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Procedia Economics and Finance 28 (2015) 76 – 84

Procedia
Economics and Finance

www.elsevier.com/locate/procedia

7th INTERNATIONAL CONFERENCE ON FINANCIAL CRIMINOLOGY 2015
13-14 April 2015, Wadham College, Oxford, United Kingdom

A Microeconomic Model of Opportunistic Financial Crimes: Prosecutorial Strategy When Firms Are Too Big To Jail

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Abstract

In the cases of corporate crime, US prosecutors can lodge charges against the corporation, its managers, or both. However, the emergence of systemically important firms, most notably in the financial sector, constrains prosecutors. This paper develops a new model of corporate criminal liability and shows how the Too Big To Jail problem reduces the deterrence effect of a crime control policy relying primarily on large corporate fines. Furthermore, this paper shows how corporate criminal liability may not incentivize a Too Big to Jail firm to invest in internal controls and may even attempt to subsidize an employees' criminal activity. In the presence of Too Big to Jail firms, prosecutors should shift resources toward prosecutions of individual managers, so they bear a substantial personal risk from dealing dishonestly.

Peer-review under responsibility of ACCOUNTING RESEARCH INSTITUTE, UNIVERSITI TEKNOLOGI MARA

Keywords: Financial crime; corporate criminal liability; microeconomics;principal-agent theory; Too Big To Fail;prosecution;law and economics.

1. Introduction

Financial crime control has moved to the forefront of public, policy, and academic discussion since 2008. Official investigations have documented widespread malfeasance in the financial sector before, during, and after the crisis (US Senate Permanent Subcommittee on Investigations 2011; Financial Crisis Inquiry Commission 2011). Despite the billions of dollars financial institutions have paid to settle criminal and regulatory actions in the United States and United Kingdom, few of their employees have faced individual prosecution for conduct relating to the

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Peer-review under responsibility of ACCOUNTING RESEARCH INSTITUTE, UNIVERSITI TEKNOLOGI MARA
doi:10.1016/S2212-5671(15)01084-9

crisis, and no executives or high-level managers have been incarcerated. In the US, many corporate prosecutions have been settled out of court using deferred prosecution agreements or non-prosecution agreements that include only limited public admissions of guilt, thereby restricting firms' exposure to civil liability. There have been relatively few cases where large corporations were found guilty of criminal charges, either at trial or through plea agreements; virtually no high-level decision makers from these companies have faced individual prosecution (Rakoff 2014; Fisher et al. 2011).

Criminal authorities' reluctance to convict large corporations is rooted in the widespread fear that a felony conviction amounts to a "corporate death penalty," which will inflict unacceptable collateral damage on employees, shareholders, and the broader economy. This belief was reinforced when the multinational accounting firm Arthur Andersen LLP collapsed following a criminal conviction for its role in the Enron scandal (Markoff, 2013). The collapse precipitated massive job losses and further consolidation of the accounting industry, even though the US Supreme Court overturned the conviction in 2005. This episode chastened many prosecutors, who fear that convicting a large corporation could destroy thousands of jobs and impose costs on shareholders who had no direct responsibility for the unlawful conduct. This reaction, along with the legal record in the years since the financial crisis, has led policy makers, commentators, and scholars to argue that some firms are so large and interconnected that they have effectively become Too Big To Jail ("TBTJ") (Holder, 2013; Sorkin, 2013; Gilchrist, 2014; Garrett, 2014).

This risk of collapse is especially acute for financial institutions, because they rely on maintaining relevant operating licenses, high credit ratings, and public credibility, all of which are vulnerable to damage following a corporate criminal conviction. Since large financial institutions are invariably connected to myriad others as transaction counterparties, the collapse of one "Too Big To Fail" ("TBTF") bank may cause a cascade of financial contagion and market panic, such as the crisis that followed the bankruptcy of Lehman Brothers Holdings Inc. in September 2008 (Brunnermeier 2009). Theoretical models have also shown that a liquidity shortfall – such as the capital loss that could result from a large criminal fine – at even one highly connected institution can be sufficient to trigger contagion in the financial sector (Gai, Haldane, and Kapadia 2011).

This paper develops a novel microeconomic model of corporate criminal liability that directly analyzes the strategic options available to financial crime prosecutors facing TBTJ firms. While there is a substantial literature on the microeconomics of corporate criminal liability, it tends to model criminal activity within a corporation as a misallocation of effort from productive to socially harmful forms (Garoupa, 2000; Polinsky and Shavell, 1993). These models reflect the microeconomics of corporate criminal negligence, such as in environmental crimes, but are less well-suited to crimes like fraud or insider trading. This paper develops a new "crime of opportunity" model that better reflects the economics of these financial crimes. Further, this paper embedded this model in the constraints facing authorities prosecuting SIFIs and analyzes how a deterrence strategy can adapt to the TBTJ problem.

The next section reviews the literature on corporate criminal liability, first from a legal perspective and then from a microeconomic perspective. The third section presents the paper's novel "crime of opportunity" model of corporate crime deterrence. The fourth section explores the strategic implications of this model for financial crime prosecutors working in the presence of TBTJ banks. Finally, the last section concludes.

2. Theory of Corporate Criminal Liability

2.1 Legal Theory of Corporate Criminal Liability

Although the legal burdens prosecutors face in establishing corporate criminal liability vary by jurisdiction, the idea that courts can convict corporations is well established in common law systems. Because companies can only act through their agents or employees, tests of corporate criminal liability hinge on attributing legal responsibility for an individual's action to the firm.

UK courts have traditionally restricted corporate criminal liability using the *identification doctrine*, which holds that the corporate body is only liable for acts taken by "the directing mind and will of the corporation" (AC 1915). This test has served to strictly limit corporate criminal liability in the UK, particularly in an age in which firms are very large, and it is difficult to prove that executives or directors are sufficiently involved in an operation's details. However, section 7 of the Bribery Act 2010, under which a company can be held liable for failing to prevent bribery, pioneered a new circumvention of the identification doctrine (UK Parliament 2010). Indeed, the UK Attorney General has suggested a new "failure to prevent fraud" offence that would follow the same model, further