Decision and Punishment: Or—Hold Bankers Responsible! Corporate Criminal Liability from an Economic Perspective

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Abstract From an economic perspective, the "principle of liability" is central: Those who decide should pay. This should hold true for white-collar crime. The decision-makers are not the corporations, but the managers—during the financial crisis, they often acted against the interests of the companies. Yet "modern" criminal prosecution focuses on prosecuting corporations. This leads to wrong incentives. Prosecution should increase its focus on managers, even if this turns out to be more difficult than prosecuting the corporation.

1 Introduction

Perhaps Dale Lattanzio was nothing but a nice colleague. He was working as a Managing Director with the investment bank Merrill Lynch, when some of his colleagues got into trouble. It was their job to create securities from mortgages. But on the market, these securities were not regarded as being too safe anymore, and buyers were hard to find. So Dale Lattanzio created a group of Merrill Lynch employees and ordered them to buy these securities, which another group at Merrill Lynch had created and which nobody else wanted to buy. The securities' creators received several million dollars in bonuses and shared them with the securities' buyers, which was not uncommon. But later, these securities had to be written down. In the financial crisis, Dale Lattanzio was fired. In high distress, Merrill Lynch was sold to Bank of America.[1] The U.S. regulator, the Securities and Exchange Commission (SEC), thoroughly checked Merrill Lynch's bonuses and sued the company. But up to this day we do not know whether Dale Lattanzio broke

This document reflects the view of the author, not necessarily those of F.A.Z.

[1] Narrated after Bernstein and Eisinger (2010).

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the law. There has been no trial. Meanwhile, Lattanzio has founded an investment advisory.

Perhaps Dale Lattanzio is just a nice colleague. But he might also be a good example for current shortcomings in addressing and punishing white-collar crime. From an economic perspective, in crime as in other issues, the "principle of liability" is central: Those who decide should pay. It is not only important for a sense of justice, but first of all this principle is important for setting the right incentives to act. Too often, the principle of liability seems to be disregarded.

2 Who Decides?

In much of the literature about corporate criminal law, companies are seen as a single rational actor. This model may be a good choice for studying interactions on markets or whole economies, but for studying white-collar crime and the question of corporate crime, it seems more useful to have a closer look at corporate decision making.[2]

Unfortunately, economics and management science still lack a widely recognized positive theory of corporate decision making. Of course, there are several normative theories who tell managers how they should be deciding. But the question how decisions actually take place has no reliable answer today.

Fortunately, there is a popular theory which can at least shine a light on one important aspect of the decision-making process. It is the "Principal Agent Theory".[3] The "Principal Agent Theory" formalizes the observation that the agent's (or: the employee's) utility is influenced by more motivations than only the interests of the principal (or: the boss, the shareholders). In practical terms, employees may be motivated by money, status, professional standards, human relations or by other things—for example by fear of prosecution. In discussing white-collar crime, it is mandatory to differentiate between the interests of the company as the interests of shareholders and other stakeholders on the one hand—and the interests of employees themselves on the other hand.

What is the interest of companies and their shareholders? There are several notable calculations which suggest that criminal activity pays off for the company and its shareholders.[4] However, none of these calculations completely consider the damaging effects crime can have to the public image. None of these calculations completely consider subsequent losses of orders, turnover and earnings. In Germany, companies seem to view the Siemens corruption scandal as a particularly bad example. Anecdotal evidence suggests that many Siemens employees thought that bribery was good for the company, but while not all of them are convinced that

[2] Similar arguments in Metzger and Schwenk (1990).

[3] See, e.g. Ross (1973).

[4] See, e.g. The Economist (2012).

business without corruption is possible, many now regard corruption as detrimental to the company because of the public outcry. Judging from actions, top managers of other companies now seem to think in a similar way. Be it because crimes being uncovered brings huge cost, be it because of top managers' own desire for status and a righteous self-image, many companies have introduced compliance systems of rules and controllers in order to prevent crime from happening. In fact, these compliance systems are so excessive that German employees start to talk about a "compliance delusion".[5]

At the same time, another kind of white-collar crime seems to have become more virulent, especially in crime surrounding the financial crisis: It is crime motivated by employees' own agenda, for example their desire for status or for huge bonuses. At least, some action of employees clearly violated their companies' guidelines.

Dale Lattanzio is just one example for bankers who acted not in the interest of their employers, but against them. Another example is the one of J.P. Morgan's trader Bruno Iksil, best known under his nickname "London Whale", who is connected to a $6 billion loss due to overly risky trading and whose losses—according to the SEC's case—were under-reported up the chain[6] and to the regulation authorities.

3 Who Is Punished?

Of course, most bank managers around these incidents have had to bear some consequences, the most severe often being the loss of their job. In the affair around the "London Whale", even Ina Drew, the long-time head of J.P. Morgan's Chief Investment Office, has retired from her job.[7] But: Losing a job cannot be regarded as punishment. Losing a job is part of the risk that most managers face all of the time, sometimes they are forced to retire simply due to a lack of success after circumstances changed. Many just try to avoid being fired by breaking the law.

In the case of the "London Whale", only two of J.P. Morgan's employees are possibly facing prison, not including the "London Whale" himself. According to George Canellos, Co-Director of the SEC's Division of Enforcement, "J.P. Morgan failed to keep watch over its traders".[8] But it is not the managers who are held accountable for this. Instead, the bank J.P. Morgan has agreed to pay fines which total to $920 million, in addition to the loss that the bank already has to bear.[9] The discrepancy between consequences for the bank and for managers seems to be a

[5] See DPA (2012).

[6] Gandel (2013).

[7] Dominus (2012).

[8] SEC (2013).

[9] Schäfer and Saigol (2013).

problem for the public, at least it has quickly been pointed out by the German boulevard website "Deutsche Wirtschafts Nachrichten".[10]

In the United States, it is not unlike in Germany: Up to now only few trials against individual bankers have surfaced. Of course, a financial crisis can happen even without anybody breaking the law. Nonetheless, in the investigations after the financial crisis, some wrongdoings were uncovered. But the main targets of the investigations are the banks, not the bank managers themselves. Deutsche Bank alone has accrued €3bn for possible costs from trials because of the financial crisis and other scandals.[11] At the same time, only few bank managers have been put to trial in person, e.g. Stefan Ortseifen (IKB) and Dirk Jens Nonnenmacher (HSH Nordbank). Germany's national newspaper F.A.Z. concludes that most of the bankers "fell softly".[12]

But punishing companies does not necessarily punish the right entities. In economics, the "incidence of costs" has been studied at least since 1924.[13] In general, it is widely accepted that costs—such as criminal fines—are not borne by those who are charged with the costs, but the costs are passed on: to the owners of a company, to managers or workers, to customers, to other stakeholders or to any combination of these. This is not just some kind of spillover effect, but a fundamental change in the distribution of costs. In the end, costs are borne by those stakeholders whose elasticity of their relationship to the company and the cost is lowest. Put less technically, the cost is borne by those stakeholders who cannot or will not turn away.

Who is this? This question cannot be answered in general. Elasticities differ from company to company, from industry to industry. In an extreme example of a competitive market with entry-barriers, customers might even pay a fine which was originally designed to protect them. For example, if all the members of an oligopoly had joined a cartel and were fined for this, the fine would be nothing but an additional one-time cost for all suppliers, which might make it necessary and allow them to all raise their prices.

When the fine has to be paid, the managers who were responsible for the crimes often have already left the company, as has been previously discussed. This is not only the case with bankers. Some criminals even utilize the fact that authorities first look at the companies and not at the individuals behind them. The German "telecommunications law" ("Telekommunikationsgesetz") allows for administrative fines up to 100,000 Euro. There was a time in the early years of the twenty-first century when some companies did cold calls. When the fines came, the companies went bankrupt, but their founders just started over with another company, until they were held responsible in person.

[10] Deutsche Wirtschafts Nachrichten (2013).

[11] Armbruster (2013).

[12] F.A.Z. (2013).

[13] Carver (1924).

4 What to Do?

Regarding corporate crime from an economic perspective means taking into account the "principle of liability". With this principle in mind, it seems like there has been too much attention on holding companies responsible and too little attention on individuals.

One thing is certain: Holding individuals responsible is not going to be easy. Often the right law is missing. The more important barrier is the fact that it is difficult to prove criminal intent—and it is absolutely necessary to prove it, since companies need to take risks which may turn out the bad way. Drawing the line between risk and hazard is not going to be easy. Today already, many top managers surround themselves with lawyers in order to bulletproof their decisions, and this situation contributes to discouraging some eligible candidates from aspiring to a top management position.[14]

It gets even more complicated due to the development of "criminal cultures" in companies. According to some analyses, employees—particularly employees at the bottom of the hierarchy—are more inclined to criminal activities because many of their colleagues commit crimes.[15] Still, somebody is responsible for letting such a corporate culture develop and exist.

It is not an economists' expertise to point out which particular laws might be missing, which laws might already be in place and how to prove intent. All an economist can do is to acknowledge that this is a very difficult task. However, it may be worth the while.

Let's take a look back to the case of the London Whale, in which the bank was held responsible for failing to supervise, but the supervisors such as Ina Drew, the long-time head of the chief investment office, were not. Fortune senior editor Stephen Gandel asks: "Why not charge Ina Drew with failure to supervise?".[16]

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[14] See Jahn (2013).

[15] See, for example, Campbell and Göritz (2013).

[16] Gandel (2013).

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