

# 1. Introduction

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## 1.1 REGULATORY ENFORCEMENT AND CORPORATE COMPLIANCE

Most of the economic activity in modern societies is conducted through business corporations.<sup>1</sup> Given the profound impact of corporate activity on the entire society, corporate misconduct comprises a significant threat to social welfare. Imprudent or irresponsible corporate actions may harm a wide group of people, both economically and physically.<sup>2</sup> Hence, despite recent “free market” global trends, governments in modern societies hold a central position in directing and controlling corporate activity. In an attempt to promote societal goals, and broadly protect the interests of society, governments issue a wide range of regulations with the aim of establishing the necessary rules of conduct required to engender a socially desirable state of affairs.

The enforcement of regulations is a key aspect of every regulatory system. The social value of regulations is contingent, first and foremost, on the desirability of the standards of behavior dictated by them. Nevertheless, the promulgation of socially desirable standards of behavior does not guarantee their positive impact on society.<sup>3</sup> To attain socially desirable ends, regulations must be adequately enforced, while the particularities

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<sup>1</sup> The central role of business corporations in modern societies has been acknowledged by courts, see, for instance, *New York Cent. & Hudson River R.R. v. United States*, 212 U.S. 481, 495–496 (1909); see also, Roland Hefendehl, “Corporate Criminal Liability: Model Penal Code Section 2.07 and the Development in Western Legal Systems,” *Buffalo Criminal Law Review* 4 (2000), p. 290.

<sup>2</sup> See Law Reform Commission of New South Wales, “Sentencing: Corporate Offenders,” Issues Paper 20 (2001); available at: <http://www.lawlink.nsw.gov.au/lrc.nsf/pages/ip20chp01>.

<sup>3</sup> For a discussion of the particularities of regulatory enforcement see Anthony Ogus, “Criminal Law and Regulation,” in *Criminal Law and Economics*, Nuno Garoupa ed., 2nd edn (Cheltenham, U.K. & Northampton, MA, U.S.A.: Edward Elgar Publishing, 2009), 90–110; Anthony Ogus, “Enforcing Regulation: Do We Need the Criminal Law?” in *New Perspectives on Economic Crime*, H. Sjogren and G. Skogh eds (Cheltenham, U.K. & Northampton, MA, U.S.A.: Edward Elgar Publishing, 2004), 42–55.

of the regulatory ecology are taken into consideration.<sup>4</sup> For instance, as opposed to the enforcement of traditional criminal law (e.g., murder, burglary), the enforcement of regulations cannot be blind to potential *positive* externalities of regulated activities. If excessively enforced, regulatees may either avoid socially desirable activities or employ excessive (costly) precautions to the detriment of social welfare.<sup>5</sup> Therefore, rather than applying aggressive, uncompromising enforcement measures, regulators must find a creative way to induce regulatory compliance without generating excessive social costs.<sup>6</sup> Moreover, unlike traditional civil and criminal laws, regulations normally provide detailed standards of behavior; they are frequently updated to meet ever-changing market needs; and often require a certain level of expertise to be fully grasped and obeyed. Hence, an enforcement policy directed at inducing regulatory compliance must encourage regulatees to move from a “reactive” to a “proactive” compliance approach – that is, to take the required steps to learn and correctly implement regulatory requirements. Furthermore, regulations normally seek to overcome market failures that may hamper the proper functioning of market forces, thereby securing a particular social benefit.<sup>7</sup>

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<sup>4</sup> From a social perspective, regulations are worthless if market agents do not comply with them. See Anthony G. Heyes, “Making Things Stick: Enforcement and Compliance,” *Oxford Review of Economic Policy* 14 (1998), p. 61: “Regulations are only useful insofar as they are enforced – either fully or partially;” Paul Fenn and Cento G. Veljanovski, “A Positive Economic Theory of Regulatory Enforcement,” *The Economic Journal* 98 (1988), p. 1055: “The enforcement of regulation and government controls is complex and to a large extent determines the effects of the law.” See also, Robert Baldwin and Martin Cave, *Understanding Regulation: Theory, Strategy, and Practice* (New York: Oxford University Press, 1999), p. 96; John Armour, Henry Hansmann and Reinier Kraakman, “Agency Problems and Legal Strategies,” in *The Anatomy of Corporate Law: A Comparative and Functional Approach*, Reinier Kraakman and others, eds (New York: Oxford University Press, 2009), p. 45.

<sup>5</sup> See Ogus, “Criminal Law and Regulation,” 90–110; Ogus, “Enforcing Regulation: Do We Need the Criminal Law?,” 42–55.

<sup>6</sup> The particular legal environment in which enforcement policies are employed is crucial to consider when crafting an enforcement policy. See, for instance, Robert D. Cooter, “Prices and Sanctions,” *Columbia Law Review* 84 (1984), 1523–1560, who suggests that in legal areas, in which a certain behavior needs to be deterred, enforcement should employ punitive measures. In contrast, when the goal of an enforcement policy is to induce the internalization of the ramifications of certain actions, enforcement policies better employ a pricing mechanism. See also, Robert Cooter and Thomas Ulen, *Law and Economics*, 5th edn (Boston: Pearson Addison Wesley, 2007), p. 493.

<sup>7</sup> See Ogus, “Criminal Law and Regulation,” 90–110; Ogus, “Enforcing Regulation: Do We Need the Criminal Law?,” 42–55.

Accordingly, when crafting a regulatory enforcement policy, the expected social benefit of regulations should be juxtaposed against the social cost associated with the enforcement of such regulations. Hence, from a social welfare perspective, the employment of regulatory enforcement measures can be justified merely to the extent that the social marginal cost of misconduct reduction clears its social marginal benefit.<sup>8</sup> Additionally, where corporate regulatees are concerned, policymakers must be attentive to the regulatees' organizational settings, where various agents may act on the behalf of the corporation. This complex structure of corporate regulatees requires policymakers to consider certain challenges pertaining to the dispersion of responsibility and the control of agents' behavior, as well as to potential conflicts of interest that may arise within the corporate "black box." If regulatory enforcement policies are aimed at inducing, efficiently, corporate proactive compliance, then all such considerations should be factored in when tailoring a particular regulatory enforcement regime.

### 1.1.1 The Goal of the Book

The goal of this book is to identify a structure of enforcement policies that efficiently induces corporate proactive compliance. To this end, the book initially aims at exploring the major philosophies of law enforcement and analyzing their application within the regulatory enforcement ecology. It seeks to examine what, in fact, comprises each of these major schools of thought, and to identify the major promises and pitfalls of actual enforcement regimes developed based on these approaches. Provided that the traditional schools of thought regarding law enforcement do not generate an optimal enforcement regime, the book aims at examining whether a combination of different elements of the traditional schools of thought may generate an improved enforcement paradigm. Having analyzed the major approaches to law enforcement on a general level, the book seeks to look closely at the two key components of regulatory enforcement policies, *i.e.*, corporate liability regimes and regulatory monitoring. It aims to explore how each of these policy components should be structured to efficiently induce corporate proactive compliance, and how the two components may be integrated into a comprehensive, efficient regulatory enforcement policy.

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<sup>8</sup> See Cooter and Ulen, *Law and Economics*, p. 511. See also, George J. Stigler, "The Optimum Enforcement of Laws," *The Journal of Political Economy* 78(3) (1970), p. 526; Mitchell A. Polinsky, "Punitive Damages: An Economic Analysis," *Harvard Law Review* 111(4) (1998), pp. 877–878.

### 1.1.2 Methodology

This book follows a multifaceted analytical approach. As a major methodology, it uses a law and economics approach to identify structures of enforcement regimes that may efficiently induce corporate proactive compliance. The point of departure of the analysis is the “Deterrence Theory,” which has been accepted among the law and economics scholarly literature as the fundamental economic theorem of crime and punishment.<sup>9</sup> Applying the deterrence theory to the context of corporate regulatory compliance, the book examines various structures of enforcement policies according to the compliance incentive schemes they introduce to corporate regulatees, in order to enlist them as proactive players in the battle against law-breaking. Each enforcement regime is evaluated according to its impact on the total social welfare, taking into consideration both the costs and benefits associated with achieving misconduct reduction.

A key concept in the analysis is the notion of *efficiency*. This book follows the law and economics literature on corporate compliance and regulatory enforcement in perceiving the maximization of total social welfare as the goal of enforcement policies. The book analyzes alternative enforcement regimes according to their prospective impact on the wealth of the society as a whole, rather than according to the utility of individual players. Wealth distribution within a society is not taken into consideration. This analytical framework corresponds with the well-established Kaldor-Hicks measure of efficiency.<sup>10</sup> Accordingly, an optimal enforcement policy is taken to imply a policy that minimizes the sum of

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<sup>9</sup> See Gary S. Becker, “Crime and Punishment: An Economic Approach,” *The Journal of Political Economy* 76 (2) (1968), 169–217; Stigler, “The Optimum Enforcement of Laws,” 526–536; Heyes, “Making Things Stick: Enforcement and Compliance,” 50–63; Mitchell A. Polinsky and Steven Shavell, “The Economic Theory of Public Enforcement of Law,” *Journal of Economic Literature, American Economic Association* 38(1) (2000), 45–76; David B. Spence, “The Shadow of the Rational Polluter: Rethinking the Role of Rational Actor Models in Environmental Law,” *California Law Review* 89(4) (2001), p.919. The deterrence theory and its policy applications are discussed in Chapter 2.

<sup>10</sup> The Kaldor-Hicks measure of economic efficiency is named after the economists Nicholas Kaldor (1908–1986) and John Hicks (1904–1989). Under this measure, changes in the evaluated system are perceived as efficient when the gains produced by them to some society members are larger than the losses caused to others. Kaldor-Hicks-efficiency is achieved when – *theoretically* – those members of society made better off by the change would fully compensate those members made worse off and still be better off. See Nicholas Kaldor, “Welfare Propositions of Economics and Interpersonal Comparisons of Utility,” *The Economic Journal*

the social costs associated with corporate regulatory misconduct and its prevention.<sup>11</sup>

Notwithstanding, the book acknowledges the criticism voiced by many social scientists on a purely economic approach to law enforcement, and considers the alternative philosophy proposed by those scholars. The analysis reveals that the enforcement philosophy proposed by those scholars, known as the “Cooperative Enforcement” approach, is not flawless in itself. Therefore, rather than favoring either approach, the book seeks to identify enforcement policies that reconcile both schools of thought in a way that overcomes their pitfalls while sustaining their promises.

To identify a practical, socially beneficial reconciliation of deterrence-based and cooperative approaches to law enforcement, the book uses the wisdom of the game theoretic “prisoner’s dilemma” and applies the Tit-for-Tat strategy to the regulatory ecology. In addition, the book relies on a legal analysis of existing enforcement policies, and explores policy development within civil and criminal areas of enforcement. Finally, the book relies on a comparative legal analysis of recent enforcement policy developments on both sides of the Atlantic Ocean.

## 1.2 THE STRUCTURE OF THE BOOK

The book is structured in three major parts. Part I, which follows the introductory chapter and is composed of Chapters 2 through 4, explores two major *philosophies regarding law enforcement* and the potential reconciliation thereof. Part II, composed of Chapters 5 and 6, focuses attention on *corporate liability regimes*, and aims at identifying a liability regime that efficiently induces corporate proactive compliance. Part III, composed of Chapters 7 and 8, addresses *regulatory monitoring policies* and aims at identifying a regulatory monitoring policy that efficiently induces corporate proactive compliance. The conclusions of this book are drawn in Chapter 9.

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49 (1939), 549–552; John R. Hicks, “The Foundations of Welfare Economics,” *The Economic Journal* 49 (1939), 696–712.

<sup>11</sup> See Cooter and Ulen, *Law and Economics*, pp.511–512; see also, Stigler, “The Optimum Enforcement of Laws,” p.533; Arun S. Malik, “Avoidance, Screening and Optimum Enforcement,” *RAND Journal of Economics* 21(3) (1990), p.397.

### 1.2.1 Part I – Major Schools of Thought Regarding Law Enforcement

Chapters 2 and 3 explore two major schools of thought regarding law enforcement: the *deterrence-based enforcement* approach and the *cooperative enforcement* approach, respectively. Both schools share the same objective, *i.e.*, ensuring regulatory compliance in a socially desirable manner. Yet, each approach endorses different enforcement styles in achieving this objective. Chapters 2 and 3 present the building blocks of each school of thought, and describe the different structures of enforcement regimes endorsed by each of them. Furthermore, these chapters include an analysis of the different enforcement paradigms offered by the different schools of thought, according to their promises and pitfalls from a social welfare point of view. As a conclusion, Chapters 2 and 3 propose that neither of the “stand-alone” schools of thought is categorically superior to the other, and that each of them is fraught with various perils that may thwart their intended function.

Chapter 4 proposes that within the context of corporate regulatory compliance, policymakers are not necessarily required to follow a single enforcement paradigm. Given the heterogeneity of regulatees, social welfare maximization favors an inclusive approach that addresses all types of regulatees, while integrating deterrence-based and cooperative enforcement styles of enforcement. The main aim of this chapter is to explore “regulatory mixed regimes” that combine deterrence-based and cooperative enforcement strategies, while generating higher social welfare compared with the “stand-alone” enforcement regimes. Initially, the chapter explores the enforcement dilemma arising within the regulatory contexts in a realistic setting of a world with heterogeneous regulatees. Then, it presents the game theoretic wisdom of the well-known prisoner’s dilemma and its potential application to the regulatory ecology. Next, the chapter presents various structures of “regulatory mixed regimes,” which have been developed in the scholarly literature, and highlights the virtues of such mixed regimes from a social welfare standpoint. Eventually, the chapter points at the major pitfalls of these mixed regimes that have not received sufficient attention in the polemic literature, although they may hamper the efficient functioning of such regimes. Given such shortcomings, this chapter concludes that in order to overcome their pitfalls while sustaining their promises, the regulatory mixed regimes should be looked at afresh. This chapter, which closes the first part of the book, establishes the intellectual challenge for the ensuing parts of the book, in which more efficient regulatory mixed regimes are developed.

## 1.2.2 Part II – Corporate Liability and the Incentive Apparatus for Corporate Proactive Compliance

This part of the book aims at identifying a structure of corporate liability regimes that may efficiently induce corporate proactive compliance. Such a structure is sought to sustain the promises of the mixed enforcement regimes proposed by the existing literature while overcoming their pitfalls.

Chapter 5 provides a legal overview of major corporate liability regimes that are employed in practice to control corporate misconduct. This chapter mainly focuses on the U.S. legal system, which has gone through the most comprehensive transformation of perceptions regarding the optimal structure of corporate liability regimes. In addition to canvassing the alternative structures of liability regimes, the chapter identifies a clear tendency of recent U.S. corporate liability developments to depart from the traditional strict approaches to corporate liability. The chapter presents various policy-development channels through which corporate liability regimes – both civil and criminal – have been softened in recent years by accepting corporate internal enforcement efforts as a mitigating factor of – and sometimes even as a shield from – corporate liability. Furthermore, the analysis of the U.S. legal system is complemented by insights from other legal systems (the British, Canadian, and Australian systems) that have undergone similar developments, as well as by insights from another major system (the EU legal system), which has undergone a completely reverse transformation. This chapter exposes the reader to the great diversity of existing corporate liability regimes, and to diverse policy perspectives upheld on both sides of the Atlantic. This multiplicity of corporate liability structures emphasizes the complexity of this field. In conclusion, Chapter 5 calls for a systematic evaluation of the alternative regimes from a social welfare perspective. Such an evaluation, which is the central goal of the following chapter, may illuminate a socially desirable structure of corporate liability regimes.

Chapter 6 takes on the challenge of evaluating the alternative corporate liability regimes through law and economics lenses. Initially, the chapter presents the economic functions of corporate liability regimes and their particular roles from a social welfare perspective. Thereafter, each of the major types of liability regimes discussed in this chapter is evaluated according to its aptitude to achieve the social goals of corporate liability regimes. The comparative analysis concludes that neither of the existing regimes presents an optimal structure of corporate liability regimes for efficiently inducing corporate proactive compliance. Corresponding to the findings of Part I of this book, the analysis is attentive to the perils of both “stand-alone” approaches to law enforcement. Hence, rather than focus-

ing on the choice between a “harsh” and a “conciliatory” corporate liability framework, the chapter conceives an innovative corporate liability regime, the “Compound Corporate Liability Regime,” that may succeed where existing liability regimes fail. The proposed regime reconciles both stand-alone approaches to law enforcement in a socially desirable manner, and ensures an efficient inducement of corporate proactive compliance.

### **1.2.3 Part III – Corporate Monitors: Can “Swords” Turn into “Shields”?**

This part of the book aims at identifying a structure of regulatory monitoring regimes that may efficiently induce corporate proactive compliance. The structure developed in this part utilizes corporate monitors as a signaling mechanism that facilitates the creation of a targeted monitoring system. This monitoring system is sought to sustain the promises of the mixed enforcement regimes discussed in Part I of the book, while overcoming their pitfalls.

Chapter 7 explores the unique enforcement instruments, known as Deferred Prosecution Agreements (DPAs) and Non-Prosecution Agreements (NPAs), which have been developed recently in the U.S. as an alternative enforcement measure against culpable corporations. An intriguing feature of the newly emerged DPAs and NPAs is the use of corporate monitors as “watchdogs” that seek to ensure compliance by culpable corporations. The book considers corporate monitors a valuable instrument that may facilitate the formation of an efficient regulatory monitoring system. Hence, the goal of this chapter is to expose the reader to the contemporary use of corporate monitors in a related enforcement context, and to the specific challenges arising when using this enforcement mechanism. Accordingly, this chapter looks closely at the evolution of corporate monitors as an enforcement instrument within the emerging policies of DPAs and NPAs, and explores the primary criticisms of such policies found in the scholarly literature. This exposition facilitates the analysis for the ensuing chapter, in which corporate monitors are utilized to establish an efficient regulatory monitoring policy.

Chapter 8 takes on the challenge of developing an innovative regulatory monitoring system that may efficiently facilitate corporate proactive compliance. This chapter begins by presenting the major challenge involved in the classification of corporate regulatees into differently monitored groups as part of a targeted monitoring system, and discusses the alternative classification criteria proposed by the existing literature. Thereafter, the chapter develops an innovative monitoring policy, the “Third-Party-Based Targeted Monitoring System,” or the “TPTM



system,” which utilizes both liability threats and reputation concerns in inducing corporate proactive compliance. The proposed policy allows for a delegation of some enforcement powers to corporate monitors functioning both as third-party enforcers and as a signaling mechanism attesting to corporations’ genuine normative commitment. Such corporate monitors are specifically designed to overcome the flaws of currently used molds of corporate monitors in DPAs and NPAs policies, as revealed in Chapter 7. The proposed monitoring system increases the private gains resulting from employing genuine internal enforcement efforts, and thereby efficiently strengthens the corporations’ motivation to become proactive in ensuring compliance among their employees.

Chapter 9 refines the findings of the book and proposes a comprehensive structure of regulatory enforcement policy that may efficiently induce corporate proactive compliance.

### 1.3 CAVEATS

The book seeks to identify regulatory enforcement policies that may induce corporate proactive compliance. Accordingly, the book focuses attention on *regulatory violations*, rather than any other type of wrongdoing; and on *corporate regulatees*, rather than individual ones. Hence, broader theories and insights discussed in the book with respect to law enforcement, compliance motivations, and misconduct risks are analyzed and interpreted as applied within the context of corporate regulatory compliance.

The book does not deal with the question of the *desirability* of *governmental intervention* through *regulations*, or of particular standards of behavior set forth by regulations. The desirability of governmental regulation has been questioned in many contexts and heavily criticized in the scholarly literature. The opponents of regulatory intervention often identify with the neoclassical economic approach, which favors the ideas of economic liberalism and free markets rather than a central planner dictating behavioral standards.<sup>12</sup> In addition, a great deal of criticism addresses particular standards of behavior set by such regulations. Commentators often criticize regulations for being excessively ambiguous, inefficient,

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<sup>12</sup> The leading neoclassical school of thought within the academic community of economists is identified with the Chicago School of Economics. For a discussion of the Chicago School of thought see Ross B. Emmett, ed., *The Elgar Companion to the Chicago School of Economics* (Cheltenham, U.K. & Northampton, MA, U.S.A.: Edward Elgar Publishing, 2010).

or at odds with other social ends.<sup>13</sup> The current analysis departs from the broader discussion of the desirability of regulation and focuses instead on the enforcement of such regulations provided that they include clear and valid regulatory standards.

The analysis in this book addresses regulatory enforcement systems that are based on *public* (criminal or administrative) *enforcement*. Private enforcement is indirectly considered merely as part of the discussion concerning potential policy implications of the deterrence-based school of thought in Chapter 2. The liability and monitoring regimes developed in Parts II and III of the book may apply to enforcement systems in which public enforcement is complemented by a private enforcement system. Nevertheless, in such cases the optimal sanction may differ, whereas when public and private enforcement mechanisms are used together, an optimal corporate liability regime should generate an expected liability that equals the total social cost of the misconduct minus the expected liability generated by the private enforcement mechanism.

Furthermore, the book does not address the well-established *principal-agent problem* between corporate management and shareholders, but rather focuses on a different agency problem; the one that exists between corporations (or the management thereof) and corporate employees undertaking corporate activity. Each of these agency problems has different causes and therefore requires a focused evaluation. As shown by the scholarly literature, the agency problem between managers and shareholders is caused by the separation of ownership and control within corporations, which often generates costs pertaining to potential conflicts of interest between those who run the corporation and those who own it.<sup>14</sup> Recent corporate scandals have propelled this agency problem to the front of the corporate governance debate, and spurred the re-evaluation

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<sup>13</sup> See for instance, John T. Scholz, "Cooperation, Deterrence, and the Ecology of Regulatory Enforcement," *Law and Society Review* 18 (1984), p.183; John T. Scholz, "Voluntary Compliance and Regulatory Enforcement," *Law & Policy* 6(4) (1984), p.386; John T. Scholz, "Enforcement Policy and Corporate Misconduct: The Changing Perspective of Deterrence Theory," *Law and Contemporary Problems* 60(3) (1997), 253–268; Eugene Bardach and Robert A. Kagan, *Going by the Book: The Problem of Regulatory Unreasonableness* (Philadelphia: Temple University Press, 1982), pp.58–59; Scholz, "Enforcement Policy and Corporate Misconduct: The Changing Perspective of Deterrence Theory," p.258. See also, Baldwin and Cave, *Understanding Regulation: Theory, Strategy, and Practice*, pp.103–106.

<sup>14</sup> For an overview of the agency problems between managers and shareholders see, for instance, John Armour, Henry Hansmann and Reinier Kraakman, "Agency Problems, Legal Strategies, and Enforcement," in *The Anatomy of*

of disciplinary mechanisms, such as internal monitoring schemes, market controls, and remuneration packages to corporate executives.<sup>15</sup> In contrast, despite its great importance, the agency problem between corporations and their employees undertaking corporate activity has received only scant attention in the scholarly literature. This agency problem, which results from the difficulties involved in controlling numerous employees working as an integrated group in undertaking corporate activity, is not solved by the disciplinary mechanisms mentioned above, and requires a closer look and a separate evaluation. This book pays close attention to the aptitude of enforcement policies to induce corporations to proactively ensure compliance among employees undertaking their activity.

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*Corporate Law: A Comparative and Functional Approach*, Reinier Kraakman *et al.* eds (New York: Oxford University Press, 2009), 21–32.

<sup>15</sup> For an overview of disciplinary mechanisms of corporate management see Stephen G. Marks, “The Separation of Ownership and Control,” in *Encyclopedia of Law and Economics*, Bouckaert, Boudewijn and De Geest, Gerrit eds, Vol. 5630 (available online: <http://encyclo.findlaw.com/index.html>; Edward Elgar and the University of Ghent, 1999), 692–724; George Bittlingmayer, “The Market for Corporate Control (Including Takeovers),” in *Encyclopedia of Law and Economics*, Bouckaert, Boudewijn and De Geest, Gerrit eds, Vol. 5640 (available online: <http://encyclo.findlaw.com/index.html>; Edward Elgar and the University of Ghent, 1999), 725–771.

