the compliance industry, which includes multiple American Lawyer 100 firms who proudly trumpet their assistance on their websites, severely undercuts the notion that corporations and compliance providers are engaged in a concerted, bad-faith attempt at intentional window-dressing.[12]

Rather, a substantial portion of the problem lies with the institutional structure by which compliance regulation is generated and enforced: through an informal quasi-adjudicative process.[13] Regulation-by-adjudication is the government's preferred method of generating compliance. Due to commonly cited drawbacks of adjudication— particularly its penchant for fueling adversarial relationships—the government has failed to achieve the benefits it seeks from compliance programs.[14] Despite an intense emphasis on compliance, corporations are no more transparent or ethical than their predecessors.[15]

Although numerous agencies participate in the regulation of compliance throughout various industries, this Article focuses primarily on the Department of Justice ("DOJ") and its United States Attorneys' Offices. Through their unequaled power to indict corporate entities, federal prosecutors have grasped the ability to define and impose no-

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[9] *See* Tanina Rostain, *General Counsel in the Age of Compliance: Preliminary Findings and New Research Questions*, 21 GEO. J. LEGAL ETHICS 465, 467 (2008) ("The emphasis on compliance pervades every sphere of corporate regulation, including environmental protection, occupational health, health care regulation, anti-terrorism legislation, and employment discrimination.").

[10] ERNST & YOUNG, BEST IN SHOW: CROSS-INDUSTRY CORPORATE COMPLIANCE SURVEY RESULTS (2003) *available at* http://corporatecompliance.org/Content/NavigationMenu/Resources/Surveys/Best-in-Show_CorporateCompliance.pdf (describing conclusions of survey of eighty-three companies across eleven industries).

[11] Kimberly Krawiec, *Cosmetic Compliance and the Failure of Negotiated Governance*, 81 WASH. U. L.Q. 487, 487, 491 (2003).

[12] *Contra id.* at 491.

[13] *See* Todd D. Rakoff, *The Choice Between Formal and Informal Modes of Administrative Regulation*, 52 ADMIN. L. REV. 159, 160 (2000) (discussing the growth of informality in administrative lawmaking).

[14] *See* Susan D. Carle, *Progressive Lawyering in Politically Depressing Times: Can New Models for Institutional Self-Reform Achieve More Effective Structural Change*, 30 HARV. J.L. & GENDER 323, 325 (2007); *infra* notes 163–169 and accompanying text.

[15] *See infra* notes 185–224 and accompanying text.

tions of what constitutes effective "corporate compliance."[16] As a result, compliance regulation is quasi-adjudicative in nature, and the debates that surround it are both legalistic and adversarial.[17] Despite the fact that the DOJ has intoned an interest in generating a more ethical "corporate culture," its prosecutors have little expertise in bringing about this development and their practices belie a greater interest in using the threat of entity-level liability to more easily identify and prosecute individual employees.[18] Although the prosecution of criminally responsible employees and the invocation of corporate-wide ethics may serve overlapping interests, these goals are not necessarily identical.[19]

Despite this backdrop, a number of scholars have begun to describe the DOJ's model of compliance regulation as a form of "New Governance," a reference to the deliberative, information-pooling regimes that regulatory theorists have promoted with an eye toward increased deliberative democracy and more efficient regulation.[20] For example, Cristie Ford and David Hess approvingly label the DOJ's settlement process with corporations as an example of New Governance.[21] Other scholars trace compliance regulation's New Governance characteristics to the Organizational Sentencing Guidelines ("OSG") that have been promulgated by the Sentencing Commission, and which reward more compliant and cooperative firms with lesser sentences.[22] Although not all of these scholars approve of New Governance as a means of regulating corporate compliance,[23] they nevertheless assume that the government's directive to firms to create effective compliance pro-

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[16] *See infra* notes 48–162 and accompanying text.

[17] *See infra* notes 163–256 and accompanying text.

[18] *See infra* notes 185–224 and accompanying text.

[19] *See infra* notes 225–256 and accompanying text.

[20] *See* David Hess & Cristie Ford, *Corporate Corruption and Reform Undertakings: A New Approach to an Old Problem*, 41 CORNELL INT'L L.J. 307, 312 (2008); William H. Simon, *Solving Problems vs. Claiming Rights: The Pragmatist Challenge to Legal Liberalism*, 46 WM. & MARY L. REV. 127 (2004).

[21] *See* Hess & Ford, *supra* note 20, at 312; *see also* Cristie Ford, *Toward a New Model for Securities Law Enforcement*, 57 ADMIN. L. REV. 757 (2005); David Hess, *A Business Ethics Perspective on Sarbanes-Oxley and the Organizational Sentencing Guidelines*, 105 MICH. L. REV. 1781 (2007).

[22] *See* Charles F. Sabel & William Simon, *Destabilization Rights: How Public Law Litigation Succeeds*, 117 Harv. L. Rev. 1015, 1097 (2004) (praising the organizational provisions of the Sentencing Guidelines for "making good-faith compliance monitoring efforts an important mitigating factor" in federal corporate prosecutions).

[23] *See* Krawiec, *supra* note 11, at 487–88, 490 (viewing compliance regulation as a form of New Governance—termed "negotiated governance" —but doubting its power to reform firms).

grams is a form of delegation much the same way Congress delegates statutory interpretation to administrative agencies.[24]

"New Governance" eludes easy description.[25] It is often described as a theory of regulation characterized by a collaborative tone between regulator and regulated entity, a problem-solving orientation, continuous assessment and revision of both expected outcomes and implementation processes, pooling of information by and among regulated entities and regulators, and interagency cooperation.[26] Most importantly, New Governance rejects the notion that adversarial relationships produce good regulation.[27] As two New Governance proponents, On Amir and Orly Lobel recently explained, "[b]ehavioral insights about social norms and motivation indicate that adversarialism reduces the willingness of companies and individuals to share information and to engage in mutually beneficial problem solving."[28]

This Article challenges the notion that corporate compliance regulation is an example of New Governance.[29] To the contrary, it is at best an illusory delegation of responsibility whereby the government commands firms *ex ante* to implement "effective" compliance programs, but offers little pragmatic guidance for determining effectiveness, and intentionally leaves them very little room for discretion in the event such programs uncover violations of law.[30] Despite its use of self-enforcement rhetoric, the DOJ's compliance regulation grants regulated entities little opportunity to engage in experimentation, the

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[24] Kenneth Bamberger, *Regulation as Delegation: Private Firms, Decisionmaking and Accountability in the Administrative State*, 56 DUKE L.J. 377, 377–78 (2006); *see also* Cynthia Estlund, *Rebuilding the Law of the Workplace in an Era of Self-Regulation*, 105 COLUM. L. REV. 319, 379–80 n.245 (2005) (viewing workplace compliance programs as examples of "self-regulation").

[25] *See* Katherine Kruse, *Instituting Innocence Reform: Wisconsin's New Governance Experiment*, 2006 WIS. L. REV. 645, 676–77.

[26] *See id.* "The primary goal of democratic experimentalist governance is to set into motion and then sustain a style of governance that promotes continuous learning and improvement in a middle ground between top-down command-and-control methods of traditional regulation and the undisciplined free-for-all of deregulation." *Id.* at 676.

[27] *See, e.g.*, On Amir & Orly Lobel, *Stumble, Predict, Nudge: How Behavioral Economics Informs Law and Policy*, 108 COLUM. L. REV. 2098, 2131 (2008) (reviewing RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS (2008) and DAN ARIELY, PREDICTABLY IRRATIONAL: THE HIDDEN FORCES THAT SHAPE OUR DECISIONS (2008)).

[28] *Id.*

[29] This article focuses on compliance programs aimed at deterring violations of criminal law. Compliance efforts aimed at lesser wrongs are not the focus of the Department of Justice and therefore may not be subject to some of the pathologies discussed herein.

[30] *Cf.* Bamberger, *supra* note 24, at 377–78 (describing the administrative model of delegating the task of identification and reduction of risk to the regulated parties themselves).

hallmark of New Governance regimes.[31] Instead, internal corporate compliance programs are the instrumentalities of hard law: formal regimes designed to supply internal monitoring and punishment, so that the firm can then assist the government in fulfilling its duties of external monitoring and punishment.[32] However one might feel about such a system, it is important to call it for what it is, and corporate compliance devoted to the prevention and detection of criminal wrongdoing is not New Governance.[33]

Given the expanding scholarly interest in New Governance regimes, it is useful to consider how a "true" New Governance compliance regime might alter the firm's relationship with government actors, as well as the internal relationships between the firm's compliance personnel and its managers and employees. One could idealistically propose an alternate regime that promises a less adversarial, more collaborative approach to the problem of preventing corporate crime. Proponents would argue that such a regime would more effectively regulate compliance without the externalities of adjudication. Critics would challenge such regimes as vulnerable to capture and rent-seeking by unethical corporate actors.[34]

Putting aside fears that private actors would abuse the New Governance paradigm, it is difficult to see how New Governance will take hold in the compliance arena so long as the primary response to corporate wrongdoing is the prosecution and punishment of individuals.[35] One of the keys to New Governance's success is information: by creating a space within which regulators and regulated entities trust each other, information is more freely exchanged and pooled, allowing for more enlightened policy.[36] Criminal procedure, by contrast, is premised on a zero-sum game in which information is most valuable to the party who controls it.[37] One of the great challenges for policymakers,

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[31] *See* Donald C. Langevoort, *Monitoring: The Behavioral Economics of Corporate Compliance with Law*, 2002 COLUM. BUS. L. REV. 71, 74.

[32] *See id.* at 73 (stating that, despite arguments that firms should use "integrity-based" methods for improving corporate compliance culture, "aggressive monitoring is still the baseline for most compliance initiatives").

[33] *See infra* notes 302–391 and accompanying text.

[34] *See, e.g.*, Kimberly D. Krawiec, *The Return of the Rogue*, 51 ARIZ. L. REV. 127, 129–30 (2009) (criticizing self-regulation regimes for managing operational risk in financial institutions).

[35] *See id.* at 154–55; *see also* Baer, *supra* note 6, at 1062–63.

[36] *See* IAN AYRES & JOHN BRAITHWAITE, RESPONSIVE REGULATION 86–87 (1992).

[37] *Cf.* Lisa Kern Griffin, *Compelled Corporation and the New Corporate Criminal Procedure*, 82 N.Y.U. L. REV. 311, 313 (2007) (describing prosecutors' use of "compelled cooperation" by corporations in order to bypass employees' Fifth Amendment protections).

then, is to craft rules and regulations that force firms to internalize the long-term costs of their wrongdoing without crowding out individual incentives to disclose information. Neither New Governance nor the current model of compliance regulation solves this problem.

Moreover, New Governance will not likely infiltrate the compliance world any time soon because a key ingredient of its success—mutual trust between regulators and business organizations—is sorely missing. This is unfortunate because at its best, the New Governance paradigm illuminates the benefits of a more administrative compliance model.[38] That is, it may be healthier (and ultimately more beneficial) to "govern" corporate compliance, rather than to adjudicate it.[39] Under a governance model, regulators and regulated entities would treat compliance problems—even large scale violations of criminal law—as a symptom of a continuing problem to be addressed over time, rather than as a cultural failure that could be "cured" by some combination of prosecutorial threat and internal ethics remediation.

Part I of this Article discusses the evolution of corporate compliance regulation over the last two decades.[40] For institutional reasons, corporate compliance is a creature of the federal criminal justice system and has arisen in an ad hoc fashion.[41] Although corporate entities are technically criminally liable for nearly all of their employees' misconduct, the government has learned not to formally prosecute these entities due to the steep collateral consequences of indictment.[42] Instead, the government uses corporate entities to assist in the identification and prosecution of individual employees, and obtains concessions and organizational reforms from corporate entities through informal dispositions known as Deferred Prosecution Agreements ("DPAs").[43]

Much of corporate compliance regulation, at least where criminal violations are concerned, is therefore the product of a quasi-

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[38] *See* Bamberger, *supra* note 24, at 377–78.

[39] *See* AYRES & BRAITHWAITE, *supra* note 36, at 19–20.

[40] *See infra* notes 48–162 and accompanying text.

[41] *See* Corporate Compliance Comm., ABA Section of Bus. Law, *Corporate Compliance Survey*, 60 BUS. LAW. 1759, 1759–60 (2005) [hereinafter *Corporate Compliance Survey*].

[42] *See* Ridge & Baird, *supra* note 7, at 195 ("[I]n today's enforcement environment, even well-financed and capable defense counsel capitulate to a prosecutor's demands rather than assume the risks of trial."); *see also* Baer, *supra* note 6, at 1062–63 (discussing collateral consequences of corporate indictment).

[43] *See* Brandon Garrett, *Structural Reform Prosecutions*, 93 VA. L. REV. 853, 893–902 (2007) (describing DPA process). The government entered into substantially fewer DPA's in 2008. Marcia Coyle, *Deferred, Nonprosecution Deals Fall by 60%*, NAT'L L.J., Feb. 10, 2009, *available at* http://www.law.com/jsp/nlj/PubArticleNLJ.jsp?id=1202428013402&slreturn=1. The reasons for the reduction are, as yet, unclear. *See id.*

adjudicative system administered by the DOJ. It is "adjudicative" in that following some investigatory phase, corporate attorneys and government prosecutors argue over how the DOJ should apply its internal policy for bringing entity-level indictments against a particular corporation in light of the facts elicited during the DOJ's investigation. Prosecutors then pass judgment on the company by offering the corporation, in lieu of indictment, a DPA that includes certain sanctions and demands structural reforms.[44] Those reforms invariably relate to the company's compliance program. Through this informal process, the government refines the relatively broad standards it has set forth in the DOJ's "prosecutorial charging guidelines," which are the internal memoranda that guide prosecutors on deciding whether to indict a corporation for its employee's crimes.

Part II examines several critiques of adjudication and applies them in the compliance context.[45] These drawbacks include the reduced accountability of prosecutors for compliance decisions that are made privately by firms, but are nevertheless influenced by government procedures. Other drawbacks stem from the increasingly adversarial relationships between government and private actors, between private compliance officers and the rest of the firm, and a consequent reduction in the flow of information between private and public entities.

Part III identifies the beneficiaries of the current model: the DOJ and the professional compliance industry.[46] It explains that the allocation of compliance responsibility to firms simultaneously increases the DOJ's enforcement power while reducing the transparency of compliance costs. It also explains how legal rules that favor compliance subsidize suboptimal compliance services because officers and prosecutors are unable (and perhaps disinclined) to discern *ex ante* the difference between effective and ineffective compliance products.

Part IV then considers the New Governance model and its presumed benefits and drawbacks.[47] New Governance is touted as a hybrid form of regulation that maneuvers around both the harsh excesses of command-and-control regulation and the weak controls of a private market undermined by imperfect information. Whatever promise New Governance may hold for solving multiple social problems, its implementation in the compliance area is highly unlikely. Nevertheless, this Article ends on a cautiously positive note. Although New Governance

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[44] *See* Garrett, *supra* note 43, at 888.
[45] *See infra* notes 163–256 and accompanying text.
[46] *See infra* notes 257–301 and accompanying text.
[47] *See infra* notes 302–391 and accompanying text.

may not provide a viable framework for compliance regulation, several characteristics provide ample reason for innovative policymakers to focus their efforts more on "governing" rather than "adjudicating" corporate compliance. Whether these lessons will prevail in the current environment, however, remains to be seen.

I. The Origins of Corporate Compliance Regulation

A. *Defining Compliance*

"Compliance" is a system of policies and controls that organizations adopt to deter violations of law and to assure external authorities that they are taking steps to deter violations of law.[48] General compliance programs address the overall conduct of business in accordance with prescribed legal, and increasingly ethical and cultural, norms.[49] Although compliance programs often focus on all types of misconduct, and therefore are within the purview of numerous federal and state agencies, this Article is primarily concerned with the manner in which corporations respond to criminal violations.[50]

The agency that effectively regulates "general" corporate compliance, at least where criminal violations are concerned, is the DOJ. Additionally, the DOJ receives aid from more specialized agencies such as the Securities and Exchange Commission ("SEC"), which oversees enforcement with the securities laws and focuses specifically on broker-dealer compliance, and self-regulatory organizations such as the Financial Industry Regulatory Authority ("FINRA").[51] Because the general

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[48] *See* Langevoort, *supra* note 31, at 81–82 (describing standard features of compliance programs, such as firm-wide education and monitoring); Rostain, *supra* note 9, at 466–67 (explaining that compliance functions include "the promulgation of codes of behavior, the institution of training programs, the identification of internal compliance personnel and the creation of procedures and controls to insure company-wide compliance with legal mandates"); *Corporate Compliance Survey*, *supra* note 41, at 1759–60 (describing common components of corporate compliance programs).

[49] *See Corporate Compliance Survey*, *supra* note 41, at 1759.

[50] For a discussion of how compliance programs can deter non-criminal violations, such as workplace harassment and discrimination, see Estlund, *supra* note 24, at 334.

[51] The SEC's Office of Compliance Inspections and Examinations monitors registered entities such as broker-dealers, investment advisors and investment companies, and self-regulatory organizations (which in turn conduct their own monitoring programs). *See* SEC Office of Compliance Inspections and Examinations, http://www.sec.gov/about/offices/ocie.shtml (last visited Aug. 22, 2009). FINRA is a self-regulatory organization created by the merger of some regulatory functions of the New York Stock Exchange and the National Association of Securities Dealers. About the Financial Industry Regulatory Authority, http://www.finra.org/AboutFINRA/index.htm (last visited Aug. 22, 2009). Securities firms that fail to comply with FINRA's rules risk disciplinary sanctions up to and including expul-

corporate compliance program is common to all industries, and because the DOJ effectively wields more power than administrative agencies,[52] this Article focuses primarily on the DOJ's regulation of general compliance programs. Nevertheless, those familiar with securities regulation may recognize earlier initiatives by the SEC to compel public firms to adopt compliance programs.[53]

The common justification for corporate compliance programs is that they deter wrongdoing and generate ethical norms within the firm.[54] Compliance programs deter wrongdoing by expanding the government's overall enforcement resources, thereby increasing the likelihood that a given corporate employee will be apprehended either before or after the employee commits a crime.[55] Further, corporate compliance programs deter wrongdoing because their chosen enforcers (corporate compliance officers and their teams) possess greater knowledge of the firm than government investigators.[56] Accordingly, the compliance program simultaneously expands both the amount and efficacy of enforcement resources.[57] If these assumptions are correct, then corporate managers should be effectively deterred.[58]

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sion. *See, e.g.*, FINRA SANCTION GUIDELINES, *available at* http://www.finra.org/Industry/Enforcement/SanctionGuidelines/SG/P011484 (last visited Aug. 22, 2009).

[52] *See* Neal Devins & Michael Herz, *The Uneasy Case for Department of Justice Control of Federal Litigation*, 5 U. PA. J. CONST. L. 558, 563 (2003).

[53] ROBERTA KARMEL, REGULATION BY PROSECUTION 170–71 (1982) (describing then SEC Enforcement Division Director Stanley Sporkin's call in 1977 for firms to create the position of "business practices officer" who "presumably would act like a civil policeman and would be more responsive to government regulatory policies than the average corporate officer"). Professor Karmel criticized the use of the settlement process to impose such "business practice officer" requirements on firms. *See id.*; *see also* Jayne W. Barnard, *Corporate Therapeutics at the Securities and Exchange Commission*, 2008 COLUM. BUS. L. REV. 793, 814–15 (reporting that Sporkin embraced the internal monitor as someone who could "serve as the 'eyes and ears' of the [SEC] staff").

[54] *See Corporate Compliance Survey*, *supra* note 41, at 1759.

[55] *See* Gary Becker, *Crime and Punishment: An Economic Approach*, 76 J. POL. ECON. 169, 169 (1968). As Steven Shavell has explained, Becker was drawing on Jeremy Bentham and Cesare Becarria's ideas. *See* Steven Shavell, *Criminal Law and the Optimal Use of Nonmonetary Sanctions as a Deterrent*, 85 COLUM. L. REV. 1232, 1246 n.53 (1985).

[56] *See, e.g.*, Jennifer Arlen & Renier Kraakman, *Controlling Corporate Misconduct: An Analysis of Corporate Liability Regimes*, 72 N.Y.U. L. REV. 687, 692 (1997) (explaining that entity-level liability can "reduce enforcement costs by inducing firms to sanction wrongdoers in those circumstances where firm-level sanctions are cheaper (or more accurate) than government-imposed sanctions").

[57] *See* AYRES & BRAITHWAITE, *supra* note 36, at 110–16.

[58] *See* Arlen & Kraakman, *supra* note 56, at 692–93.

Compliance programs also deter wrongdoing by generating social norms that champion law-abiding behavior.[59] Norms can exert pressure externally, through reputation costs or loss of friendship, for example, or internally, by undermining one's sense of self worth.[60] Social norms fill the gaps left by more formal enforcement mechanisms.[61] Norm-based compliance programs also increase deterrence insofar as they permit organizations to discipline employees for violations that transgress social norms, but otherwise fall just short of legal violations.[62] To the extent one views the violation of a social norm as the precursor to illegal conduct, the compliance program's enforcement of social norms enlarges the number of instances in which a putative criminal will be detected and sanctioned.[63] In this manner, "normative" compliance enforcement functions much like attempt liability in criminal law: it enlarges the probability of detection.[64]

To accomplish the dual ends of deterrence and norm-generation, most corporate compliance departments include both policy-setting and investigatory functions.[65] Compliance personnel frequently write and revise corporate-wide codes of business conduct.[66] These codes advise employees to follow the law and seek assistance from designated authorities within the organization either when employees are unsure of the law or when they become aware of someone else's violation.[67] In addition to promulgating such codes, compliance departments monitor and discipline employees who appear to have breached either external laws or internal corporate policies.[68] Along with the corpora-

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59 *See* Steven Shavell, *Law Versus Morality as Regulators of Conduct*, 4 AM. L. & ECON REV. 227, 232 (2002).

60 *See id.* (distinguishing internal and externally imposed "moral incentives").

61 *See id.* at 228.

62 *See id.* at 235–36.

63 *See id.* at 234–35.

64 *See* Shavell, *supra* note 55, at 1250 ("[T]he punishment of attempts in effect increases the probability of sanctions.... [It] is a socially inexpensive means of increasing the probability, since opportunities to punish attempts often arise as a byproduct of society's investment in apprehending parties who actually do harm.").

65 *See* Harvey L. Pitt & Karl A. Groskaufmanis, *Minimizing Corporate Civil and Criminal Liability: A Second Look at Corporate Codes of Conduct*, 78 GEO. L.J. 1559, 1559–62 (1990).

66 *See id.*

67 *See id.* at 1644–45. The Sarbanes-Oxley Act of 2002 requires public companies to disclose whether they have a code for officers and directors and explain why they have chosen not to adopt one. *See, e.g.*, Sarbanes-Oxley Act of 2002, 15 U.S.C.A. § 7264(a).

68 *See* Sung Hui Kim, *Gatekeepers Inside Out*, 21 GEO. J. LEGAL ETHICS 411, 450 (2008) ("To ensure that employees carry out their corporate duties in ways that do not expose the company to unreasonable risks of criminal or civil liability, inside counsel's duties have formally expanded to include training employees about potential liability . . . planning and

tion's general counsel, compliance departments assist in the investigation of wrongdoing after government agents and prosecutors have become aware of illegal conduct within the organization.[69] As a result of several legal developments discussed below, many corporate compliance programs now include board-level oversight.[70]

Taken as a whole, the corporation's compliance function has become a salient and visible feature of the modern American corporation. Whether it reduces actual criminal wrongdoing (or at the very least, the costs of investigating and prosecuting such wrongdoing) through its deterrent and normative power, or whether it simply creates an illusion of false security remains an open question.[71]

B. *A Brief History of Corporate Compliance Regulation*

Compliance regulation has developed over the last four decades in a fairly ad hoc fashion, shadowing the growth in the regulation of financial reporting and the proliferation of "internal controls" mechanisms.[72] As the Delaware courts demonstrated their reluctance to interfere with the internal governance of corporate firms, the federal government increasingly expanded both the content and enforcement of criminal law.[73] By the time Delaware re-entered the compliance arena in 1996, the regulation of compliance was firmly in the hands of the DOJ.[74]

1. The Origins of Federal Power

The origins of modern-day compliance regulation can be traced back to 1963, when the Delaware Supreme Court rejected the notion that a company's directors were responsible for implementing a structure that ensured compliance with the law: "[A]bsent cause for suspicion there is no duty upon the directors to install and operate a cor-

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design of corporate compliance programs . . . and monitoring ongoing compliance practices . . . .").

[69] *See infra* notes 225–227 and accompanying text.

[70] ERNST & YOUNG, *supra* note 10, at 1 ("Board and compliance oversight participation by outside directors, are nearly universal compliance activities in large companies.").

[71] *See* Barnard, *supra* note 53, at 833–35 (voicing skepticism that compliance programs provide benefit to shareholders and the corporation).

[72] *See* Lawrence A. Cunningham, *The Appeal and Limits of Internal Controls to Fight Fraud, Terrorism and Other Ills*, 29 J. CORP. L. 267, 273–74 (2004) (discussing the growth of internal control systems within corporations).

[73] *See* Jennifer Arlen, *The Story of* Allis-Chalmers, Caremark, *and* Stone*: Directors' Evolving Duty to Monitor*, *in* CORPORATE LAW STORIES 8, 22 (J. Mark Ramseyer ed., 2009), *available at* http://ssrn.com/abstract=1304272 (November 2008).

[74] *See id.* at 7–9.

porate system of espionage to ferret out wrongdoing which they have no reason to suspect exists."[75] The Delaware Supreme Court's decision in *Graham v. Allis-Chalmers Manufacturing Co.* was consistent with its general hands-off attitude toward internal corporate affairs, which it expressed through the business judgment rule.[76] Accordingly, directors and officers had little reason to fear that either the Delaware legislature or courts would review, much less interfere in, the internal monitoring systems they chose or declined to enact to ensure their companies' compliance with the law.[77]

In the ensuing years, the federal government jumped into Delaware's void.[78] In 1977, Congress ushered in the modern corporate-compliance movement by enacting the Foreign Corrupt Practices Act ("FCPA").[79] The statute was intended to counteract the problem of corruption among defense contractors and other companies, whose bribery of foreign officials had come to light during the investigation of the Nixon administration.[80] In addition to imposing criminal penalties on individuals who bribed foreign officials in exchange for business, the FCPA required public companies to devise a system of books and records of their employees' disposition of corporate assets.[81]

In response to the FCPA's books and records provision, corporate attorneys advised their corporate clients to initiate internal processes designed to deter violations of law (which, conveniently, required additional legal advice and auditing services).[82] The FCPA's use of criminal sanctions to compel changes in corporate governance was consistent

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[75] *See* Graham v. Allis-Chalmers Mfg. Co., 188 A.2d 125, 130 (Del. 1963).

[76] *See, e.g.*, Schreiber v. Pennzoil Co., 419 A.2d 952, 956 (Del. Ch. 1980) ("The business judgment rule is a presumption that a rational business decision of the officers or directors of a corporation is proper unless there exists facts which remove the decision from the protection of the rule . . . ."); *Allis-Chalmers Mfg. Co.*, 188 A.2d at 130.

[77] *See* Arlen, *supra* note 73, at 22.

[78] *See id.* at 8.

[79] Foreign Corrupt Practices Act, Pub. L. No. 95-213, 91 Stat. 1494 (1977), *amended by* Foreign Corrupt Practices Act Amendments of 1988, Pub. L. No. 100-418, 102 Stat. 1415 (1988).

[80] Rebecca Walker, *The Evolution of the Law of Corporate Compliance in the United States: A Brief Overview*, 1561 PLI/Corp. 13, 17–18 (2006).

[81] 15 U.S.C. § 78m(b)(2)(A) (requiring corporate issuers to: "A) make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the issuer; [and] (B) devise and maintain a system of internal accounting controls sufficient to provide reasonable assurances" that transactions are executed and recorded properly and assets are disposed properly and audited appropriately).

[82] *See* Krawiec, *supra* note 11, at 529–30 (arguing that attorneys, in order to inflate their importance, frequently overestimate liability under the FCPA).

with an overall trend in federal criminal law.[83] Since at least the 1970's, federal criminal statutes have expanded in both breadth and intensity.[84] They cover business misconduct previously defined as commercial wrongdoing, and they apply far more punitive sanctions to both the newly criminalized misconduct and to the activities—such as embezzlement and bribery—that were traditionally viewed as crimes.[85] The emergence of the administrative state has further empowered and expanded federal criminal law.[86]

As the federal government's interest in white collar crime grew, so too did its interest in the corporate entities that nurtured and protected such wrongdoers.[87] Prosecutors wisely understood that corporations either could shield employees from liability and hinder prosecutions, or, if properly incentivized, aid the government in promoting its newly christened war on corporate crime. Although rarely exercised, the doctrine of *respondeat superior* criminal liability for corporate entities provided just such an incentive: hold organizations liable for their employees' wrongs and then those organizations would have the

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[83] *See* JOHN HASNAS, TRAPPED: WHEN ACTING ETHICALLY IS AGAINST THE LAW 31–44 (2006) (describing new offenses that Congress created to attach to a broader range of misconduct).

[84] Although federal criminal law's reach has grown steadily since the nation's founding, a number of statutes with important implications for corporations and corporate actors were first enacted in the 1970s and 1980s. *See, e.g.*, Racketeer Influenced & Corrupt Organizations Act (RICO), 18 U.S.C. §§ 1961–1968 (1982); Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 (1977) (amending the Securities and Exchange Act of 1934) (codified at 15 U.S.C.z §§ 78m(b)(2)–(3), 78dd-1, 78dd-2, & 78ff (1978)); Antitrust Procedures & Penalties Act of 1974, Pub. L. No. 93-528, § 3, 88 Stat. 1706, 1708 (1974) (codified at 15 U.S.C. § 2 (1982)).

[85] *See* HASNAS, *supra* note 83, at 31–44; John C. Coffee, Jr., *Paradigms Lost: The Blurring of the Criminal and Civil Law Models—And What Can Be Done About It*, 101 YALE L.J. 1875, 1880 (1992). For more general discussions of federal criminal law's excessive (and overlapping) reach, see DOUGLAS HUSAK, OVERCRIMINALIZATION 9–10 (Oxford 2008); Ronald L. Gainer, *Federal Criminal Code Reform: Past and Future*, 2 BUFF. CRIM. L. REV. 45, 49 (1998) (criticizing the "morass of statutory provisions and judicial decisions" that make up federal criminal law).

[86] *See* Gainer, *supra* note 85, at 72-73. Writing in 1998, Ronald Gainer, a former DOJ attorney, observed:

> Today, when a congressional committee adopts new requirements concerning commercial transactions . . . or virtually any other regulated activity, it routinely incorporates at the end of the requirements a statement that any deviation constitutions a federal crime. This tendency has led to a gradual absorption of non-criminal law by the criminal law.

Id.

[87] *See* Arlen & Kraakman, *supra* note 56, at 689.

proper incentive to take necessary steps to prevent those wrongs.[88] Accordingly, the government has increasingly harnessed its control over corporate compliance via federal criminal prosecutions.[89]

Although simple and rhetorically pleasing, the pure strict liability approach to organizational crime could not achieve its primary goal of deterring corporate crime.[90] This was the case because a pure strict liability rule did not reward firms that failed to prevent misconduct but otherwise found and reported such misconduct to government authorities.[91] A pure strict liability rule therefore failed to deter violations *ex ante* (since employees knew that their employers had little incentive to police and uncover misconduct) and to detect wrongdoers *ex post*.[92]

The desire to reward corporate policing and leverage enforcement resources across private firms drove the federal government toward a "composite" liability system that held corporations strictly liable for their employees' wrongdoing, but mitigated the effects of that liability upon a showing of certain compliance measures.[93] Accordingly, the OSG, promulgated by the United States Sentencing Commission in 1991, provided a structure of penalties that increased or reduced sanctions (a fine and usually some form of probation) according to, among other things, the existence of a corporate compliance program and the corporation's provision of assistance in identifying and prosecuting individual employee-violators.[94] This structure of carrots and sticks further spurred the growth of the compliance industry.[95]

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[88] *See id.* (explaining standard argument for *respondeat superior* liability for criminal misconduct in corporate firms). Arlen and Kraakman recognized that strict liability regimes would produce suboptimal compliance programs if the legal regime failed to reward firms for detecting and reporting, but not preventing, criminal misconduct. *Id.* at 714 n.64.

[89] *See* Mary Jo White, *Corporate Criminal Liability: What Has Gone Wrong?*, 1517 PLI/CORP. 815, 817 (2005) (former United States Attorney for the Southern District of New York describing her office's first Deferred Prosecution Agreement with Prudential).

[90] *See* Arlen & Kraakman, *supra* note 56, at 707–09; *see also* Jennifer Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, 23 J. LEGAL. STUD. 833, 833–34 (1994).

[91] *See* Arlen & Kraakman, *supra* note 56, at 707–09; *see also* Arlen, *The Potentially Perverse Effects of Corporate Criminal Liability*, *supra* note 90, at 833–34.

[92] Arlen & Kraakman, *supra* note 56, at 714–15.

[93] *Id.* at 726–30 (describing "composite" liability regimes).

[94] *See* U.S. SENTENCING GUIDELINES MANUAL ch. 8 (2008); *see also* Barry D. Baysinger, *Organization Theory and the Criminal Liability of Organizations*, 71 B.U. L. REV. 341, 341 (1991) (describing "basic components" of Organizational Sentencing Guidelines).

[95] *See* Diana Murphy, *The Federal Sentencing Guidelines for Organizations: A Decade of Promoting Compliance and Ethics*, 87 IOWA L. REV. 697, 710 (2002) (contending that OSG's preference for compliance programs had spurred interest in corporate compliance and

Despite the compliance industry's impressive growth in the years following the OSG's enactment in 1991, a convergence of corporate crime scandals, such as Enron, WorldCom, and Adelphia, suggested to some observers that ethical norms had insufficiently permeated the corporate world.[96] Accordingly, in 2004, at the direction of a provision of the Sarbanes-Oxley Act of 2002, the Sentencing Commission amended the OSG to provide greater clarity as to what constituted an effective compliance program.[97] In doing so, the Sentencing Commission explicitly included provisions for board oversight and for compliance programs to educate employees on the importance of corporate ethics.[98] As evidenced by the Commission's claims at the time, the reforms were intended to transform corporate governance by improving corporate culture.[99] "Cultural corporate governance" in turn would result in more compliance and less crime.[100]

Despite these changes, the Sentencing Commission's definition of what constituted a good compliance program remained vague; corporations were required to implement programs that were "reasonably designed, implemented, and enforced so that the program [was] generally effective in preventing and detecting criminal conduct."[101] Although the amendments further expanded the compliance industry,[102] they arguably fell short of ushering in a new era of corporate ethics.[103]

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had thereby improved corporate culture). Diana Murphy, a former sentencing commissioner, credited the OSG for creating "an entirely new job description: the Ethics and Compliance Officer." *Id.*

96 *See, e.g.*, David Hess et al., *The 2004 Amendments to the Federal Sentencing Guidelines and Their Implicit Call for a Symbiotic Integration of Business Ethics*, 11 FORDHAM J. CORP. & FIN. L. 725, 734–37 (2006).

97 *See* U.S. SENTENCING GUIDELINES MANUAL § 8B2.1.

98 *Id.* at § 8B2.1(a)(2) (requiring organizations to "promote an organizational culture that encourages ethical conduct and a commitment to compliance with the law"), § 8B2.1(b)(2) (requiring organization's "governing authority" to be "knowledgeable about the content and operation of the compliance and ethics program" and "exercise reasonable oversight [over a program's] implementation and effectiveness").

99 News Release, U.S. Sentencing Comm'n, Commission Tightens Requirements for Corporate Compliance and Ethics Programs 1 (May 3, 2004), *available at* http://www.ussc.gov/PRESS/rel0504.htm.

100 *See* Miriam H. Baer, *Corporate Policing and Corporate Governance: What Can We Learn from Hewlett-Packard's Pretexting Scandal?*, 77 U. CIN. L. REV. 523, 544 (2009).

101 U.S. SENTENCING GUIDELINES MANUAL § 8B2.1(a)(2).

102 Tanina Rostain, *The Emergence of Law Consultants*, 75 FORDHAM L. REV. 1397, 1404–05 (2006) (tracking the rise of compliance industry).

103 *See* Hess et al., *supra* note 96, at 725.

Whatever the OSG's value, they eventually were overshadowed by the DOJ's internal charging guidelines for federal prosecutors.[104] The OSG applied only at sentencing, which invariably occurs at the virtual conclusion of a criminal case.[105] Many corporations, however, operated in industries in which they perceived an inability to survive a grand jury indictment, much less the uncertainty stemming from an indictment and possible conviction in criminal court.[106] The OSG could not eliminate the collateral effects of such indictments.

Because of the OSG's shortcomings, putative corporate defendants sought to short-circuit the formal adjudicative process by negotiating an agreement in advance and in lieu of any formal indictment.[107] Accordingly, the United States Attorneys' Offices began during the 1990's, to utilize DPAs—contractual agreements whereby the government agreed not to prosecute the defendant corporation in return for the corporation agreeing to assist the government's investigations and to take remedial measures to improve its internal controls.[108] Although the agreements drew on the OSG for content, deep procedural differences prevailed insofar as the United States Attorney, and not a federal judge, acquired the power to dictate the corporate entity's effective punishment.[109]

2. Delaware's Return

In 1996, the Delaware Chancery Court revisited the issue of director liability for insufficient compliance activity in *In re Caremark Derivative Litigation.*[110] Caremark's shareholders contended that Caremark's directors had violated their fiduciary duties of care by failing to prevent conduct that ultimately led to the company's indictment and steep criminal fines.[111] In his review of a proposed settlement between the company's shareholders and Caremark's directors, Chancellor William Allen observed that the legal landscape had changed considerably from the one that the Delaware Supreme Court encoun-

[104] *See* U.S. ATTORNEY'S MANUAL, PRINCIPLES OF FEDERAL PROSECUTION OF BUSINESS ORGANIZATIONS § 9-28.1200 (2008), *available at* http://www.usdoj.gov/opa/documents/corp-charging-guidelines.pdf (last visited Aug. 22, 2009).

[105] *See* U.S. SENTENCING GUIDELINES MANUAL § 8B2.1(a)(2).

[106] *See* United States v. Stein, 435 F. Supp. 2d 330, 381–82 (S.D.N.Y. 2006) (noting that companies consider criminal indictments the equivalent of a death sentence).

[107] *See* White, *supra* note 89, at 818.

[108] *See id.*

[109] *See id.* at 824–25.

[110] *In re* Caremark Int'l Inc. Derivative Litigation, 698 A.2d 959 (Del. Ch. 1996).

[111] *Id.* at 970.

tered in the *Allis-Chalmers* case.[112] The federal government's use of criminal law and procedure to regulate corporate compliance placed corporate directors in a different position from their earlier counterparts.[113] Prudent directors had no choice but to ensure that their own companies had at least erected systems designed to ensure compliance with the law; otherwise they would be risking severe losses for their companies.[114] Allen concluded that the Delaware Supreme Court's opinion in *Allis-Chalmers* could not foreclose the directors' "obligation to be reasonably informed concerning the corporation," which necessarily included the responsibility of ensuring the existence of information and reporting systems that would provide sufficient information about "the corporation's compliance with law and its business performance."[115]

Even though the Delaware Supreme Court did not formally adopt Allen's approach until over a decade later,[116] lawyers and compliance providers responded to *Caremark* by expanding the level of services available to help directors ensure that proper systems were in place to prevent and detect criminal violations.[117]

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112 *See id.* at 969–70.

113 *See id.* at 969 ("[T]his question has been given special importance by an increasing tendency, especially under federal law, to employ the criminal law to assure corporate compliance with external legal requirements, including environmental, financial, employee and product safety as well as assorted other health and safety regulations.").

114 *See id.* at 970 ("Any rational person attempting in good faith to meet an organizational governance responsibility would be bound to take into account [the federal Organizational Sentencing Guidelines] and the enhanced penalties and the opportunities for reduced sanctions that it offers.").

115 *Id.*

116 Stone *ex rel.* AmSouth Bancorp. v. Ritter, 911 A.2d 362, 370 (Del. 2006).

> We hold that *Caremark* articulates the necessary conditions predicate for director oversight liability: (a) the directors utterly failed to implement any reporting or information system or controls; *or* (b) having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention.

Id.

117 Rebecca Walker, *Board Oversight of a Corporate Compliance Program: The Implications of* Stone v. Ritter, 1661 PLI/Corp. 67, 69 (2008) ("While the standard articulated in *Caremark* was *dicta* . . . it did create a much keener awareness of the importance of board oversight of a company's compliance program, both within the compliance community and among government regulators and legislators.").

3. The DOJ Exercises Control

Despite the fact that Chancellor Allen worded his *Caremark* opinion very carefully so that directors would be held liable only where they exhibited "utter failure" to determine that a compliance program existed and were explicitly relieved of guaranteeing the program's effectiveness,[118] the DOJ expanded the board's obligation to ensure the comprehensiveness and design of the program, and not simply its existence.[119]

As DPAs began to proliferate, the centralized policy-making arm at the DOJ headquarters stepped in to exert control over divergent practices that had developed throughout the individual United States Attorney's offices.[120] In 1999, the Holder Memorandum, the first internal DOJ guideline memorializing "best practices" in corporate criminal prosecutions, was circulated to the individual United States Attorney's offices.[121] The Holder Memorandum was intended primarily for line prosecutors and their local supervisors, some of whom were known to deviate from DOJ priorities when it suited their purposes.[122] Following the structure of the OSG, the Holder Memorandum suggested that corporate prosecutions should be deferred, thus enabling corporations to escape potentially devastating criminal indictments, if prosecutors concluded that corporations had taken appropriate steps to prevent wrongdoing by enacting compliance programs prior to the given instance of misconduct, and were now taking

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[118] *Caremark*, 698 A.2d at 971. "To employ a different rule—one that permitted an 'objective' evaluation of the decision [relating to compliance]—would expose directors to substantive second guessing by ill-equipped judges or juries, which would, in the long-run, be injurious to investor interests." *Id.* at 967.

[119] *See* Memorandum from Mark R. Filip, Deputy Att'y Gen., on Principles of Fed. Prosecution of Bus. Orgs. to Heads of Dep't Components and U.S. Attorneys, § 9-28.800(B), at 15–16 (Aug. 28, 2008), *available at* http://www.usdoj.gov/opa/documents/corp-charging-guidelines.pdf [hereinafter Filip Memorandum].

[120] For a discussion of the tension between the DOJ and the individual United States Attorney's Offices, see generally Daniel Richman, *Federal Criminal Law, Congressional Delegation, and Enforcement Discretion*, 46 UCLA L. REV. 757, 805–10 (1999), and Daniel Richman, *Federal Sentencing in 2007: The Supreme Court Holds—The Center Doesn't*, 117 YALE L.J. 1374 (2008).

[121] Memorandum from Eric H. Holder, Deputy Att'y Gen., on Fed. Prosecution of Corps., § VII, (June 16, 1999), *available at* http://www.usdoj.gov/criminal/fraud/docs/reports/1999/chargingcorps.html [hereinafter Holder Memorandum].

[122] *See* Michael Siegel, *Corporate America Fights Back: The Battle over Waiver of the Attorney-Client Privilege*, 49 B.C. L. REV. 1, 3–4 (2008) ("Prior to 1998, DOJ had no set policy regarding the prosecution of corporations, and many prosecutors did not see the point of charging an entity that . . . could not be put in jail. A memorandum written by then-Deputy Attorney General Eric Holder in 1998, however, changed all this.") (citations omitted).

steps to remedy the misconduct by cooperating with the government and shoring up weaknesses in their compliance programs.[123]

By the end of 2000, following the collapse of a "dot.com"-inspired speculative economy, public firms issued a "wave of financial restatements . . . [that] shook investor confidence and depressed the equity market."[124] In response to significant investor losses and widely reported apprehension about the integrity of capital markets, Congress enacted the Sarbanes-Oxley Act, and the Bush administration promised to vigorously prosecute the individual officers and employees that had been responsible for promulgating securities frauds.[125] Knowing that the prosecution of such individuals would be nearly impossible without the help of the corporations in which they worked, the government set out to shore up its legal apparatus in order to guarantee its ability to prosecute individual wrongdoers.[126]

In 2001, Larry Thompson, then Deputy Attorney General, released a revised memorandum that, unlike the earlier Holder Memorandum, explicitly commanded all prosecutors to consider entity-wide criminal liability for corporations whose employees were targets of investigations for criminal violations.[127] In addition, the Thompson Memorandum clarified that prosecutors would consider the corporation's voluntary waiver of its attorney-client privilege and its willingness to refrain from paying its employees' attorneys' fees as facts relevant to its determination of whether the corporation had adequately cooperated with the government.[128] The Thompson Memorandum's ostensible guidance to prosecutors was understood as the government's attempt to flex its muscle and force corporations to hand over otherwise protected documents and information in exchange for en-

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123 *See* Holder Memorandum, *supra* note 121.

124 John C. Coffee, Jr., *Law and the Market: The Impact of Enforcement*, 156 U. PA. L. REV. 229, 290–91 (2007).

125 *See* Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745 (codified as amended in scattered sections of 11, 15, 18, 28, and 29 U.S.C.); Coffee, *supra* note 124, at 276 ("Since the Department of Justice's Corporate Fraud Task Force was formed in 2002 in the wake of Enron, it has charged over 1300 defendants and obtained over 1000 guilty pleas and convictions."); Griffin, *supra* note 37, at 314–16 (describing the government's war on corporate crime in the wake of Enron and other accounting scandals).

126 *See* Griffin, *supra* note 37, at 331 (tracking an increase in individual liability for criminal misconduct within corporate firms).

127 Memorandum from Larry D. Thompson, Deputy Att'y Gen., U.S. Dep't of Just. to Heads of Dep't Components and U.S. Attorneys on Principles of Fed. Prosecution of Bus. Orgs. (Jan. 20, 2003) *available at* http://www.usdoj.gov/dag/cftf/corporate_guidelines.htm.

128 *Id.*

tity-wide leniency.[129] Following the DOJ's lead, the SEC adopted a similar approach to judging corporate compliance and cooperation in its Seaboard Memorandum, which announced the release of a parent corporation from liability for the conduct of its subsidiary.[130]

Several years later, following a raft of complaints by scholars and practitioners, as well as one well-regarded district court judge presiding over a now infamous prosecution of KMPG partners,[131] Deputy Attorney General Paul McNulty circulated a revised memorandum that kept intact corporations' compliance obligations, but reduced the individual United States Attorney's offices' discretion to ask for attorney-client privilege waivers.[132] Prosecutors who contemplated the need for such materials were first expected to determine if they fell within a factual category (Category I) or a more advisory category (Category II), and then seek approval from appropriate authorities within the DOJ to request such materials from corporate defense counsel.[133] As critics noted at the time and thereafter, the guidelines were non-binding and virtually unenforceable against individual prosecutors within the ninety-four United States Attorneys' offices.[134]

Despite the McNulty Memorandum's wording, prosecutors and the corporate defense bar continued to fight over the scope and frequency of corporate privilege-waivers, culminating in widely publicized hearings before a House Judiciary Subcommittee in 2008.[135] In response to threatened legislation, the DOJ announced yet another

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[129] *See* Sarah Helene Duggin, *The McNulty Memorandum, the KPMG Decision and Corporate Cooperation: Individual Rights and Legal Ethics*, 21 GEO. J. LEGAL ETHICS 341, 353–56 (2008).

[130] *See* Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934 and Commission Statement on the Relationship of Cooperation to Agency Enforcement Decisions, Exchange Act Release No. 44969, 76 SEC Docket 220 (Oct. 23, 2001), *available at* http://www.sec.gov/litigation/investreport/34-44969.htm.

[131] *See* Duggin, *supra* note 129, at 347–48. Judge Lewis Kaplan presided over the government's prosecution of twelve KMPG partners who had allegedly marketed fraudulent tax shelters. *See id.* Over the course of opinions issued in 2006 and 2007, Judge Kaplan pointedly criticized the government's exercise of leverage over KPMG (the entity) in order to gain an advantage in its prosecution of thirteen of KPMG's employees. *See id.* For more on general opposition to the government's leverage of corporate liability to improve its prosecution of individual employees, see *id.* at 353–56.

[132] Memorandum from Paul J. McNulty, Deputy Att'y Gen., U.S. Dep't of Just., to Heads of Dep't Components, U.S. Attorneys (Dec. 12, 2006), *available at* http://www.usdoj.gov/dag/speeches/2006/mcnulty_memo.pdf [hereinafter McNulty Memorandum].

[133] *Id.* at 9–10.

[134] *See, e.g.*, Garrett, *supra* note 43, at 905 (noting that prosecutors' internal guidelines are "legally unenforceable"); Gideon Mark & Thomas Pearson, *Corporate Cooperation During Investigation and Audits*, 13 STAN. J.L. BUS. & FIN. 1, 69–70 (2007).

[135] *See* Duggin, *supra* note 129, at 364.

revision of its charging principles, now known as the Filip Memorandum (promulgated by new Deputy Attorney General Mark Filip), which would require prosecutors to judge the corporation's cooperation on how well the corporation produced relevant facts in the course of the government's investigation.[136] Although this development has been touted by the government as an improvement over McNulty's two-step process, defense practitioners have already begun to question whether "relevant facts" ultimately will include attorney work product and/or privileged communications.[137]

Meanwhile, on the same day the DOJ released the Filip Memorandum, the Court of Appeals for the Second Circuit affirmed Judge Lewis Kaplan's dismissal of charges against eight former employees of the accounting firm, KPMG.[138] The employees, who were former partners of the firm, had been indicted for promoting fraudulent tax shelters.[139] To ward off an entity-level indictment, KMPG had cooperated with the government by terminating prior agreements to pay its employees' attorneys' fees and by threatening those employees still working at the firm with summary termination if they failed to cooperate with the government's investigation.[140] Contemplating that the Second Circuit would affirm the district court's determination that such conduct constituted illegal state action in violation of the employees' Fifth and Sixth Amendment rights,[141] Deputy Attorney General Filip announced that the DOJ would no longer consider the cor-

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[136] *See* Letter from Mark Filip, Deputy Att'y Gen., to Senators Patrick Leahy and Arlen Specter, July 9, 2008, *available at* http://www.gibsondunn.com/publications/Documents/FilipLetter070908.pdf [hereinafter Filip Letter]; Filip Memorandum, *supra* note 119, at 9.

[137] *See* Mark J. Stein & Joshua A. Levine, *The Filip Memorandum: Does It Go Far Enough?*, N.Y. L.J., Sept. 11, 2008, *available at* http://www.law.com/jsp/ihc/PubArticleIHC.jsp?id=1202424426861 ("The thrust of the Filip Memo is that DOJ simply wants the facts . . . . The obvious problem is that the 'facts' uncovered in an internal investigation are actually an attorney's distillation of numerous interviews and documents and therefore work product.").

[138] *See* United States v. Stein, 541 F.3d 130, 158 (2nd Cir. 2008); Filip Memorandum, *supra* note 119.

[139] *Stein*, 541 F. 3d at 137.

[140] *Id.*

[141] *See* United States v. Stein, 435 F. Supp. 2d 330, 356 (S.D.N.Y. 2006) (finding violation of 5th and 6th Amendment rights due to government's pressure on KPMG to overrule its prior practice of paying its employees' legal expenses for criminal investigations); United States v. Stein, 440 F. Supp. 2d 315, 337–38 (S.D.N.Y. 2006) (holding that the government violated employees' 5th Amendment rights by encouraging KMPG to condition continued employment and payment of attorneys' fees on employees' willingness to speak with government investigators); United States v. Stein, 495 F. Supp. 2d 390, 394 (S.D.N.Y. 2007) (dismissing indictments against affected KMPG defendants).

poration's payment of attorneys' fees, nor its retention of targeted employees, as factors in determining whether the firm had cooperated with the government.[142] Failure to sanction culpable employees, however, would still be a factor in determining the compliance program's overall effectiveness.[143]

Regardless of these skirmishes, the structure of compliance regulation has remained remarkably stable over the last two decades. Firms that monitor, discipline, and report their noncompliant employees to government authorities are eligible for prosecutorial leniency; firms that forego such activities do so at their peril.[144]

C. *Compliance Regulation as Informal Adjudication*

As the foregoing section demonstrates, corporate compliance is a creature of federal criminal law.[145] Although numerous other agencies assist in regulating compliance, the DOJ, by dint of its power to bring criminal charges, is one of the most powerful—and therefore most prominent—institutions with the authority to declare a corporation's compliance program effective or deficient.[146]

No doubt, many other agencies have far more expertise and responsibility to issue and monitor a wealth of industry-specific regulations. Moreover, agency officials who work with prosecutors may temper or influence the decision-making of prosecutors and high-level DOJ officials.[147] As a result, compliance officers may focus their daily tasks more on industry-specific regulations than on the DOJ's broad directives.[148] But when either the DOJ (or, more commonly, a particular United States Attorney or one of the prosecuting attorneys) announces that a company's compliance controls are deficient, other

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[142] Filip Letter, *supra* note 136, at 2.

[143] Filip Memorandum, *supra* note 119, at 17.

[144] *See* Holder Memoradum, *supra* note 121.

[145] *See* Daniel Richman, *Prosecutors and Their Agents, Agents and Their Prosecutors*, 103 COLUM. L. REV. 749, 751–52 (2003).

[146] *See* Jeffrey Standen, *An Economic Perspective on Federal Criminal Law Reform*, 2 BUFF. CRIM. L. REV. 249, 263 (1998) (arguing that prosecutors enjoy a "monopoly" over charging decisions, and their monopoly in turn allows them to extract "rents").

[147] Daniel Richman, *supra* note 145, at 751–52 (2003). For an exploration of how federal prosecutors and their agents might provide mutual checks on their respective exercise of power, see generally *id.*

[148] *See, e.g.*, SEC. INDUS. ASS'N, SURVEY REPORT: THE COSTS OF COMPLIANCE IN THE U.S. SECURITIES INDUSTRY (2006), *available at* http://www.sifma.org/research/surveys/pdf/CostofComplianceSurveyReport.pdf (focusing almost exclusively on compliance with SEC, SRO, and state regulator mandates).

corporations, or more precisely their counsel, listen quite carefully.[149] And well they should. Unlike those other agencies, the DOJ has the singular power to decide whether to bring criminal charges against the corporate entities and individuals that have failed to comply with the law.[150] Moreover, as corporate attorneys are well aware, the ramifications of an administrative enforcement action pale in comparison to the direct and collateral consequences of even the announcement of a potential criminal investigation.[151] Accordingly, the DOJ carries more power in the compliance arena than observers ordinarily would expect.[152]

Because many corporations cannot shoulder the direct and indirect costs of a criminal indictment, the federal compliance regulation process takes place largely outside any formal legal process.[153] The predominant model of corporate compliance regulation in the United States is therefore one of informal adjudication.[154] Through increasingly broad federal criminal statutes and the *respondeat superior* rule of corporate criminal liability, the DOJ has harnessed the power to define compliance standards, to examine compliance programs when firms' employees violate the law, and to impose sanctions and demand changes in those programs determined to be defective.[155]

The term "adjudication" is used quite broadly here to mean a system in which the government investigates and sanctions compliance failures on a case-by-case basis after such failures have occurred.[156] Although the DOJ's charging criteria mimic agency rule-making procedures in the sense that they apply prospectively and broadly to all business organizations, these standards are internal

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149 *See* FIN. SERVS. ROUNDTABLE, THE COMPLIANCE FUNCTION IN DIVERSIFIED FINANCIAL INSTITUTIONS 27–28 (2007), *available at* http://www.fsround.org/publications/pdfs/ComplianceFunctioninDiversifiedFinancialInstitutions.pdf (highlighting and discussing both the OSG and the DOJ's internal charging memoranda). The DOJ's influence over corporate compliance professionals is purposeful, as the DOJ uses its power to reform "an entire industry." *See* Kathleen M. Boozang & Simone Handler-Hutchinson, *"Monitoring" Corporate Corruption: DOJ's Use of Deferred Prosecution Agreements*, 35 AM. J.L. & MED. 89 (2009) (noting the health care industry's interest in DOJ prosecutions and deferred prosecution agreements).

150 Peter Spivack & Sujit Raman, *Regulating the "New Regulators": Current Trends in Deferred Prosecution Agreements*, 45 AM. CRIM. L. REV. 159, 159–61 (2008).

151 *See* Boozang & Handler-Hutchinson, *supra* note 149, at 89.

152 *See id.* at 89–90.

153 *See* Rakoff, *supra* note 13, at 160.

154 *See id.*

155 *See* Ridge & Baird, *supra* note 7, 197–99.

156 *See* William Araiza, *Agency Adjudication, the Importance of Facts and the Limitations of Labels*, 57 WASH. & LEE L. REV. 351, 353 (2000).

guidelines that are wholly unenforceable.[157] They acquire detail solely as a result of the process through which the DOJ investigates, prosecutes, and ultimately disposes of the corporation's case.[158] Indeed, they are intended to help the prosecutor decide how to dispose of a *particular* investigation. Insofar as this process requires the company's lawyers to hand over documents, debate relevant facts, and urge a particular outcome for their client, the process is functionally "adjudicative" in that the parties debate how a particular entity ought to be treated in light of prior events and previously formulated charging standards.[159]

Despite the fact that the government and corporate defense counsel bargain over various issues in the shadow of this quasi-adjudicative process, the term "negotiated governance"[160] fails to reflect the reality of corporate criminal procedure. By the time a corporation becomes the subject of a federal criminal investigation, it has little ability to negotiate the core of its fate. It must accede to legal demands for documents, produce witnesses in response to grand jury subpoenas, and most importantly, agree to substantially whatever compliance reforms the government requests. Otherwise, the corporate defendant runs the serious risk that it will be indicted.

If this process is functionally adjudicative, it is of course not fully adjudicative in one very important respect: there is no neutral, third-party arbiter that mediates the competing claims of two adversaries

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[157] *See supra* note 134 and accompanying text.

[158] *See* Rachel Barkow & Peter Huber, *A Tale of Two Agencies: A Comparative Analysis of FCC and DOJ Review of Telecommunications Mergers*, 2000 U. CHI. LEGAL F. 29, 59. Because the DOJ's process is informal, the term "adjudication" as used here is broader than the more formal process described by the Administrative Procedure Act, 5 U.S.C. § 551(7) (2006) (defining "adjudication" as "agency process for the formulation of an order"). "The APA has no explicit provisions for informal adjudication." Araiza, *supra* note 156, at 357 n.34.

[159] Rachel Barkow and Peter Huber provide an instructive explanation of how the adjudicative process deliberately narrows the scope of information received, and public participation in its process:

> Because adjudication begins from the reactionary premise that government should interfere only when particular parties bring a specific matter before it, it is not a process designed to obtain the massive amounts of information needed to formulate general policy that affects large numbers of individuals. Thus, the general public is not entitled to notice of the action, nor is it given the right to comment on all the issues raised by the matter.

Id.

[160] *See* Krawiec, *supra* note 11, at 487.

and their counsel.[161] Instead, the DOJ effectively plays two roles throughout the process: judge and prosecutor.[162] As discussed in Part II, the DOJ's assumption of these roles, as well as its determination to conduct much of its analysis outside the public eye, contributes to the accountability problems that arise from the regulation and implementation of corporate compliance.

II. The Drawbacks of Adjudicating Compliance

In recent years, a number of scholars have criticized what they believe is an excessive reliance on adjudication-based legal strategies to achieve societal goals.[163] In contrast to free-market adherents who have challenged the substantive outcomes of litigation in purportedly liberal courts, the new critique of adjudication focuses primarily on its procedural shortcomings, including the unintended externalities and transaction costs that have undermined the liberal and democratic values that the litigants sought to enforce in the first place. Susan Carle summarizes:

> Even at its best, litigation is expensive and time consuming. It is surely a much better use of limited resources on all sides to devote efforts to finding creative methods for moving forward, rather than to be involved in endless gamesmanship and finger-pointing focused on what has gone wrong in the past.[164]

Whereas traditional accounts of agency action contrast adjudication with rule-making,[165] more recent discussions contrast adjudication with

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[161] *See* Lon Fuller, *The Forms and Limits of Adjudication*, 92 HARV. L. REV. 353, 382 (1978) (exploring normative consequences of different forms of adjudication).

[162] *See* Ridge & Baird, *supra* note 7, 197–99.

[163] *See, e.g.*, Carle, *supra* note 14, at 325; Susan Sturm, *Second Generation Employment Discrimination: A Structural Approach*, 101 COLUM. L. REV. 458, 462 (2001).

[164] *Id.* "Compared to other forms of regulation, litigation is often unnecessarily complex, protracted, costly, unpredictable, and inconsistent." Timothy D. Lytton, *Using Tort Litigation to Enhance Regulatory Policy Making: Evaluating Climate Change Litigation in Light of Lessons from Gun-Industry and Clergy-Sexual-Abuse Lawsuits*, 86 TEX. L. REV. 1837, 1837 (2008) (formulating a framework for determining when litigation might enhance regulation).

[165] *See, e.g.*, David Zaring, *Rulemaking and Adjudication in International Law*, 46 COLUM. J. TRANSNAT'L L. 563, 570 (2008) ("Regulation through rulemaking classically involves the promulgation of standards of general applicability that apply prospectively . . . . Regulation through adjudication is different. It is individualized, and makes policy by resolving disputes over particular issues, generally after the fact.") (citations omitted); *see also* Colin S. Diver, *Policymaking Paradigms in Administrative Law*, 95 HARV. L. REV. 393 (1981).

less formal methods of regulation.[166] In doing so, scholars focus on the relational—rather than on the formal—characteristics of these governance structures. For example, Daniel Crane contrasts adjudication with a more administrative "governance" approach in the antitrust context.[167] According to Crane, regulation relies on regulators to act in a continuous problem-solving mode, whereas adjudication "requires a binary determination about the conformity of the defendant's comportment with abstract norms."[168] More generally, Cary Coglianese and Robert Kagan contrast "legal processes" of regulatory enforcement (which includes adjudication) with more "social" approaches to regulation, which are "aimed at stimulating cooperative government-business problem-solving."[169] Not surprisingly, it is this socio-legal approach to regulating wrongdoing that forms the basis of the New Governance, which is discussed at greater length in Part IV.

Compliance regulation, which is at once informal and adjudicative, shares a number of the same features that have caused critics to question adjudication's value as a means of enforcing social norms. Moreover, because it occurs in a pre-indictment setting, it lacks the characteristics of more formal systems that ensure informed decision making and accountability.

A. *Lack of Accountability*

Despite the fact that the DOJ does not formally promulgate compliance policy, its prosecutors nevertheless create de facto corporate compliance policies through their investigation and enforcement of individual cases of corporate malfeasance, which in turn are guided by the DOJ's memoranda outlining the criteria for deciding whether to seek corporate indictments.[170] Because it is both informal and self-regulated, this method of policy formation lacks what Rachel Barkow

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[166] Daniel Crane, *Technocracy and Antitrust*, 86 TEX. L. REV. 1159, 1181–1210 (2008).

[167] *See id.*

[168] *Id.* at 1190.

[169] CARY COGLIANESE & ROBERT KAGAN, REGULATION AND REGULATORY PROCESSES, at xvi (2007).

[170] *See* Spivack & Raman, *supra* note 150, at 161 ("In a post-Enron world, DOJ officials appear to believe that the principal role of corporate criminal enforcement is to reform corrupt corporate cultures—that is, to effect widespread structural reform."). For discussions of "regulation by prosecution," see Baer, *supra* note 6, at 1065 (discussing "regulation by prosecution" phenomenon in corporate criminal law), and more generally, KARMEL, *supra* note 53.

has identified as two "cornerstones of administrative law—reasoned decisionmaking and judicial review . . . ."[171]

Corporate compliance regulation does not invite "reasoned decisionmaking." Contrary to the processes designed by the APA, the DOJ does not propose rules subject to notice and comment from interested stakeholders. Instead, the centralized DOJ issues off-the-rack compliance guidelines and the decentralized United States Attorneys' offices add detail to those guidelines through individual prosecutions, with some help from industry-specific agencies such as the EPA and SEC.

Additionally, there is no judicial review of corporate compliance regulation because courts have long held unreviewable the prosecutor's discretion not to file an indictment. Such unreviewable exercise of discretion embraces the very internal guidelines that purportedly guide prosecutorial discretion.[172] Unless they affect an individual defendant who decides to press his case in court, the prosecutors' compliance-related decisions will likely never make their way to a courtroom.[173]

Moreover, unlike designated experts in administrative agencies, prosecutors do not review compliance plans prior to their implementation, test compliance processes over time, pool information learned from disparate firms, consult on a regular basis with compliance officers on key issues or concerns, or address procedural shortcomings as they discover them.[174] They may, in certain instances, assign a monitor to the corporation as part of a DPA, but the monitor's goals are themselves unclear[175] and the information that the monitor uncovers is not required to be systematically pooled by the government for future

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[171] Rachel Barkow, *The Ascent of the Administrative State and the Demise of Mercy*, 121 HARV. L. REV. 1332, 1365 (2008). For further discussions of how prosecutors lack accountability, see generally Douglas Husak, OVERCRIMINALIZATION 27 (2008) (arguing that prosecutors' "discretionary power, unchecked and unbalanced by other branches of government, is incompatible with the rule of law"), and Stephanos Bibas, *Prosecutorial Regulation Versus Prosecutorial Accountability*, 157 U. PENN. L. REV. 959 (2009).

[172] Barkow, *supra* note 171, at 1351–52 ("Prosecutors need not follow any particular protocols before reaching a decision not to bring charges, nor must they provide reasons for their decision.").

[173] *See id.* at 1352. The best example of this lack of review comes from the individual KPMG defendants who challenged the government's strong-arming of KPMG to press its advantage with current and former employees who were targets of its investigation. *See* United States v. Stein, 435 F. Supp. 2d 330, 356 (S.D.N.Y. 2006).

[174] *See, e.g.*, James R. Doty, *Toward a Reg FCPA: A Modest Proposal for Change in Administering the Foreign Corrupt Practices Act*, 62 BUS. LAW. 1233, 1244 (2007).

[175] *See* Garrett, *supra* note 43, at 865; Vikramaditya Khanna & Timothy Dickinson, *The Corporate Monitor: The New Corporate Czar?*, 105 MICH. L. REV. 1713, 1737 (2007) (recommending "greater specificity in the DPA about the tasks and powers of monitors").

proactive use.[176] Whatever care individual line prosecutors may give to their individual decisions to forego prosecution, the system in which they operate provides little opportunity for them to engage in a system-wide evaluation of corporate compliance regulation, much less its costs and benefits to society.[177]

Absent the structures that compel either reasoned decision-making up front, or judicial review at the back end, the DOJ retains neither the obligation nor the incentive to measure the societal costs of its compliance regulation.[178] A self-interested agency is unlikely to measure the costs of a policy that, technically, it has not even promulgated.[179] Even if privately-initiated surveys hint at the costs of such policies, the DOJ can question the source of such surveys and thereby undermine their conclusions. Moreover, because the DOJ influences rather than compels compliance purchases for most firms (as only a small percentage come within its formal purview), it can plausibly argue that excessive compliance costs come about through the choices of private firms, and not the broad principles enunciated in the DOJ's charging memoranda.[180]

In sum, adjudication acts as a shield for individual prosecutors, who by definition are not expected to keep track of costs.[181] Rather, they are "tasked with seeking justice . . . by defining the state's en-

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[176] *See* Boozang & Handler-Hutchinson, *supra* note 149, at 29–30. Under an internal guideline known as the Morford Memorandum, circulated in March 2008 in response to congressional inquiries regarding conflicts of interests that arose in the hiring of monitors, the Assistant Attorney General is required to maintain a record of all Deferred Prosecution Agreements that contain a provision for a corporate monitor. *See id.* Nothing in the Morford Memorandum, however, provides for the DOJ to review the monitor's information, to review the information obtained from multiple monitors, or to evaluate the cost-effectiveness of monitors as a whole. *See id.* at 29–31.

[177] *See* Garrett, *supra* note 43, at 875. Admittedly, it may be both difficult and costly to engage in this type of analysis because "compliance effectiveness measures are difficult to create and quantify." *See* ERNST & YOUNG, *supra* note 10, at 12 (finding that only nine percent of respondents had reported developing measures to evaluate reduction in legal exposure). For a discussion of the challenges of measuring the inputs and outputs of public (as opposed to private) enforcement institutions, see generally Howell Jackson, *The Impact of Enforcement: A Reflection*, 156 U. PA. L. REV. 400 (2008).

[178] *See* Garrett, *supra* note 43, at 875.

[179] Devins & Herz, *supra* note 52, at 578.

[180] For a general argument that the executive branch should find methods to generate policy other than through DOJ litigation decisions, see Devins & Herz, *supra* note 52, at 578 ("[A]ctual policymaking authority in any given area belongs to the [administrative] agency, not DOJ. Giving DOJ control of federal litigation is certainly an inadequate, arguably an irrelevant, and possibly a perverse way of achieving presidential control of agency policymaking.").

[181] *See* Garrett, *supra* note 43, at 875.

forcement goals and deciding when to prosecute those they deem deserving of criminal sanction."[182] Upholding the public interest and seeking justice, however, are concepts "so diffuse and elastic that they do not constrain prosecutors much, certainly not in the way that an identifiable client would."[183] Accordingly, the DOJ can justify most compliance-related commands as serving the interests of justice and the public interest, regardless of their actual effectiveness or costs.[184]

B. *Adversarialism I: The Corporation and the Government*

One of the reasons compliance regulation is costly is that it is extremely adversarial, and it is dominated by accusations, legalistic requests and responses, increasing levels of distrust, and extremely high legal fees.[185] Adversarialism has different meanings. Used in a narrow legal context, "adversarialism" refers to a formal legal process of accusations lodged by the government that are tested before a juror and judge.[186] This is in contrast to the European inquisitorial system, in which fact-finding, case development, and decision making are all lodged in the same body.[187] For example, Geraldine Szott Moorh has suggested that the federal criminal justice system shares certain characteristics of an inquisitorial system because federal prosecutors exercise so much power at both the investigation and charging stages of criminal cases.[188]

In the broader regulatory context, "adversarialism" (or sometimes "adverseness") is a socio-legal term that has come to describe the relationship between the government and regulated parties; in such in-

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[182] *Id.*

[183] Bibas, *supra* note 171, at 961.

[184] *See id.*

[185] *See, e.g.*, David Crawford & Mike Esterl, *Siemens Pays Record Fine in Probe*, WALL ST. J., Dec. 16, 2008, *available at* http://online.wsj.com/article/SB122936135680907233.html (reporting that Siemens Inc., in its defense of an FCPA investigation, paid more than $850 million in fees and expenses to its outside law firm, Debevoise & Plimpton, and to its accountant, Deloitte & Touche).

[186] Gerard Lynch, *Our Administrative System of Criminal Justice*, 66 FORD. L. REV. 2117, 2119, 2143 (1998).

[187] Although American criminal procedure is iconically adversarial, it includes a number of "inquisitorial" aspects. *See, e.g.*, *id.* at 2119, 2147–48 (explaining that procedures such as plea bargaining and other administrative procedures have introduced inquisitorial aspects to American criminal procedure).

[188] *See* Geraldine Szott Moorh, *Prosecutorial Power in an Adversarial System: Lessons from Current White Collar Cases*, 8 BUFF. CRIM. L. REV. 165, 168 (2004). Moorh is critical of this quasi-inquisitorial system because it "operates without the benefit of institutional arrangements and procedures that provide a counter-weight to prosecutorial power." *See id.*

stances, it is the opposite of cooperative or collaborative governance.[189] As used here, adversarialism implies a temperament, and not a distinct, idealized structure.

It is hardly an overstatement to say that most of the people who staff the United States Attorneys' offices and implement DOJ policy are temperamentally adversarial.[190] Prosecutors who oversee the investigation of corporate entities also oversee the prosecution of the individual officers and employees of those corporations.[191] Like all litigators, prosecutors are particularly "trained and steeped in the adversary system."[192] The war-like temperament that one adopts in one context can bleed over to some other, quasi-administrative context with potentially negative consequences.[193] To the extent prosecutors use corporate criminal liability to fuel their prosecutions of individual employees, corporate criminal procedure—which inherently includes corporate compliance—is war by other means.[194]

In the criminal context, the adversarial model is often reflexively justified as the best way to defend the accused from the state's arbitrary power and provide accuracy and reliability.[195] In the regulatory context, the argument for adverseness flips: instead of protecting the

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[189] *See* ROBERT KAGAN, ADVERSARIAL LEGALISM: THE AMERICAN WAY OF LAW 3, 9 (2001); Lynch, *supra* note 186, at 2143.

[190] *See* Rebecca Hollander-Blumoff & Tom Tyler, *Procedural Justice in Negotiation: Procedural Fairness, Outcome Acceptance, and Integrative Potential*, 33 LAW & SOC. INQUIRY 473, 474 (2008).

[191] For example, two of the original prosecutors who indicted the thirteen employees in the KPMG case were the same prosecutors who negotiated the company's deferred prosecution agreement. *See supra* notes 138–143 and accompanying text (discussion of KPMG).

[192] Hollander-Blumoff & Tyler, *supra* note 190, at 474 (arguing that the adversary system "with its duty of zealous representation, encourages attorneys to exalt their client's interests while ignoring or denigrating those of their opponent"). Although Hollander-Blumoff and Tyler ascribe these characteristics to lawyers generally, their observations are particularly relevant with regard to prosecutors and litigators generally. *See id.*

[193] Lynch, *supra* note 186, at 2120–21 (questioning whether adversarial temperament of prosecutors is desirable as criminal procedure becomes more administrative).

[194] Edward Diskant, Note, *Comparative Corporate Criminal Liability: Exploring the Uniquely American Doctrine Through Comparative Criminal Procedure*, 118 YALE L.J. 126, 152 (2008) ("American prosecutors leverage the powers they possess over corporations . . . to facilitate the prosecution of individual directors otherwise protected by American criminal procedure."); *see also* HASNAS, *supra* note 83, at 23–29 (explaining that *respondeat superior* criminal liability for corporations is a solution for criminal procedure hurdles).

[195] *See, e.g.*, Gideon v. Wainwright, 372 U.S. 335, 345 (1963) (establishing right to counsel in criminal trials); Daryl Brown, *The Decline of Defense Counsel and Rise of Accuracy in Criminal Adjudication*, 93 CAL. L. REV. 1585, 1590 (2005) (suggesting that persistent underfunding of defense counsel has weakened the adversary system's protection of criminal defendants and undermines the adversary system's promise of accuracy).

accused from the state, it protects the state from powerful special interests.[196] "Regulatory adversarialism" prevents regulated entities from capturing their government monitors.[197] For example, William Bratton argues:

> Early in the agency's life cycle . . . [the agency's] actors maintain an adverse posture, perhaps activated by an original regulatory vision. Later on, personal career interests, interest group influence activities and the cooperative dispositions that accompany personal relationships can cause administrators' motivations to shift in a more accommodating direction. The regulatory mission becomes compromised as a result.[198]

For Bratton, an adversarial posture goes hand in hand with good regulation.[199] Without it, regulators lose the healthy dose of skepticism necessary to monitor and discipline rent-seeking private actors.[200]

In the wake of the 2009 financial crisis and the meltdown of the preceding year, much criticism has focused on regulators, including the SEC, the Federal Reserve, and the Treasury Department, among others, that allegedly were captured by private business and unable to issue sound regulations or enforce the regulations already on the books.[201] According to this narrative, because of political ideology or simply a selfish intent to secure future employment in the private sector, feckless regulators allegedly ignored the significant risks that financial institutions and other corporations took, which were far in excess of their assets.[202] The Bush administration made matters worse by either reducing

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[196] *See* William Bratton, *Enron, Sarbanes-Oxley and Accounting: Rules Versus Principles Versus Rents*, 48 VILL. L. REV. 1023, 1032 (2003).

[197] *See id.*

[198] *Id.*

[199] *See id.*

[200] *See id.*

[201] *See, e.g.*, Norman Poser, *Why the SEC Failed: Regulators Against Regulation*, 3 BROOK. J. CORP. FIN. & COMM. L. 289, 289 (2009) (arguing that the main reason for the decline in capital markets is that the SEC "succumbed to the anti-regulatory climate of recent years. Too many of its members just did not believe in regulation."). For the claim that SEC investigators refrained from aggressive investigations because they sought, or would soon be seeking, jobs in the private sector, see Michael Lewis & David Einhorn, *The End of the Financial World as We Know It*, N.Y. TIMES, Jan. 4, 2009, at 3, *available at* http://www.nytimes.com/2009/01/04/opinion/04lewiseinhorn.html; *see also* Stavros Gadinis, *Is Investor Protection the Top Priority of SEC Enforcement? Evidence from Actions Against Broker-Dealers* (Harvard Law and Econ. Discussion Paper No. 27, 2009), *available at* http://ssrn.com/abstract=1333717.

[202] *See* Lewis & Einhorn, *supra* note 201, at 3. For a more sophisticated psychological account of how people can be drawn into "inner circles" and become blinded by cognitive

agency resources or encouraging agencies to hire personnel who neither understood the entities they were regulating nor were particularly inclined to intervene in their business decisions.[203]

However true it may ring in some sectors, there is a limitation to the claim that the government's overly cozy relationship with the private sector produced the current financial meltdown and all of its attendant problems.[204] Not *everyone* in the government enjoyed a warm relationship with private actors. Few commentators who witnessed the DOJ's stance toward corporate actors in the wake of Enron's meltdown would describe the DOJ as captured.[205] Federal prosecutors are not as likely to fall prey to capture as their counterparts in administrative agencies because, unlike the policymakers at the SEC and similar agencies, prosecutors are judged primarily by their criminal convictions.[206] Prosecutors become famous and sought-after in the private sector for convicting and incarcerating CEOs, not for declining to prosecute them.[207]

Finally, prosecutors are less prone to capture than other administrative actors in part because they work in an explicitly adversarial at-

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biases and paralyzed by group pressures, see James Fanto, *Whistleblowing and the Public Director: Countering Corporate Inner Circles*, 83 Or. L. Rev. 435, 460–71 (2004).

203 Lewis & Einhorn, *supra* note 201, at 3. Lewis and Einhorn observed that when a tipster informed the SEC that Bernard Madoff was engaging in a Ponzi scheme, the branch chief of the SEC's division of enforcement lacked the tools necessary to understand the scheme. *See id.* at 4. Moreover, Lewis and Einhorn note that

> [t]he new director of risk assessment was no more likely to grasp the risk of Bernard Madoff than the old director of risk assessment because the new guy's thoughts and beliefs were guided by the same incentives: the need to curry favor with the politically influential and the desire to keep sweet the Wall Street elite.

Id.

204 *See* Moorh, *supra* note 188, at 165.

205 *See id.* (observing prosecutors' aggressive prosecution of white collar criminals in the wake of Enron's collapse). In fact, "[r]iding a tide of public outrage following the discovery of massive fraud at Enron and other firms, prosecutors have attained something akin to heroic status." *Id.*

206 *See* Posting of David Zaring to The Conglomerate Blog, *Einhorn and Lewis on the Financial Crisis*, http://www.theconglomerate.org/2009/01/einhorn-and-lew.html (Jan. 4, 2009).

207 *See id.* (arguing that prosecutors prosper more from high-profile prosecutions than from declinations or losses); *see also* Lawrence A. Cunningham, *Beyond Liability: Rewarding Effective Gatekeepers*, 92 Minn. L. Rev. 323, 378 (2007) (observing that former New York Attorney General Eliot Spitzer was treated as a hero for his high-profile prosecutions of businesses).

mosphere that encourages them to be aggressive.[208] When prosecutors take on the additional role of "regulator," however, considerable costs may arise from this adversarial stance.[209] Robert Kagan has criticized the adversarial nature of litigation because it is "markedly inefficient, complex, costly, punitive, and unpredictable" and because it inspires legal defensiveness and contentiousness among its key players: lawyers.[210] These attitudes, in turn, "impede socially constructive cooperation, governmental action, and economic development, alienating many citizens from the law itself."[211]

Although Kagan's analysis pertains primarily to formal processes such as civil discovery and criminal trials, his critique applies as well to more informal, but equally adversarial processes. Within the corporate compliance context, the government and corporate defense attorneys, as lawyers, naturally distrust each other.[212] Except to negotiate a particular disposition of corporate wrongdoing, government prosecutors and corporate defense attorneys do not work with each other on a regular basis. Despite the DOJ's valiant attempt to portray the government and corporations as partners[213] in the policing of corporate crime, the backdrop of criminal law undermines any serious notion that the prosecutors and corporate defense attorneys have anything more than a temporary and combustible joint interest. As a

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[208] *See* Posting of David Zaring, *supra* note 206; *see also* Cunningham, *supra* note 207, at 378.

[209] This argument is not unprecedented. For an earlier claim that "adversarial relations" can injure regulatory initiatives, see JAY SIGLER & JOSEPH MURPHY, INTERACTIVE CORPORATE COMPLIANCE: AN ALTERNATIVE TO REGULATORY COMPULSION, at viii (1988) (contending that regulation's success has been undermined by "the adversarial character of the administrative structures built to manage the problems of business-government relationships"). Much of Sigler and Murphy's argument is a precursor to the calls for "responsive regulation" that Ian Ayres and John Braithwaite later made in their book, which is discussed at length in Part IV. *See infra* notes 302–391 and accompanying text.

[210] KAGAN, *supra* note 189, at 4.

[211] *Id.* For the view that adverse relationships deter wrongdoing, see Bratton, *supra* note 196, at 1029 (arguing that threat of legal liability and reputational costs for poor gatekeeping brought "a needed adverseness to the auditor-client relationship").

[212] Duggin, *supra* note 129, at 348 ("The corporate cooperation controversy lies uniquely within the province of the legal profession. Lawyers created the policies at issue; lawyers continue to implement the challenged strategies; and lawyers advise client entities to submit to privilege waiver and other corporate cooperation demands.").

[213] *See* Deputy Att'y Gen. Mark R. Filip, Remarks at ABA Securities Fraud Conference (Oct. 2, 2008), *available at* http://www.usdoj.gov/dag/speeches/2008 [hereinafter *Filip Remarks*] ("[T]he Department believes that it shares a common cause with responsible corporate leaders: we are all committed to promoting the public's trust and security in our markets . . . . Given these common interests, the government often has an important ally in the investigation of potential corporate wrongdoing: the corporation itself.").

result, opportunities for useful and timely (that is, pre-scandal) exchanges of information between firms and prosecutors are low.[214]

Post-scandal, despite facial claims of cooperation, the adversarial nature of the compliance process further incentivizes parties to lock down information, which in turn fuels further distrust and aggression.[215] Indeed, the government prosecutor's struggle to obtain the corporation's internal information has all but dominated the compliance discussion in legal and political circles for the prior decade.[216]

This information-reducing spiral proceeds as follows: The threat of significant individual and entity-level criminal sanctions triggers the entity's instinct to rely on its attorneys.[217] The corporation's lawyers, in turn, collect and repackage their client's information, utilizing legal rules such as the corporate-attorney client privilege to tightly control the manner by which the corporation disseminates information to the government and the public at large.[218] In response, the government increases its demands, backed by severe sanctions, for additional information.[219] The government ultimately forces the corporation to waive its attorney-client privilege by threatening the corporate defendant with a potentially devastating criminal indictment.[220] Undeterred, the corporate defense bar responds by appealing to Congress to enact a law that forbids the government from requesting such waivers.[221] The government responds by backing down from such waiver requests, but nevertheless maintaining its right to seek all "relevant facts" from the corporation that seeks credit for cooperating in government investigations.[222] Thus, the spiral—and the substantial administrative and transaction costs that it fuels—shows little sign of repose.[223]

It is difficult to conceive of the above contest as anything but Kagan's definition of adversarial legalism. Rather than focusing on the

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214 *See* Simon, *supra* note 20, at 142.

215 *See id.* (observing "strong confidentiality safeguards [in litigation] . . . and an emphasis on the role of lawyers in the strategic control of information").

216 *See* Duggin, *supra* note 129.

217 *See* Samuel Buell, *Criminal Procedure Within the Firm*, 59 STAN. L. REV. 1613, 1614 (2007). It should come as no surprise that one of the corporate bar's general concerns with the government's procedures in investigating and sanctioning firms is that such a process "depriv[es] firms of information control and bargaining power . . . ." *Id.* at 1615.

218 *See id.* at 1618.

219 *See id.*

220 *See id.*

221 *See* Attorney-Client Privilege Protection Act of 2007, S. 186, 110th Cong. (2007); Attorney-Client Privilege Protection Act of 2006, S. 30, 109th Cong. (2006).

222 *See* Filip Memorandum, *supra* note 119, at 9.

223 *See* Buell, *supra* note 217, at 1615.

internal processes that thwart compliance, much less explaining inherent compliance risks to investors, the process encourages battalions of attorneys to fight to the death over the dispersal of documents and related information, all without learning—or doing—anything new.[224]

C. *Adversarialism II: The Corporation and its Employees*

The adjudicative model of compliance regulation effectively forces the corporation's counsel to adopt an adversarial posture towards the corporation's employees.[225] As Professor Samuel Buell has observed, the criminal procedure of corporate criminal liability effectively interposes the corporation between the government on one hand, and the individual employee-targets of the government's investigation on the other.[226] The opening statement that corporate attorneys routinely recite to employees during an internal investigation is "the corporate *Miranda* warning," which advises the employee that no attorney-client privilege exists between the employee and the corporation's attorney.[227] For their own protection, employees thus become the equivalent of criminal suspects.

Although the DOJ has repeatedly intoned a desire to improve corporate culture within firms, the practical components of this interest in culture link directly back to the prosecutor's ability to identify and convict individual employees.[228] Good corporate culture is synonymous with monitoring, discipline, and reporting, because these are the key attributes of the prosecutor's culture.[229] The prosecutor's culture, however, is one that is populated by legal adversaries and law enforcement agents.[230] Accordingly, adjudication not only pits the firm against the government, but it also pits the firm's compliance

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[224] *See id.*

[225] *See* Ridge & Baird, *supra* note 7, at 196.

[226] *See* Buell, *supra* note 217, at 1616, 1634–62; *see also* Duggin, *supra* note 129, at 346–47 (arguing that the DOJ's stance towards corporations forces corporate defense lawyers to become "de facto government agents").

[227] Duggin, *supra* note 129, at 406 (noting that the practice has become common among corporate attorneys).

[228] *See* Duggin, *supra* note 129, at 359 (citing then-Deputy Attorney General Paul McNulty's congressional testimony that corporate cooperation policies "are essential tools in holding corporate wrongdoers accountable").

[229] *See* Cunningham, *supra* note 207 at 333–37.

[230] *See id.* at 325. This may be a problem with lawyers more generally and not just prosecutors. *See id.* at 326 (observing that lawyers are better versed in creating liability-based systems that punish than in creating systems that reward auditors for implementing good internal controls).

apparatus against the rest of the firm.[231] When the cost of being non-compliant is termination or worse, the firm's monitors become the natural adversaries of line employees and their mid-level supervisors.[232] The end result may be a degeneration of the very social norms that would help restrain wrongful behavior.[233]

The adjudicative model of corporate compliance does not take into account these problems. To the contrary, it treats the corporation as a monolithic entity.[234] Although this conception of the firm presents a convenient fiction, it blurs a realistic understanding of the challenges of securing compliance within the firm.[235]

As both a sociological and organizational matter, the study of compliance requires a more detailed understanding of the vacuous notion of the firm.[236] Whereas some firms may organize horizontally through overlapping and diffuse networks, others may divide labor and information within a traditional hierarchical structure.[237] In either case, the structure presents varying opportunities for employees and managers to hide, misrepresent, or simply lose important pieces of information.[238] Cognitive biases and heuristics may exacerbate these gaps.[239]

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[231] *See* HASNAS, *supra* note 83, at 75–79 (explaining how the obligation to monitor and prosecute employees reduces the employees' trust in their supervisors and loyalty to the organization).

[232] *See id.*

[233] *Cf.* Michael P. Vandenbergh, *The Private Life of Public Law*, 105 COLUM. L. REV. 2029, 2076 (2005) (observing that "[s]trong government enforcement . . . [may] undermine prosocial norms" that prevent environmental violations in the first place).

[234] *See* McNulty Memorandum, *supra* note 132, at 2 ("Corporations are 'legal persons,' capable of suing and being sued, and capable of committing crimes.").

[235] *See* Bamberger, *supra* note 24, at 382 (describing cognitive mistakes that undermine decisionmaking within firms). "[A]s regulators turn to regulation that relies less on specific directives and more on judgment within firm boundaries, a stylized theory of the firm as a unitary rational actor provides, at best, an incomplete account of firm decisionmaking." *Id.*

[236] *See* Fanto, *supra* note 202, at 459–60 (calling for social and psychological inquiry into dynamics of corporate governance). "To understand regulation, we need to aggregate firms into industry associations and disaggregate firms into corporate subunits, subunits into individual corporate actors, and individuals into multiple selves." AYRES & BRAITHWAITE, *supra* note 36, at 19.

[237] *Compare* Yane Svetiev, *Antitrust Governance: The New Wave of Antitrust*, 38 LOY. U. CHI. L.J. 593, 620–21 (2007) (describing firms that have adopted more innovative management structures), *with* Stephen M. Bainbridge, *Participatory Management Within a Theory of the Firm*, 21 J. CORP. L. 657, 669–71 (1996) (describing "branching hierarchies" within large public organizations that divide and specialize labor, delegate authority to managers and supervisors of units and subunits, and transmit information up and down different units).

[238] *See* HASNAS, *supra* note 83, at 81 (describing "organizational blocks" that inherently obstruct flows of information within firms); Cunningham, *supra* note 72, at 269 (observing that internal controls are "inherently leaky"); Donald C. Langevoort, *The Social Construction*

Finally, the firm's complexity may make it quite difficult to diagnose, much less generate, a singular corporate culture.[240] Instead, multiple cultures may exist across geographic regions, task-oriented divisions, or between rank-and-file employees and their managers. Accordingly, the compliance risks inherent in one corner of the company may have little or no relation to the risks present in another.

The adjudicative model chooses not to disaggregate firms because disaggregation blurs the lines of culpability. Under the adjudicative model's convenient fiction, the *firm* is guilty of committing a corporate crime. The *firm* failed to implement an effective compliance program, and the *firm* failed to follow through with its promise of cooperation with the government. Any recognition of warring subunits or information gaps within the firm dilutes the moral justification for punishment and the exercise of prosecutorial power.[241]

Whereas it is easy to presume that a monolithic firm has more information about itself than the government actors who regulate it, it is far less reasonable to take this position when the firm is viewed as a combination of complex subunits that continuously maneuver for power and resources.[242] Describing the challenges of investigating wrongdoing within firms, Samuel Buell observes:

> Private organizations are relatively opaque, the more so the larger and more sophisticated they are. Layers of hierarchy must be penetrated to reach principal actors. Division of la-

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of Sarbanes-Oxley, 105 MICH. L. REV. 1817, 1826 (2007) (observing that it is possible that "deficiencies with respect to independent directors result not so much from blind loyalty to the CEO but from an inability to determine when the CEO is not telling the truth about the company or is otherwise unfit to serve"); *see also* Lawrence Mitchell, *Structural Holes, CEO's and Informational Monopolies*, 70 BROOK. L. REV. 1313, 1322–23 (2005) (explaining ways in which managers can control flow of information across overlapping networks and thereby manipulate "structural holes" to their personal advantage).

239 *See* Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Mislead Stock Market Investors (And Cause Other Social Harms)*, 146 U. PA. L. REV. 101, 102 (1997).

240 *See* Lynn Dallas, *A Preliminary Inquiry into the Responsibility of Corporations and Their Officers and Directors for Corporate Climate: The Psychology of Enron's Demise*, 35 RUTGERS L.J. 1, 23 (2003) (observing that the "[c]orporate climate is not static, but is an ongoing process. It may vary among sub-units of the corporation, although the corporation may have a dominant type").

241 *See* Kruse, *supra* note 25, at 724 ("In the law enforcement worldview, society tends to be divided between law-abiders and lawbreakers, with clear moral imperatives to punish lawbreakers.").

242 *Cf.* Lynn Stout & Margaret Blair, *A Team Production Theory of Corporate Law*, 85 VA. L. REV. 247, 264–67 (1999) (describing hierarchy as a means of mediating "horizontal disputes" that arise in the course of production).

> bor makes ascription of responsibility for conduct and results challenging. Organizational activities are often by nature highly complex, involving technologically advanced and specialized means of production that are difficult for outsiders to understand.[243]

Because of these attributes, Buell concludes that government investigators are likely to experience difficulty identifying the sources of criminal conduct within firms.[244]

Although Professor Buell's argument is persuasive, there is no reason that it should not extend to the compliance departments of large corporations. Just like their government counterparts, compliance officers of sophisticated firms also may find themselves stymied by the same "[l]ayers of hierarchy,"[245] divisions of labor, and highly technical decisions that they are likely not to understand.

To be effective monitors, compliance officers must establish a comfortable middle ground between independence and familiarity.[246] If they are too close to the employees they monitor, they may fail to prevent bad behavior.[247] On the other hand, if compliance officers are too remote from the employees in their firm, they will be no better suited than their government counterparts to grasp the firm's internal dynamics.[248]

In the best of worlds, firms would retain the opportunity to experiment to find the optimal relationship.[249] The adjudicative process does not allow for such experimentation, however, because it already treats the firm as a monolith and because prosecutors control the contours of the DPA. Accordingly, firms are far more likely to favor independence than they might otherwise if they were seeking optimal long-term compliance.

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243 Buell, *supra* note 217, at 1625.

244 *See id.*; *see also Filip Remarks*, *supra* note 213, at 1 ("In many cases, corporations are uniquely suited to identify relevant personnel and evidence, to provide relevant business records, and to convey pertinent information to the government.").

245 *See* Buell, *supra* note 217, at 1625.

246 *See* William W. Bratton, *Private Standards, Public Governance: A New Look at the Financial Accounting Standards Board*, 48 B.C. L. Rev. 5, 8 (2007) "There emerges a puzzle for those interested in the design of private governance institutions: How can a private standard setter simultaneously maintain its independence and achieve institutional stability while operating in a politicized context, in the teeth of opposition from its own constituents?" *Id.*

247 *See id.* at 7.

248 *See* Hui Kim, *supra* note 68 (comparing relative monitoring strengths of in-house and outside counsel).

249 *See* Bratton, *supra* note 246, at 8.

Finally, because it treats the firm as a monolith, the adjudicative process fails to recognize the divergence of interests between a firm that seeks leniency and an individual employee who wishes to avoid detection for past crimes.[250] Although employees retain ample opportunity for hiding misconduct,[251] they have little incentive to disclose such misconduct to their organizations once they have broken the law. The Filip Memorandum offers leniency to those firms that attempt to penetrate their layers of bureaucracy, but entity-level lenience does not trickle down to employees.[252] Instead, the Filip Memorandum commands firms to discipline their employees as part of their compliance program.[253]

That the Filip Memorandum trades entity lenience for internal punishment is, unfortunately, one of the less discussed ironies of compliance regulation: whereas the government stresses its own flexible stance towards firms, because flexibility presumably encourages cooperation, it cannot and will not delegate the same flexibility to private firms in how they order their relationships with employees.[254] To the contrary, the government's mercy is possible only if its private proxy, the corporate firm, adopts an entirely *un*merciful stance toward its own employees. Given this state of affairs, rational self-interested employees are likely to respond by hiding their own, or another's, wrongdoing insofar as they conclude that openness produces punishment.[255]

In sum, the adjudicative model of compliance regulation creates a number of transactional costs. Because prosecutors are usually not

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[250] *See supra* notes 225–233 and accompanying text. "People who violate the law go out of their way to avoid getting caught. This is one of the defining features of law enforcement." Chris William Sanchirico, *Detection Avoidance*, 81 N.Y.U. L. REV. 1331, 1332 (2006).

[251] *See supra* notes 225–233 and accompanying text. "[I]t is the complexity of the firm, rather than just the complexity of the regulations, that lies at the root of regulatory violations." Timothy F. Malloy, *Regulation, Compliance and the Firm*, 76 TEMP. L. REV. 451, 459 (2003).

[252] *See* Filip Memorandum, *supra* note 119, at 20. Of course, the government may negotiate separately to sign up certain employees as cooperating witnesses. This process, however, is divorced from the corporation's internal compliance efforts. For a discussion of the cooperation process in the federal criminal system, see generally Caren Myers Morrison, *Privacy, Accountability, and the Cooperating Defendant: Towards a New Role for Internet Access to Court Records*, 62 VAND. L. REV. 921 (2009).

[253] Filip Memorandum, *supra* note 119, at 4.

[254] *Id.* at 13.

[255] *See* Lupone, *supra* note 2, at 526 ("[W]hen problems like this occur in companies, when there is an investigation whether it's internal or there is a threatened indictment, employees watch to see how the company reacts. They watch to see how their fellow employees are being treated.").

held responsible for the costs of their policies, however, there is little government accountability for those costs. However poorly a governance model might recognize and take into account the challenges of identifying and preventing wrongdoing, the adjudicative model of compliance vastly underestimates them due to its reliance on the anthropomorphic fiction that the firm is a "singular person."[256]

III. The Beneficiaries of Corporate Compliance Regulation

One view of corporate compliance regulation is that it endures, despite its costs, precisely because it benefits corporate entities.[257] Under this theory, business leaders embrace the current regime because it allows them to enact cosmetic yet ineffective compliance programs without actually altering the profitable business conduct that violates the law.[258] A better argument is that compliance regulation endures because it aids the two groups most invested in its proliferation: the DOJ and the compliance industry.

A. *The Department of Justice*

It is remarkable that over the last decade, the Deputy Attorney General of the Department of Justice has in some instances exercised greater power over the corporate governance of specific firms than has the Chancery Court of Delaware, or to a lesser extent, the SEC.[259] Through promulgation of the prosecutorial guidelines alone, the DOJ has encouraged the expansion of corporate compliance departments, as

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[256] *See* McNulty Memorandum, *supra* note 132, at 2.

[257] *See, e.g.*, Vikramaditya S. Khanna, *Corporate Crime Legislation: A Political Economy Analysis*, 82 Wash. U. L.Q. 95, 100 (2004).

[258] Ford, *supra* note 21, at 759 ("Extending leniency to firms that have a compliance program in place can mean in practice that formulaic and facial compliance indicia substitute for evidence that a real culture of compliance exists."); Krawiec, *supra* note 11, at 491 (observing that internal compliance programs may "largely serve a window-dressing function that provides both market legitimacy and reduced legal liability").

[259] Indeed, to the extent that the SEC has stepped up its own intervention in corporate governance, its stance and its ability to force companies to accept its terms can be attributed to the DOJ. *See* Barnard, *supra* note 53, at 801 (observing that the SEC's "most intrusive" enforcement actions are usually accompanied by simultaneous criminal charges by the DOJ). Corporations that are the subject of SEC enforcement actions are more likely to accept the SEC's penalties, such as the imposition of a corporate consultant, for example, with less complaint because they know that life could quickly become much worse if the DOJ gets involved. *Cf. id.*

well as the purchase of compliance services, much of it in the form of legal advice and training, sufficient to support a burgeoning industry.[260]

More specifically, by negotiating and administering deferred prosecution agreements, federal prosecutors have caused corporations to reorganize their compliance departments and redesign the ways in which they monitor and interact with employees (the bare minimum of most DPAs), fire key personnel, including high-level officers not formally accused of criminal wrongdoing, hire hand-picked internal monitors, who report to and take orders from prosecutors, and attend meetings with board members regarding the company's outstanding compliance issues.[261]

Some would argue that the DOJ's enhanced profile stems from the populist interest in prosecuting white collar criminals, particularly corporate chieftains. That may well be the case, but the DOJ's ability to tell corporations that they must control their employees' wrongdoing is a function of society's decision to regulate corporate compliance through "back-end" adjudicative methods to the detriment of more transparent front-end regulation or legislation.

"Back-end" methods are when government regulators decline to direct private firms in the first instance ("front-end"), but punish them severely when some triggering event occurs.[262] The analysis here is slightly different from the usual rules versus standards debate, whose usefulness Lawrence Cunningham has rightly questioned.[263] The issue is not so much the level of detail provided to a given rule or standard, but rather, the nature of interaction between the government agency and regulated entity. Front-end regulation presumes frequent interaction, and sometimes intervention, between the government and regulated entities, regardless of whether certain events have

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[260] *See* Cristie Ford & David Hess, *Can Corporate Monitorships Improve Corporate Compliance*, 34 J. CORP. L. 679, 689–92 (2009) (describing growth of compliance industry); *cf.* Usha Rodrigues, *From Loyalty to Conflict: Addressing Fiduciary Duty at the Officer Level*, 61 FLA. L. REV. 1, 29 (2008) (observing that compliance is very expensive).

[261] For discussions of internal compliance programs, see Garrett, *supra* note 43, at 864. For a description of how the United States Attorney in New Jersey commandeered the termination of Bristol-Myers Squibb's CEO during a company board meeting, see Baer, *supra* note 6, at 1070–71. For a discussion of internal monitors, see generally Ford & Hess, *supra* note 260 (surveying and comparing different uses of monitors) and Khanna & Dickinson, *supra* note 175.

[262] *See* AYRES & BRAITHWAITE, *supra* note 36, at 19–20.

[263] Lawrence A. Cunningham, *A Prescription to Retire the Rhetoric of "Principles-Based Systems" in Corporate Law, Securities Regulation and Accounting*, 60 VAND. L. REV. 1411, 1412–13 (2007).

occurred. The purpose of front-end regulation is to prevent the occurrence, or at least reduce the frequency, of such events.

Back-end regulation, by contrast, features little interaction between regulators and entities until the triggering of an event, such as a massive accounting fraud, an environmental disaster, or a financial meltdown. Although back-end regulation focuses on clean-up and punishment, it implicitly regulates firms insofar as it provides them incentives to the triggering events. The back-end method accords with two political aims: the conservative interest in less regulation and the desire to reduce the costs of government programs.

The problem with this approach is that, at least where corporate compliance is concerned, back-end regulation is not "less regulation" and certainly is not free of costs.[264] Although the DOJ has yet to promulgate any formal rules, no one would gainsay its influence in the corporate compliance context. Nor is the substance of such regulation cheap.[265] It only appears less costly because it allocates partial enforcement responsibility to private actors.[266]

In sum, the DOJ benefits from the adjudicative model of compliance regulation in several ways. First, its influence over internal corporate affairs is far greater than one would expect, even for the nation's preeminent criminal attorneys. Second, it can retain such influence without seeking the budget outlays it might otherwise need to accomplish its investigative and prosecutorial goals. Corporate compliance regulation increases the DOJ's power and simultaneously decreases its budget.

Finally, compliance regulation increases the DOJ's power relative to other administrative agencies. Whereas compliance is exactly the type of contextual, fact-specific topic that should be the province of experts within industry-specific agencies, it has become the source of power for generalist prosecutors. This has come about because administrative agencies have been hobbled by a deregulation narrative that prevents them from focusing on compliance problems at the front-end. Such a vacuum leaves the DOJ wide room to recast compliance as criminal matter, and thereby regulate it at the back-end.

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[264] *See* AYRES & BRAITHWAITE, *supra* note 36, at 19–20.
[265] *See id.* at 114.
[266] *See id.*

B. *The Compliance Industry*

The adjudicative model of compliance regulation also has benefitted the compliance industry.[267] Indeed, it has helped create it. First, by declining to define effectiveness in detail, the government's open-ended compliance mandate creates the need for a private compliance industry that performs both gap-filling and signaling functions for putative corporate defendants.[268] For example, lawyers not only advise on specific codes of conduct and compliance policies, but now routinely promote workshops so that *other* attorneys (both in-house and outside counsel) may learn how to implement and monitor compliance for their own corporate practice.[269]

For example, the Practicing Law Institute describes the compliance-oriented services provided by the law firm Mayer Brown LLP.[270] In this case, the relevant compliance services are aimed at corporations seeking to avoid violations of the Foreign Corrupt Practices Act ("FCPA"):

> We advise clients on developing and implementing internal compliance programs to reduce the risks of FCPA violations. We conduct compliance assessments to identify strengths and weaknesses in existing compliance programs. We . . . prepare training and other educational materials, draft compliance

[267] Whether the compliance industry continues to prosper in the current economic climate remains to be seen. *See, e.g.*, Joint Press Release, Health Care Compliance Ass'n and Soc'y of Corporate Compliance and Ethics, Legal and Ethical Violations Risks Seen Rising, but not Res. to Control the Risk (Jan. 6, 2009) *available at* http://www.hcca-info.org/Content/NavigationMenu/AboutHCCA/PressReleases/SurveyResults.pdf (reporting on survey conducted in late 2008 indicating that compliance professionals were concerned about implementing and maintaining compliance reforms in light of the faltering economy and decreasing budgets).

[268] *See, e.g.*, FIN. SERVS. ROUNDTABLE, *supra* note 149, at 33 (describing fifteen elements of effective compliance programs); Krawiec, *supra* note 11, at 494. The gap-filling role of private institutions has been documented elsewhere in public regulation. *See, e.g.*, Michael P. Vandenbergh, *The New Wal-Mart Effect: The Role of Private Contracting in Global Governance*, 54 UCLA L. REV. 913, 915 (2007) (describing how "private contracts form an integral part of the emerging global environmental governance regime"); Vandenbergh, *supra* note 233, at 2073–74.

[269] The Practising Law Institute (PLI) conducts yearly "Corporate Compliance Institutes" in which panels of attorneys and compliance professionals discuss current topics on the subject of corporate compliance. *See, e.g.*, Practising Law Institute, Corporate Compliance and Ethics Institute 2009, http://www.pli.edu/product/seminar_detail.asp?id=47698 (last visited Aug. 23, 2009).

[270] Claudius O. Sokenu, Hector Gonzalez, & David Krakoff, *Is Another Record Year in Store for Foreign Corrupt Practices Act Enforcement*, 1696 PLI/CORP. 195, 225 (2008).

> certification instruments, and counsel internal auditors on evaluations of FCPA compliance programs.[271]

Should the corporation's efforts to implement such a program go awry, the law firm provides further assistance in responding to investigations and representing clients in civil and criminal investigations:

> Our experience includes negotiating the scope of enforcement proceedings, responding to requests for documents, advocating client positions in submissions to and in meetings with DOJ and SEC officials, defending against prosecutions or civil actions, and reaching settlements. . . . A number of our lawyers have served in the DOJ or the SEC prior to their tenure at the Firm and are not only familiar with the enforcement staffs but also have first-hand insights into the considerations that affect prosecutorial discretion in the enforcement of the FCPA.[272]

Mayer Brown is hardly the only top-flight law firm providing compliance-related advice.[273] Many other law firms provide services similar to those outlined above. Nor are law firms the only organizations providing compliance advice. Ernst and Young, Deloitte, KPMG, and many other large and small firms offer a bevy of forensic and consultative services to firms interested in creating, expanding, or testing their internal compliance programs.[274] Technology firms in

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[271] *Id.*

[272] *Id.* at 226.

[273] *See, e.g.*, Foley and Lardner LLP, Corporate Compliance & Enforcement, http://www.foley.com/services/practice_detail.aspx?practiceid=399 (last visited Aug. 23, 2009); Holland and Knight, Compliance Services, http://www.hklaw.com/id16048/mpgid43/ ("In today's business climate of increased regulation, oversight, and enforcement, most companies are aware of the need—and, more and more frequently, the requirement—to design and implement an effective compliance and ethics program.") (last visited Aug. 23, 2009); Jones Day, Corporate Compliance Programs Overview, http://www.jonesday.com/corporate_compliance_programs/(last visited Aug. 23, 2009); Washington DC Corporate Compliance, Skadden, Arps, Slate, Meagher and Flom, LLP, http://www.skadden.com/Index.cfm?contentID=49&officeID=21&focusID=380 (last visited Aug. 23, 2009) (describing compliance services provided by the firm).

[274] *See* Ballard Spahr Andrews & Ingersoll, LLP, Corporate Compliance and Investigations, http://www.ballardspahr.com/about/groups.asp?id=139 (last visited Aug. 23, 2009); Ernst and Young, Services, Corporate Compliance, http://www.ey.com/US/en/Services/Advisory/Fraud-Investigation-and-Dispute-Services/Advisory_FIDS-Services_Corporate-Compliance (last visited Aug. 23 2009); KPMG, Audit http://www.kpmg.com/Global/WhatWeDo/Audit/Pages/default.aspx (last visited Aug. 23, 2009).

particular have benefitted from compliance in industries such as the financial industry.[275]

Even better for the industry, compliance begets more compliance. Once a corporation hires compliance experts to design and implement a compliance program, it will likely also hire experts to audit and monitor the program.[276] Manned by lawyers and encouraged by the government's stance on self-regulation, the compliance industry grows to meet the corporation's growing need to design and manage an internal bureaucracy.[277]

The industry's growth would be desirable if it produced greater compliance and better protection for investors and the general public. In some instances, one can point to specific reforms that compliance organizations have helped establish, such as the "Know Your Customer" practices that the banking industry widely adopted in response to the Bank Secrecy Act ("BSA").[278] Despite this, compliance still has been criticized as failing to improve the value of corporate entities.[279] Although compliance may be useful in specific instances for particularized industries (particularly those problems that can be solved through technology or computer software), as a general rule, it offers little guarantee that managers and officers of firms will comply with their fiduciary and legal obligations.[280]

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[275] FIN. SERVS. ROUNDTABLE, *supra* note 149, at 24 (reporting costs of anti-money laundering compliance controls, a large portion of which "are associated with technology").

[276] *See* Barnard, *supra* note 53, at 808 (observing that after compliance consultants' recommendations are adopted following settlements with SEC, the recommendations then "become subject to periodic review by other consultants").

[277] *See id.* (discussing the broad array of issues that compliance officers and consultants have been called on to address).

[278] *See* U.S. GOV'T ACCOUNTABILITY OFFICE, REPORT TO THE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, U.S. SENATE 37 n.7 (2006), *available at* http://www.gao.gov/new.items/d06386.pdf. Although the BSA was adopted in 1970, many of the compliance-related reporting requirements and reforms were promulgated by Congress in 1987 and later in 1996. *See* Rebecca Gregory, *The Lawyers' Role: Will Uncle Sam Want You in the Fight Against Money Laundering and Terrorism?*, 72 U. MO. KAN. CITY L. REV. 23, 27–28 (2003).

[279] *See, e.g.*, Krawiec, *supra* note 11, at 490.

[280] This may be a reflection of the problem that Samuel Buell identified in his recent article, *The Upside of Overbreadth*, 83 N.Y.U. L. REV. 1491 (2008). Buell contends that resourceful and sophisticated actors drive regulators to make criminal statutes purposely vague ("overbroad") because professional criminals otherwise would find ways to evade more specific laws by relying on loopholes and similar linguistic limitations. *Id.* at 1501–06. Similar problems may plague corporate compliance programs: Although compliance officers seek to ban specific conduct through corporate policies and enforcement regimes, sophisticated actors may find different means to evade both legal and internal compliance rules. *Cf. id.*

There are two main theories for why an entire industry has flourished despite continued questions about its overall value. The first is that corporations purposely erect ineffective compliance programs because they seek to preserve the profits provided by continued noncompliance.[281] Kimberly Krawiec has most explicitly explained this dynamic and tied it to the rise in New Governance regulatory systems: "[A]lthough negotiated governance [a reference to New Governance-style regulation] may well have the capacity to enhance regulatory efficiency under some circumstances, it does not currently achieve that goal in broad and important areas of the law that govern organizational conduct."[282] Krawiec cites evidence suggesting that compliance programs do not reduce incidents of misconduct in numerous areas of the law, "and may largely serve a window-dressing function that provides both market legitimacy and reduced legal liability."[283] Accordingly, compliance fails because it is cosmetic, and negotiated governance—or New Governance as it is now often called—enables this failure.

Although Krawiec's argument is forceful, its explanatory power wanes when one relaxes either of the two assumptions on which it is based.[284] The first assumption is that because noncompliance generally benefits the firm, its leaders will go to great lengths to preserve those benefits absent an appropriate sanction.[285] The second is that firms can discern in advance whether a given compliance product is likely to be effective in detecting or preventing noncompliance. Neither assumption holds true all of the time.

For example, a rational corporate compliance officer[286] who purchases compliance services will calculate their value with regard to two probabilities: the likelihood that the service will prevent noncompliance and the likelihood that the corporation will be punished if noncompliance occurs.[287] The standard presumption is that the compli-

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[281] *See* Krawiec, *supra* note 11, at 490.

[282] *Id.*

[283] *Id.* at 491.

[284] *But see id.* at 491–92.

[285] *But see id.*

[286] For the sake of simplicity, I am assuming that one officer acts on behalf of the entire firm. In reality, multiple employees—whether compliance officers or not—will purchase products that impact their unit's compliance and not necessarily that of the entire firm. I am grateful to William Araiza for bringing up this point and the point in the following footnote.

[287] *See* AYRES & BRAITHWAITE, *supra* note 36, at 19. This analysis assumes either that the officer is acting solely in the company's best interests or that the market is so efficient that the compliance officer's interest is perfectly aligned with the company's. In reality, the

ance officer (who, after all, is supervised and paid by corporate officers and managers) will forego purchases of highly effective compliance products if she predicts little formal or informal punishment for noncompliance. Not all illegal acts, however, redound to the benefit of the corporation. Consequently, even the officer who wishes to maintain the profits of illegal behavior may nevertheless implement "real" measures to protect against those types of noncompliance, such as embezzlement, that benefit individual wrongdoers but no one else.[288]

In contrast to the foregoing, the corporate compliance officer may perceive a *high* expected value of punishment for noncompliance.[289] Although prosecutors rarely indict public corporations, the formal and informal[290] sanctions that follow an indictment are so extreme that firms may conclude that the expected value of punishment (the product of probability and the sanction) is still quite high.[291] Accordingly, a risk-averse compliance officer might be quite happy to implement a highly effective compliance program, presuming the foregone illicit profits pale in comparison to the expected punishment for keeping such profits.[292]

Unfortunately, the compliance officer may not be able to discern *ex ante* the effectiveness of a given compliance program. This is in fact

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compliance officer's personal interests in increasing power or, alternatively, making a preset budget, may affect calculation of risk and therefore result in suboptimal compliance decisions.

[288] *See* Assaf Hamdani, Essay, *Mens Rea and the Cost of Ignorance*, 93 VA. L. REV. 415, 418–19 (2007) (arguing that strict liability is necessary "when the market does not provide offenders with incentives to obtain information"). Assaf Hamdani cites this phenomenon more generally in his discussion of criminal strict liability: "Mens rea attaches a price tag to information concerning offense elements, but offenders might have a variety of market reasons to acquire such information notwithstanding the disincentive that criminal law provides." *See id.* at 418.

[289] *See* Mathew S. Miller, Note, *The Cost of Waiver: Cost-Benefit Analysis as a New Basis for Selective Waiver of the Attorney-Client Privilege*, 83 N.Y.U. L. REV. 1248, 1249 n.2 (2008).

[290] *See* Cindy R. Alexander, *On the Nature of the Reputational Penalty for Corporate Crime: Evidence*, 42 J.L. & ECON. 489 (1999) (discussing the effectiveness of extralegal sanctions).

[291] Numerous commentators have referred to a corporate indictment as tantamount to a death sentence for public companies in financial and other highly regulated industries. *See, e.g.*, Miller, *supra* note 289, at 1249 n.2.

[292] Moreover, the availability heuristic may also skew the compliance officer's analysis insofar as the media emphasizes particularly devastating government investigations and sanctions. *See* Sara Sun Beale, *What's Law Got To Do With It? Political, Social, Psychological and Other Non-Legal Factors Influencing the Development of (Federal) Criminal Law*, 1 BUFF. CRIM. L. REV. 23, 58–59 (1997). Of course, the compliance officer's risk aversion might well be cancelled out by other biases or heuristics that cause corporate officers and employees to *under-comply* with the law. *See* Jennifer Arlen, Comment, *The Future of Behavioral Economic Analysis of Law*, 51 VAND. L. REV. 1765, 1769 (1998) (contending that instances of bounded rationality may cancel each other out).

the second theory of why compliance does not work the way we want it to: Whereas some compliance products, such as computer software for tracking financial transactions, are easily evaluated in advance of purchase, others may depend far more on variables that are context specific and difficult to quantify.[293] It might take the compliance officer—and, if it exists, the compliance product market—time to sort these products.[294] The corporate criminal charging process, however, will not likely allow for such experience testing.

Under a strict liability regime, firms should eventually discard and avoid ineffective compliance products. There is no reason to expend funds for products that fail to reduce the incidence or degree of punishment.[295] Instead, firms will reduce their activity levels to a point where the firm's marginal profits exceed the marginal increase in the expected punishment.[296] When the costs and benefits of reducing activity levels are more certain than the costs and benefits of a given compliance product, firms will favor reductions in activity levels as a means of reducing liability.[297]

By contrast, under the "effective compliance" regime, prosecutors decide *ex post* if a given compliance program was effective. Because prosecutors are likely to be driven by hindsight bias and have difficulty discerning the difference between good and bad compliance products, compliance officers will err on the side of quantity rather than quality. Under this theory, the more compliance products a firm employs, the more effective its program will be considered.

As lawyers, prosecutors may prefer the presence of identifiable controls and processes simply for their own sake: "Lawyers like processes, including controls and audits; and this taste can lead them to

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[293] *See* Michael J. Trebilock & Edward M. Iacobucci, *Privatization and Accountability*, 116 HARV. L. REV. 1422, 1433–34 (2003). If such services are standardized and uniform, then efficient product market pricing will further aid the compliance officer in assessing their value.

[294] Compliance may be either an "experience good," which the purchaser cannot judge in advance of its use, or a "credence good," which the purchaser cannot assess simply from his use of it. *See id.* at 1433–34 (explaining market failures that arise from imperfect information about goods).

[295] Moreover, firms might discount the value of these services in advance, and this may create a market for "lemons", whereby purchasers drive down the value of all compliance services, effectively driving out the better providers who are unable to take less money for premium services. *See* George Akerloff, *The Market for "Lemons:" Quality Uncertainty and the Market Mechanism*, 84 Q.J. OF ECON. 488, 488–90 (1970).

[296] *See* Arlen & Kraakman, *supra* note 56, at 698; A. Mitchell Polinsky & Steven Shavell, *Punitive Damages: An Economic Analysis*, 111 HARV. L. REV. 869, 881 (1998).

[297] *See* Polinsky & Shavell, *supra* note 296, at 881.

believe auditor advertisements."[298] Moreover, because prosecutors are in the business of investigating and punishing individual employees, we should expect firms to expend their greatest resources on services and products that best assist the prosecution of individual employees *ex post*, regardless of whether these activities actually reduce noncompliance *ex ante*.[299]

In sum, the adjudicative system of compliance regulation fuels the compliance industry's growth for several reasons. It creates a need for compliance officers to fill gaps and implement broad guidelines. It also provides firms with incentives to create systems that meet prosecutors' needs, which means that it stresses processes and *ex post* investigatory functions. Finally, although prosecutors and corporate defense lawyers play adversarial roles when firms are the targets of investigations, they are firmly aligned when it comes to the purchase of corporate compliance services.[300] Like their government counterparts, private attorneys will, at the very least subconsciously, encourage their clients to overinvest in processes that increase their own welfare.[301]

IV. New Governance and Corporate Compliance

At the same time that the DOJ has solidified its control over corporate compliance regulation, newer, more experimental regulatory mechanisms have begun to infiltrate the administrative state.[302] These regulatory arrangements, which are often characterized by a greater willingness to share responsibility and power between regulators and regulated entities, have been collectively labeled "New Governance"

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[298] Cunningham, *supra* note 72, at 269.

[299] *See supra* notes 225–233 and accompanying text. It is therefore not surprising that the term "best practices" surfaces throughout much of the compliance literature. Firms take safety in practices that are widely heralded and used, regardless of their effectiveness. *See* David Zaring, *Best Practices*, 81 N.Y.U. L. Rev. 294, 298 (2006) (criticizing regulations requiring "best practices").

[300] *See* Donald Langevoort, *Internal Controls After Sarbanes-Oxley: Revisiting Corporate Law's 'Duty of Care as Responsibility for Systems'*, 31 J. Corp. L. 949, 950 (2006) (forecasting such compliance industry "rent-seeking" with regard to Sarbanes-Oxley Section 404's internal controls requirement). Langevoort suggests that "[c]ompanies are probably spending more time and resources on [§] 404 compliance than a reasonable reading of the legislation and the rules necessarily requires, heavily influenced by those who gain from issuer over-compliance."

[301] *See* Cunningham, *supra* note 72, at 269; Rostain, *supra* note 9, at 466–67.

[302] *See, e.g.*, David W. Case, *Changing Corporate Behavior Through Environmental Management Systems*, 31 Wm. & Mary Envtl. L. & Pol'y Rev. 75, 77 (2006) (discussing innovations in environmental regulatory policy).

regimes.[303] Although several scholars have suggested, either while voicing approval or critique, that corporate compliance regulation is a variant of New Governance, this characterization is inaccurate. Corporate compliance regulation diverges from New Governance in several important ways.

This Part will first sketch the tenets of New Governance, and then discuss several challenges to the implementation of New Governance regimes in the compliance context. In particular, this Part will explain why the current model of compliance regulation fails to capture the benefits of New Governance, and why it is not likely to in the foreseeable future.

A. *Defining New Governance*

"New Governance" has both democratic and welfarist roots. On one hand, a number of scholars have embraced "New Governance" as a means of improving democratic participation, whereby different groups partner with each other in shifting alliances to negotiate solutions to complex problems as they arise.[304] At the same time, a different, more technocratic group of scholars has embraced New Governance as a means of allowing public and private entities to experiment in both law-enforcement as well as law-generation activities, thereby reducing the cost of verification and compliance.[305] Together, these two theories of regulation suggest a more pragmatic problem-solving world where rules are more fluid and enforcement is conceptualized more as a product of persuasion and significantly less punishment.[306] As such, New Governance represents a significant shift from the earlier administrative ideal of regulation produced by neutral experts,

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[303] New Governance initiatives have been discussed at length in, among others, AYRES & BRAITHWAITE, *supra* note 36; Michael C. Dorf & Charles Sabel, *A Constitution of Democratic Experimentalism*, 98 COLUM. L. REV. 267 (1998); Jody Freeman & Daniel Farber, *Modular Environmental Regulation*, 54 DUKE L.J. 795, 860 (2005); Bradley C. Karkkainen, *Information as Environmental Regulation: TRI and Performance Benchmarking, Precursor to a New Paradigm*, 89 GEO. L.J. 257 (2001); Orly Lobel, *The Renew Deal: The Fall of Regulation and the Rise of Governance in Contemporary Legal Thought*, 89 MINN. L. REV. 342 (2004); Lester M. Salamon, *The New Governance and the Tools of Public Action: An Introduction*, 28 FORDHAM URB. L.J. 1611 (2001); Simon, *supra* note 20; Jason Solomon, Book Review, *Law and Governance in the 21st Century Regulatory State*, 86 TEX. L. REV. 819 (2008).

[304] *See, e.g.*, Dorf & Sabel, *supra* note 303, at 267; Simon, *supra* note 20, at 127.

[305] *See, e.g.*, AYRES & BRAITHWAITE, *supra* note 36, at 3–4.

[306] *See, e.g.*, *id.*; Dorf & Sabel, *supra* note 303, at 267; Simon, *supra* note 20, at 127.

although New Governance's pluralist roots reach back to at least the 1970s.[307]

Because they have arisen organically and in response to different problems and through different agency initiatives, New Governance programs are not all alike.[308] Indeed, the term itself has been criticized as overinclusive.[309] Nevertheless, for purposes of determining whether compliance regulation falls under the New Governance umbrella, it is sufficient to examine the following recurring themes.

1. Experimentation and Discretion

New Governance programs are premised on the notion that problems are better solved collaboratively through experimentation and with the help of the persons and entities who are the subjects of regulation. Lester Salamon explains:

> Such an approach is necessary because problems have become too complex for government to handle on its own, because disagreements exist about the proper ends of public action, and because government increasingly lacks the authority to enforce its will on other crucial actors without giving them a meaningful seat at the table.[310]

Accordingly, the single most salient characteristic of the New Governance movement is its orientation toward problem-solving and away from either the punishment of perceived wrongs (corrective justice) and/or the enforcement of personal rights.[311] The model draws its

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[307] *See* David Barron, *From Takeover to Merger: Reforming Administrative Law in an Age of Agency Politicization*, 76 GEO. WASH. L. REV. 1095, 1125 (2008).

> [A]lthough the commitment to expert, scientific truth-seeking has long been a powerful component of the administrative ideal, so too is the commitment to experimentation and social learning, rooted in doubt about there being 'right' answers in a rapidly changing world in which partial knowledge of actual conditions is the most that one can expect to obtain.

Id. at 1098; *see also* Bratton, *supra* note 246, at 17 (explaining that under the pluralist model, regulation became "a legislative and political process of balancing conflicting constituent interests in light of a legislative directive").

[308] Bradley C. Karkkainen, *"New Governance" in Legal Thought and the World: Some Splitting as Antidote to Overzealous Lumping*, 89 MINN. L. REV. 471, 471–72 (2004).

[309] *See id.*

[310] Salamon, *supra* note 303, at 1623.

[311] *See* Simon, *supra* note 20. Coglianese and Kagan offer a similar, but slightly different contrast:

strength from collaborative experimentation as opposed to retributive punishment.[312] New Governance regimes therefore grant regulated entities a fair amount of discretion to devise processes necessary to achieve the broad goals that private and public actors collaboratively debate.[313]

This problem-solving orientation, in turn, presumably allows for a less adversarial relationship between regulator and regulated entity.[314] Katherine Kruse explains: "The 'core architectural principle' of democratic experimentalist governance is the grant by governing authorities to regulated agencies of the autonomy to experiment with methods of achieving broadly stated goals in ways that will best fit local circumstances."[315]

Flexibility and experimentalism theoretically breed trust and learning. That being said, persistent and intractable power imbalances can reduce incentives for such collaboration.[316] Accordingly, Orly Lobel has warned: "Always lurking in the background is the possibility that cooperative relations will become adversarial if one party believes it will be made better off from the change."[317] New Governance attempts to solve this problem by envisioning a multilayered network of "interlocking" groups that depend on each other both to define problems and to supply solutions.[318] The uncertainty as to

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> One model treats regulatory enforcement as a *legal process* and, according to it, regulations are viewed as authoritative legal norms whose violation demands punishment. The other model treats enforcement more as a *social process*, one aimed at stimulating cooperative government-business problem-solving and which calls for remedial responses to violations.

COGLIANESE & KAGAN, *supra* note 169, at xvi.

[312] *See supra* note 311 and accompanying text.

[313] Bamberger, *supra* note 24, at 377–78; Salamon, *supra* note 303, at 1673 (explaining that New Governance mechanisms extend discretionary authority to private actors).

[314] *See* Simon, *supra* note 20, at 178 ("The rhetoric of problems and solutions suggests common interests, rather than the notion connoted by the idea of rights of individual interests competing with group interests.").

[315] Kruse, *supra* note 25, at 676.

[316] *See* Lobel, *supra* note 303, at 462.

[317] *Id.*

[318] *See* Lobel, *supra* note 303, at 461–62; Orly Lobel, *Interlocking Regulatory and Industrial Relations: The Governance of Workplace Safety*, 57 ADMIN. L. REV. 1071, 1142 (2005) [hereinafter *The Governance of Workplace Safety*]. Lobel notes that:

> The paradigm of new administrative governance acknowledges both the potential and the perils of systems of multiple authorities and interlocking power hierarchies. Because of the layered nature of multi-relational power, it is often possible to reach agreement on policy even when interests are not

whether one group will need another in the future reduces the incentive to take advantage of a less powerful group in the present.[319]

2. Shared Accountability

New Governance regimes allocate responsibility differently from the adjudicative model of regulation.[320] Instead of leaving prevention solely to the regulated entity or unilaterally mandating command-and-control rules, New Governance regulators and private entities jointly draft performance goals and procedural mechanisms designed to achieve those goals.[321] Because they play an active role in the formulation of goals and procedures, New Governance regulators are presumably in a better position to test underlying assumptions over time. They also have reason to care whether they work and at what cost because they remain partially accountable for standards to which firms are held and the means employed by firms to meet those standards. Finally, because New Governance regulators and members of regulated firms interact on a periodic basis, they are less likely to view and approach each other with an air of distrust.[322]

3. Information Pooling and Increased Stakeholder Participation

Whereas adjudicative models of regulation feature struggles between parties whose instincts are to hoard information until no longer tenable, New Governance regimes deliberately attempt to pool information within firms, across firms, and between firms and multiple administrative agencies.[323] Part of the reason for such a flow of information is to encourage multiple stakeholders to create and revise legal

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> aligned and even when there are power disparities among those engaged in the process.

Lobel, *The Governance of Workplace Safety*, *supra*, at 1142.

319 *See* Lobel, *The Governance of Workplace Safety*, *supra* note 318, at 1142.

320 *See* AYRES & BRAITHWAITE, *supra* note 36, at 106.

321 *See id.*

322 *See id.* at 91; Kruse, *supra* note 25, at 715 (praising face-to-face meetings between police enforcement officers and stakeholders in reforming investigatory measures because "face-to-face negotiation will often transform confrontational disputes into accommodative encounters where the concerns of the other are internalized").

323 *See* Kruse, *supra* note 25, at 727 ("Regulation within the democratic experimentalist paradigm exploits the possibilities of the information age by proposing structures of compliance and accountability that pool and disseminate information . . . coupled with systems of assessment that permit the relative effectiveness of different practices to be measured and compared according to their outcomes."); *see also* Dorf & Sabel, *supra* note 303, at 302–05.

standards, and the expectation that they will do so.[324] In other words, firms and individuals are more likely to disclose information because they believe it will be used to solve problems and not to hurt them.

4. Continuous Assessment

New Governance participants also continually reassess performance standards and procedural requirements.[325] Compared to traditional regulatory systems, the paradigm is far more tolerant—and indeed encouraging—of uncertainty.[326] As Orly Lobel explains: "Since a basic premise of the governance model is the inevitability and the fertility of change, the new vision is optimistic about uncertainty and doubt. In fact, unlike the traditional regulatory model, governance treats ambiguity as an opportunity rather than a burden to overcome."[327] In this way, New Governance is more dynamic than traditional models of regulation; it continuously learns from and updates itself.[328]

5. Varying Types and Degrees of Sanctions

Finally, one of the hallmarks of the New Governance movement is the scaling back of punitive enforcement efforts (at least initially) for firms that fail to achieve compliance with prescribed standards.[329] Ian Ayres and John Braithwaite have argued that Government should continue to possess a big stick, but should use it only rarely; they refer to this mechanism as the "benign big gun."[330] They further argue that social control sanctions, such as "reintegrative shaming" (which Braithwaite defines as "shaming while sustaining bonds of respect"), are more likely to "indu[ce] guilt and responsiveness in the wrongdoer"

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[324] *See* Michael Waterstone, *A New Vision of Public Enforcement*, 92 MINN. L. REV. 434, 437 (2007). "[T]he goal should be to engage stakeholders in defining these concepts in a context-specific and mutually acceptable way . . . ." *Id.* (suggesting application of New Governance theories to enforcement of the Americans with Disabilities Act).

[325] *See* Kruse, *supra* note 25, at 679 ("[T]here is an understanding that both practices and measures of performance will need to be revised in light of experience.").

[326] *See, e.g.*, Bratton, *supra* note 196, at 1024 (lamenting ongoing political and institutional uncertainty wrought by Sarbanes-Oxley legislation as "regrettable" although not necessarily avoidable).

[327] Lobel, *supra* note 303, at 395.

[328] *See* Kruse, *supra* note 25, at 677 (explaining that information pooling allows performance goals "to be more specifically articulated and continuously revised in light of experience").

[329] *Cf.* Lobel, *supra* note 303, at 391 (observing differences between sanctions under New Governance models). "Flexibility implies variation in the communications of intention to control and discipline deviance." *Id.*

[330] AYRES & BRAITHWAITE, *supra* note 36, at 40.

whereas punitive sanctions "induce anger and resistance."[331] Accordingly, when firms appear to deviate from legal and social norms, regulators should respond proportionally. Lesser and initial violations are met with persuasion and consultation; more egregious and repeated violations, on the other hand, cause government regulators to employ their "big gun."[332]

As Ayres and Braithwaite acknowledge, for this model to work regulators and entities must enjoy a "relationship of trust."[333] Thus, New Governance poses something of a circular problem. On one hand, a New Governance model is advantageous because it encourages informational exchanges and promotes trust. On the other hand, for it to work it *requires* both an existing well of trust between the parties and a sufficient level of transparency to deter cheating by either private or government actors.

Democratic experimentalists assume that uncertainty and constantly shifting factions will take care of this problem of circularity, whereas the technocratic New Governance theorists embrace self-enforcement as the answer to it.[334] As discussed below, both assumptions have their drawbacks when applied internally to the firm.

B. *New Governance and the Internal Dynamics of the Firm*

Because corporate organizations function differently from political ones, several problems arise in the attempt to translate the New Governance theory from its prescription for relationships between firms and regulators to a normative theory of how the firm should organize itself to achieve compliance with the law. As noted earlier, New Governance can either be instrumental, in that it is conceived of as a way of improving social welfare, or it can be expressed in more explicitly political and deliberative terms.[335] In the corporate compliance context, much of the interest in New Governance has been its presumed value in reducing the costs of regulatory enforcement.[336]

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[331] *Id.* at 92.

[332] *Id.* at 40.

[333] *Id.* at 86.

[334] *See* Kruse, *supra* note 25, at 676–77; Salamon, *supra* note 303, at 1623.

[335] *See* David Super, *Laboratories of Destitution: Democratic Experimentalism and the Failure of Antipoverty Law*, 157 U. PA. L. REV. 541, 549 (2008) ("'[N]ew Governance' is a moniker that brings together some quite disparate substantive and procedural impulses.").

[336] *See* AYRES & BRAITHWAITE, *supra* note 36, at 19–20 ("Punishment is expensive; persuasion is cheap. A strategy based mostly on punishment wastes resources on litigation that would be better spent on monitoring and persuasion.").

New Governance's two schools of thought offer different views of how corporate firms behave.[337] Under the "democratic experimentalist" paradigm, multiple stakeholders—and not simply the traditional triad of shareholders, corporate officers, and the corporation's board of directors—participate in the process of setting standards and testing compliance.[338] Externally, multiple stakeholders, including both private and public actors, negotiate broadly defined goals and agree on certain mechanisms for achieving them, and for verifying that they have been achieved. Within the corporation, shifting factions of unstable alliances negotiate obligations and jointly adopt different goals, which include the firm's compliance with its external obligations.[339] Out of such chaos, a more socially responsible firm (and better workplace) presumably emerges.[340]

The technocratic school of New Governance arguably does not portend such a radical transformation of the firm.[341] In their oft-cited book, *Responsive Regulation*, Ayres and Braithwaite call for a more collaborative—indeed collegial—relationship between corporations and government monitors.[342] They envision an increased role of community and public interest groups in assisting the government in keeping corporate power in check, which they refer to as "tripartism."[343] But they show less interest in dictating how corporate firms should organize themselves internally, other than directing firms to internalize the monitoring and enforcement costs previously borne by the government.[344] Instead, they presume that if corporate actors, regulators, and community stakeholders talk to each other more regularly, the corresponding laws and regulations will be more effective and comprehenive.[345] Corporate actors will more likely restrain themselves when they trust and feel trusted by their government and community

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[337] *See* Kruse, *supra* note 25, at 676–77; Salamon, *supra* note 303, at 1623.

[338] *See* Kruse, *supra* note 25, at 673.

[339] *See id.* at 677–79.

[340] *See* Estlund, *supra* note 24, at 323 ("Self-regulatory processes in which workers participate can introduce flexibility and responsiveness into the regulatory regime, and can reduce the costs and contentiousness associated with litigation, while promoting the internalization of public law norms into the workplace itself.").

[341] *See* AYRES & BRAITHWAITE, *supra* note 36, at 19–20.

[342] *See id.*

[343] *Id.* at 56–60 (describing benefits of delegating regulatory power to public interest groups).

[344] *Id.* at 114 ("Enforced self-regulation, by placing the principal inspectorial burden on internal compliance groups, also allocates most of the costs for such regulation to industry.").

[345] *Id.* at 87, 111–14.

counterparts, and have a hand in writing the rules by which they are governed.[346] In sum, the thrust of Ayres and Braithwaite's reform effort is to change the way in which regulated firms interact ***externally*** with the government and with the communities they serve.[347] The firm's internal dynamic, by contrast, receives far less attention.[348]

This model is at once a drawback and advantage. The advantage is that one can adopt Ayres and Braithwaite's model without altering widely held conceptions of the corporate firm and, along with it, much of state corporation law. Responsive regulation is simply a means by which the government smoothes its relationship with regulated entities, and simultaneously transfers much of the costs of monitoring and detecting wrongdoing from the government to private entities. Indeed, in their portrayal of an "enforced" self-regulatory regime, Ayres and Braithwaite predict that firms will adopt the inspectorial and disciplinary regimes favored by the government:

> Under enforced self-regulation, companies with strong records of disciplining their employees would be rewarded . . . . Internal discipline is in many ways more potent than government prosecution because internal enforcers do not have to surmount the hurdle of proof beyond a reasonable doubt, and do not have to cut through a conspiracy of diffused accountability within the organization. . . . [E]nforced self-regulation provides incentives for nominated accountability because *corporations that cannot demonstrate that they are conducting their own executions would be singled out for inquisition.*[349]

In sum, enforced self-regulation works when firms "conduc[t] their own executions"[350]—that is, when they adopt the very policing and disciplinary techniques that the government would employ if it could.

By leaving the firm's internal structure more or less intact, the Ayres and Braithwaite version of New Governance offers something for everyone.[351] It assures government regulators that monitoring and

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[346] *Id.* at 86–87 (explaining that trust between regulator and entity is necessary to explain purpose of rule and to improve or avoid bad rules).

[347] *See* AYRES & BRAITHWAITE, *supra* note 36, at 19–20.

[348] *But see id.* at 56–60.

[349] *Id.* at 114–15 (emphasis added).

[350] *See id.*

[351] *See id.* at 19–20. David Super similarly observes a "something for everybody" dynamic:

> For business interests, it heralds less onerous regulation . . . . For critics decrying federal agencies' vulnerability to 'capture,' new governance shrinks agen-

discipline will continue, and at less cost.[352] At the same time, it relieves corporate actors of having to abandon the hierarchical internal structures that permit the efficient production of goods and services.[353]

Sadly, this moderated approach to New Governance—flexible, collaborative inter-firm relationships, paired with punitive intra-firm relationships—falls apart on closer inspection. First, there is no reason that the social dynamics that Ayres and Braithwaite identify as inimical to external regulation would not also apply to the internal regulation of corporate employees. If firms strain under external laws and enforcement actions they disrespect and dislike, then corporate employees will respond similarly to internal policing and internal regulators. Thus, a corporate firm that adopts a collaborative, New Governance-style relationship with external regulators on one hand, yet maintains an adversarial monitoring relationship with its employees on the other, will experience two varieties of compliance failure.[354] First, incentives to violate the law will persist insofar as performance standards are unattainable, and nonperformance provides a plausible substitute for admitting one's failure to achieve management's pre-set goal.[355] Second, the conduct that the firm takes to build trust with prosecutors may simultaneously reduce trust with the firm's employees. As a result, it may reduce the caliber of the employees it attracts, because most savvy employees will do their very best to avoid those firms that have promised in advance to "execute" wrongdoers at the government's behest.[356]

Moreover, New Governance poses a terrible dilemma when one considers just how deeply the notion of compliance should penetrate the firm. If the New Governance notion of compliance leaves organizational planning systems intact, New Governance may be setting itself up for a failure. After all, noncompliance often comes about not because an employee has some burning desire to violate the law, but because he needs noncompliance to substitute for some performance

> cies' roles in order to reduce the appeal of suborning them. To conservative deregulators . . . it presents an opportunity to broaden their support at the cost of allowing some inexpensive information gathering by federal agencies.

Super, *supra* note 335, at 551.

[352] *See* AYRES & BRAITHWAITE, *supra* note 36, at 19–20.

[353] *See id.* at 110.

[354] HASNAS, *supra* note 83, at 61–79 (discussing ways corporate monitoring undermines employees' privacy, trust, and sense of organizational justice).

[355] *See* Langevoort, *supra* note 31, at 89.

[356] *See* HASNAS, *supra* note 83, at 62.

goal that has been previously set within the firm.[357] Because he lacks sufficient voice to challenge the performance goal as unrealistic *ex ante*, he violates the law *ex post* in order to meet previously set expectations.[358] To the extent New Governance generates fuzzy, feel-good discussions about ethics, but fails to attack more difficult topics such as enterprise risk and performance goals, employees will continue to have strong incentives to violate the law when the company's actual performance fails to meet previously set expectations.[359]

Finally, New Governance's emphasis on uncertainty and shifting alliances may create *too* much uncertainty, at least for some firms. Whereas democratic experimentalists can rest their laurels on the value of the process (democracy) and not the result (law), corporate officers still need to answer to the firm's residual owners—the shareholders who essentially all want the same thing: profits.[360] Thus, the benefits of New Governance are awfully tenuous and maddeningly long-term in nature. It is quite possible that shareholders, if given the chance, would overwhelmingly choose hierarchical firms that are somewhat noncompliant over New Governance firms that are more ethical. Accordingly, there may be a natural limit to just how far New Governance can penetrate most publicly owned firms.

C. *The New Governance Model of Corporate Compliance*

As should be quite obvious by now, despite some of the rhetoric contained in the DOJ's prosecutorial charging memoranda and the Organizational Sentencing Guidelines, the current mode of corporate compliance regulation is not New Governance. Although the DOJ has declined to define in great detail what it perceives as an "effective compliance and ethics program," the mere presence of an open-ended standard does not, by itself, transform the standard into a delegation of discretion or authority, particularly where the costs of failing to meet such a standard are catastrophic.[361] Rather, it is at best an illusory form of delegation, whereby an open-ended and unreliable standard forces

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[357] *See* Langevoort, *supra* note 31, at 89 (observing that "concealed compliance wrongdoing by agents is only occasionally the product of inherently bad moral dispositions. More often, a morally normal person gets caught in a situation that leads gradually to increasingly bad choices.").

[358] *See id.* Other reasons may fuel the employee or officer's noncompliance. *See, e.g.*, Bratton, *supra* note 196, at 1030 (attributing noncompliance to rent-seeking managers).

[359] *See* Langevoort, *supra* note 31, at 89.

[360] *See* Kruse, *supra* note 25, at 673.

[361] *See* U.S. SENTENCING GUIDELINES MANUAL § 8B2.1.

firms to adopt, out of a sense of overcautious risk aversion, compliance services that the government might otherwise have to justify if it promulgated rules explicitly requiring such services.

The current model is devoid of numerous other New Governance characteristics. It does not encourage interactive dialogue between the government and regulated entities, whereby the government seeks to learn from its own regulatory mistakes. Nor does it feature a voluntary trade of information between and among entities.[362] To the extent the parties negotiate with each other, they are negotiating solely the price that the firm will pay for not having met the government's open-ended compliance standard. The legal backdrop of corporate criminal liability ensures that the negotiation will be reliably one-sided and in the government's favor.[363] Finally, the predominant structure of compliance regulation—the so-called "soft" treatment of the firm conditioned on the firm's harsh treatment of its officers and employees—requires firms to inspect and "execute" their own employees, thereby creating a corporate policing atmosphere that has little to do with the forgiving, pragmatic problem-solving approach that New Governance theorists promote. In sum, the government's current approach to corporate compliance is not soft law; rather it is hard law, albeit hard law practiced through informal, less transparent means.[364]

The conclusion that the current compliance regulatory regime is not New Governance begets the question of whether we can and should reconstruct corporate compliance regulation in New Governance's image. This requires consideration of what a New Governance compliance model would look like; whether such a model would extend to relations between the firm and government regulators, or also attempt to penetrate the firm and prescribe relations between the firm's various stakeholders; whether it would be more or less effective in procuring compliance than the current model; how the two beneficiaries of the current model, the compliance industry and the DOJ, would react to a New Governance model; and lastly, whether the ef-

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[362] *See* Kruse, *supra* note 25, at 676–77.

[363] *See* Griffin, *supra* note 37, at 343 (arguing that "regulatory partnership" between federal prosecutors and corporate counsel "does not function properly . . . when it is imported into the realm of individual criminal prosecutions").

[364] To be fair, not all New Governance theorists describe the model as purely soft-law. Orly Lobel, for example, contends that New Governance's soft-law stance works only when it is backed by the threat of "hard law" enforcement. Lobel, *supra* note 303, at 389–90.

fort of recasting corporate compliance in a New Governance image is worth the trouble.

It might be easiest to first address the question of whether recasting corporate compliance in a New Governance image would be worth the effort. Although scholars continue to voice much excitement about New Governance regimes, there is little empirical evidence that New Governance produces good governance.[365] To the contrary, recent empirical evidence suggests that firms are most likely to disclose evidence of wrongdoing when they fear imminent sanction from law enforcement agencies.[366] Such evidence would suggest that firms are unwilling or unable to engage in self-regulation. But the studies do not show how firms behave in a truly self-regulatory environment because truly self-regulatory regimes do not exist.[367] Accordingly, the studies simply demonstrate that, on one hand, in the absence of enforcement threats, norms may take over and restrain wrongdoing,[368] but, on the other hand, in the absence of self-regulatory norms, law enforcement can restrain wrongdoing, but only when the threat is imminent and credible.[369] The place *not* to be is in a destabilized middle, where law enforcement activity is aggressive enough to displace salutary norms, but so weak that it is unable to deter the most dangerous actors.[370] The question, then, is whether the New Governance approach can help regulators avoid this middle. This requires us to envision a New Governance regime and inquire how it might work.

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[365] *See* Karkkainen, *supra* note 303, at 476–77; Super, *supra* note 335, at 560–61 (arguing that the experimental nature of New Governance hinders attempts to gauge its programs' effectiveness, and that New Governance has harmed antipoverty efforts).

[366] Jodi L. Short & Michael W. Toffel, *Coerced Confessions: Self-Policing in the Shadow of the Regulator*, 24 J.L. ECON. & ORG. 45, 45 (2007).

[367] *See* Lobel, *supra* note 303, at 389–90.

[368] Such norms could either be "internal" in that they impose a sense of guilt or psychological discomfort on the violator, or "external" in that they depend upon the disapproval of the community. *See* Richard McAdams, *The Origin, Development and Regulation of Norms*, 96 MICH. L. REV. 338, 376 (1997) (contrasting "esteem model" of external enforcement to Robert Cooter's internalization theory); *see also* Robert Cooter, *Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant*, 144 U. PA. L. REV. 1643 (1996).

[369] *See* Langevoort, *supra* note 238, at 1818 (2007) ("[A]bsent unusually high rates of detection and prosecution, compliance decisions are based at least as much on the perceived legitimacy of the law and prevailing norms in local context as any deliberate risk calculation.").

[370] *See* Milton Regan, *Moral Intuitions and Organizational Culture*, 51 ST. LOUIS U. L.J. 941, 973 (2007) ("When sanctions are strong, people are more likely to cooperate than when sanctions are weak. When there are no sanctions at all, however, people are also more likely to cooperate than when sanctions are weak."); *see generally id.* (summarizing the literature).

For example, one could imagine some third-party regulator ("TPR"), preferably from outside the DOJ's adversarial legal culture, charged with collecting and disseminating information on practices most, and least, likely to bring about compliance within corporate firms. To further eliminate compliance's adversarial atmosphere, we might look specifically for a non-lawyer TPR.[371] Critics might worry, however, that such a non-lawyer TPR would be ill-matched against corporate defense counsel striving to keep the firm's liability to the bare minimum.[372]

Under the New Governance model of compliance regulation, we might define the TPR's goals as follows. First, we would expect the TPR to collect information about firms' compliance.[373] This would require an internal counterpart within the firm. It would also require internal dynamics to be collaborative and flexible, which is not at all guaranteed. As noted earlier, firms that employ hierarchical systems to carry out their business may be loath to abandon them, and it is not at all clear that a collaborative compliance system could effectively operate against a more hierarchical backdrop.[374]

Nevertheless, assuming that a TPR developed a collaborative relationship with several firms' compliance officers, and that those compliance officers, in turn, developed the tools necessary to collect information from the firm to disseminate to the TPR, the question becomes one of what to do with this information.[375] Depending on the model adopted, the TPR might use that information either to supplement disclosure or to spur additional changes in corporate governance. For example, the TPR might employ sufficient expertise to analyze the compliance information received and provide the public relative risk profiles of particular industries. Investors, in turn, either would reduce investments in overly risky industries and companies, thereby decreasing the company's access to capital and reducing its activity level, or would diversify sufficiently to cover the risk. But for the position as public regulator, the TPR might operate much like a risk manager in an insurance company.[376]

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[371] *Cf.* Solomon, *supra* note 303, at 847–48 (suggesting that, because of their adversarial bent, lawyers may pose challenges to New Governance regimes).

[372] *See id.*

[373] *See, e.g.*, Dorf & Sabel, *supra* note 303, at 267.

[374] *See supra* notes 237, 353 and accompanying text.

[375] *See, e.g.*, Dorf & Sabel, *supra* note 303, at 267.

[376] *See generally* Baer, *supra* note 6 (arguing for the regulation of corporate crime by insurance companies).

As the TPR collected sufficient information to determine best practices within given industries, the TPR might also promulgate either mandatory or voluntary standards, or rules of compliance.[377] Here, the TPR would have to proceed with caution. To the extent the promulgated rules were too detailed, the TPR would risk sliding into an inflexible "command-and control" regime.[378] Overly broad standards, however, could generate overinvestment in compliance or, at the other extreme, bad faith efforts by firms to avoid all rules. In this instance, the TPR's best option might be to create a public market for compliance by publicizing the identities of those firms whose compliance measures substantially exceeded, or fell grievously below, industry norms. Investors who preferred risk might choose firms or industries despite, or because of, their lax governance standards; other investors might prefer certain firms or industries because of their state-of-the-art compliance regimes, although that would presume that compliance translated into less risky investments.

The TPR would first face the hurdle of persuading firms to disclose relevant compliance information. Surely, all firms would be happy to report that they have a compliance officer and a Code of Corporate Conduct, but there is little incentive for firms to voluntarily report ethical lapses, particularly if those lapses continue to trigger criminal liability for individual employees, and perhaps, the firm itself. Although the TPR could compel this information if Congress enacted a law[379] mandating such disclosure, this would likely throw the TPR back into the same adversarial relationship that firms and prosecutors currently maintain.[380] Mandatory reporting requirements are not the equivalent of New Governance.[381]

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[377] *See* AYRES & BRAITHWAITE, *supra* note 36, at 113.

[378] Lobel describes the standard model of command and control regulation:

> Under the traditional regulatory model, industry and private individuals are the object of regulation. Their agency is limited to choosing whether to comply with the regulations to which they are subjected. Information flows selectively to the top while decisions flow down, following rigid parameters, and leaving decision making to a small, detached group of number-crunching experts.

Lobel, *supra* note 303, at 376–77.

[379] Sarbanes-Oxley already requires corporations to report on their internal controls. Sarbanes-Oxley Act of 2002 § 404, 15 U.S.C. § 7672 (2006). It also requires corporate managers to certify the controls affecting the corporation's public filings. Sarbanes-Oxley Act of 2002 § 302, 15 U.S.C. § 7241 (2006).

[380] In is interesting to note that Jodi Short and Michael Toffel's study found that firms were more likely to self-disclose non-serious environmental violations to inspectors when they were "subject to frequent inspections," which might suggest that adversarial relation-

Accordingly, given the current backdrop of criminal law, it is unlikely that the flow of information between firms and the TPR would be particularly strong, even if the TPR were a non-lawyer from outside the DOJ. Without a reliable source of information from firms, the TPR's value to *them* as a group would predictably decrease.

Finally, if it is difficult to imagine a true New Governance-style relationship between the government and private firms, it is even more difficult to imagine New Governance infiltrating the inner "organizational-planning" sanctum of many firms, particularly those organized along more vertical or hierarchical lines.[382] If noncompliance comes about primarily because the firm sets its performance goals too high and employees must use illegal means to reach them, then a New Governance-style approach to securing compliance requires far more than promulgating compliance policies and educating the company's employees on the value of ethics.[383] It requires a willingness to reassess, on a continual basis, the performance goals that have been set within all areas of the firm.

Although companies often assess how well their employees are achieving stated goals, New Governance suggests that mid-level and high-level supervisors should be willing to readjust those goals *downward* in order to prevent noncompliance.[384] Repeatedly revising one's output and production goals downward, however, is not usually seen as a recipe for success in the market, even—and perhaps particularly—one rocked by an economic meltdown. Moreover, there is a fine line between laziness and shirking on one hand, and unrealistic goals that compel noncompliance on the other. If managers repeatedly adjust goals downward to ensure compliance, they risk creating an atmosphere where less and less is expected of employees and the firm as a whole. If fraudsters and rent-seekers use noncompliance as a means of meeting ever-rising performance standards, then rent-seekers and shirkers may use different tools to extract personal benefits from ever-sinking production requirements. In either case, the

ships promote compliance. Short & Toffel, *supra* note 366, at 62. The study, however, involved *outside* government inspectors and was limited to non-serious violations. *Id.* at 50. Therefore, this study does not illuminate whether intra-firm adversarial relationships produce additional compliance. Nor does it illuminate whether extra-firm adversarial relationships produce additional compliance, or simply accelerate self-disclosure when a government inspector is already on the verge of detecting wrongdoing.

381 *See* Kruse, *supra* note 25, at 676–77.

382 *See* Bainbridge, *supra* note 237, at 669–71.

383 *See* Langevoort, *supra* note 31, at 89.

384 *See id.*

investor and society as a whole may find itself on the losing end of the deal.

Accordingly, even those firms that implement compliance programs in good faith will find themselves caught between market forces that demand better performance and the risk that employees may use noncompliance as a means of meeting increasingly tougher goals. Despite its architects' laudable intentions, it is far from evident that New Governance can provide the tools necessary to solve this dilemma. Moreover, even if it did, it is doubtful it would thrive in the punitive environment that prevails today. For reasons both legitimate and expedient, our first impulse when companies lose lots of money is to search for criminal actors and punish them. Whatever the value of this impulse, it is not likely to foster New Governance.

D. *The End of New Governance?*

As the preceding section demonstrates, a number of factors hinder the application of New Governance in the compliance context. The adversarial and punitive backdrop of criminal law encourages firms to hold their information closely, and causes their employees to become distrustful of corporate compliance initiatives. The firm's performance demands exacerbate the situation by creating rational incentives to withhold both information and cooperation.[385] Moreover, firms whose officers and directors intone their genuine desire to generate ethical, compliance-oriented environments will find these goals at odds with the market-based needs to set performance goals and make lasting and certain decisions about the future direction of their companies. If New Governance thrives on uncertainty and collaboration, it is far from clear how it will infiltrate firms that are organized around the need for clear goals.

Unfortunately, recent events suggest an even greater reason why we may see New Governance efforts waning: the growing distrust between government regulators and the business community at large.[386] Partly as a repudiation of the Bush administration and partly as a means of masking their own complicity in past deregulation efforts, congressional leaders now routinely excoriate business leaders as

[385] *See* Langevoort, *supra* note 31, at 89.

[386] *See* Sarah Marsh, *Economic Crisis Boosts Distrust of Business: Watchdog*, REUTERS, June 3, 2009, *available at* http://www.reuters.com/article/ousiv/idUSTRE5521LX20090603.

thieves and liars.[387] Selfish CEOs interested in preserving the last of their fallen empires unfortunately fuel this narrative, overshadowing legitimate efforts to reform business practices.[388] In such an environment, it is difficult to conceive of the government implementing any program aimed at self-regulation, private delegation, or even collaboration.[389]

To the extent such distrust results in more "front-end regulation"—that is, regulation aimed at preventing socially undesirable situations before they occur—it may be a welcome and healthy development. At the end of the day, mandatory rules or structures may be more desirable than highly punitive regimes misrepresenting themselves as "soft law."[390] As this Article has argued, the government's delegation of compliance power has been, at best, illusory. Such delegation has placed the responsibility for ensuring compliance with firms, but has left itself unaccountable for the costs of the conduct that firms undertake to satisfy the DOJ requirements. It creates incentives for corporate entities to "police" their employees *ex post*, with less

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[387] *See, e.g.*, Martin Kady, II, *Grassley on AIG Execs: Quit or Suicide*, POLITICO, Mar. 16, 2009, *available at* http://www.politico.com/news/stories/0309/20083.html (quoting Sen. Charles Grassley suggesting that corporate and bank executives should "come before the American people and take that deep bow and say I'm sorry, and then either do one of two things—resign, or go commit suicide."); Amit R. Paley, *Lawmakers Line Up Bankers, Unleash Anger of the Masses*, WASH. POST, Feb. 12, 2009, at D01 (quoting Rep. Michael Capuano mocking CEOs: "Well, I have some people in my constituency that actually robbed some of your banks and they say the same things—they're sorry, they didn't mean it; they won't do it again, just let them out."); Alan Reynolds, *What to Do About Executive Compensation*, WASH. TIMES, Oct. 12, 2008, *available at* http://www.cato.org/pub_display.php?pub_id=9712 (quoting Sen. Obama's presidential campaign advertisement as saying, "You've got corporate executives who are giving themselves million dollar golden parachutes and leaving workers high and dry. That's wrong. It's an outrage."); Press Release, Senator Bernie Sanders, Wall Street Bailout (Oct. 1, 2008), http://sanders.senate.gov/news/record.cfm?id=303980 ("[I]t should be those people best able to pay for this bailout, those people who have made out like bandits in recent years, they should be asked to pay for this bailout. Go to those people who have made out like bandits. . . . Go to those people who have caused this crisis and ask them to pay for the bailout.").

[388] *See, e.g.*, Jonathan Stempel, *Thain Says Hid Nothing From Bank of America*, REUTERS, Jan. 26, 2009 (reporting that deposed Merrill Lynch CEO spent over one million dollars renovating his office).

[389] When President Obama met in March 2009 with a number of CEOs and executives of financial institutions, political pundits immediately criticized the meeting as an example of the federal government's excessive friendliness with private business. Eric Dash, *Bankers Pledge Cooperation with Obama*, N.Y. TIMES, Mar. 27, 2009, *available at* http://www.nytimes.com/2009/03/28/business/economy/28bank.html.

[390] *See* Edward Cheng, *Structural Laws and the Puzzle of Regulating Behavior*, 100 NW. U. L. REV. 655, 657 (2006) ("Structural laws establish mechanisms or procedures that push citizens toward compliance by making the undesirable behavior less profitable or more troublesome.").

regard toward reducing compliance risks *ex ante.* By forsaking regulatory intervention at the front-end and leaving firms to their own devices, and then exercising tremendous punitive force at the back end when firms and markets blow up, we set ourselves up for both regulatory and compliance failure.

It would be a mistake, however, to dismiss the New Governance model outright, for it demonstrates the drawbacks of regulation-by-adjudication. One of the key insights of New Governance is that it is better to administrate vexatious issues early and often.[391] Repeated and continuous interaction between the regulator and the regulated entity not only improves the entity, but eventually the government and the public it represents as well. As governance becomes more transparent, all parties gain a better understanding of the risks at hand.

The challenge for policymakers as they enter this period of great distrust is to find a regulatory model that encourages interaction between entities and regulators, and supports the creation of regulation, be it through rules or principles, for which entities *and* regulators can be held jointly accountable. Rather than delegating corporate compliance to firms, regulators and entities need to jointly consider which mechanisms would do a better job of restraining misconduct than open-ended discretion followed by severe punishment for transgressing broad standards of compliance. Rules and regulations that treat compliance as an ongoing administrative matter may achieve more benefits than systems that morph compliance departments into private police forces. In other words, we might be better off if we treat corporate compliance problems as a chronic condition to be managed, rather than a disease to be cured.

To move toward this administrative ideal, however, the government must be willing to take greater responsibility for front-end structural regulation, and to de-emphasize the DOJ's role in using criminal prosecutions to punish corporate entities for the failures of their employees and officers. That alone may be the greatest challenge for regulators. In a moment when distrust of corporate entities is at its zenith, it seems counterintuitive to shift resources away from punitive criminal prosecutions and investigations and instead focus greater energy on reconceptualizing the front-end relationship between firms, markets, and government regulators. But if the prior two decades have demonstrated anything, it is that the threat of punishment goes only so far in procuring compliance, and it carries with it tremendous costs.

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391 *See* AYRES & BRAITHWAITE, *supra* note 36, at 110–16.

Conclusion

For a number of reasons, corporate compliance regulation is generated and managed by a quasi-adjudicative system. That system is characterized by its adversarial nature, its reduced accountability for political actors, and its failure to promulgate significant reform. As the foregoing discussion has demonstrated, however, it may not be the system best designed to identify and fix organizational failures. At a minimum, a model of administrative governance—the concept of ongoing interaction between the regulator and the regulated entity, as well as between the company's compliance officer and the company's employees—may provide better opportunities for organizational improvement.

Nevertheless, the jump from adjudication to governance appears to be a difficult one for corporate compliance. So long as criminal law serves as the primary response for corporate compliance failure, it seems quite unlikely that either government regulators or corporate entities will fully embrace a New Governance-type relationship. Furthermore, if New Governance is difficult under ordinary conditions, it seems almost impossible in an atmosphere where strong feelings of distrust have permeated the relationship between firms and regulators, and, as layoffs and furloughs become the norm, between management and the firms' employees.

For policymakers contemplating their next step, as well as the future of corporate compliance, the value of this inquiry is twofold. It demonstrates the drawbacks of the current model of compliance regulation. Adjudication reduces the voluntary flow of information between and across firms, and increases adversarial behavior both internally and between firms and regulators. It also shields regulators—in this case, those who work in the government prosecutor's office—from the consequences of their decisions. Taken as a whole, these drawbacks suggest that a different model of compliance regulation might be preferable, one that focuses more on governance and less on punishment.

At the same time, the foregoing discussion raises palpable skepticism about the benefits of New Governance-type regimes as applied to and within corporate organizations. However appealing they may be in the abstract, such regimes may be limited in value as they are applied in different contexts. The idealistic, politically-driven tenets of New Governance that embrace uncertainty and shifting horizontal factions may conflict deeply with the economic and organizational needs of efficiency-driven firms that compete in highly-competitive markets.

In sum, we know that the government's current regulation of corporate compliance is *not* New Governance, and we also know that regulation by adjudication has a number of drawbacks. Having reached those two conclusions, we can consider more carefully the types of regulation that we *do* want to adopt in the future; whether such regulation draws on some of the advantages of the New Governance model, such as its proscription for early and continuous interaction between regulator and entity; and finally, what realistic expectations we can expect from firms in encouraging their employees' compliance with the law. The answers to these questions are hardly self-evident. Nevertheless, they are worth asking. Otherwise, we risk continuing along a well-trod path, in which the government demands policing without understanding the ramifications of those demands, and firms pay for services that fail to deliver their promised benefits.