Poisoning the well

Billions of dollars in fines have recently been imposed on US companies for activities that occurred before the offending business units were acquired. David Rowe **argues this will make future crises harder to manage and more severe**

Shadowy legal proceedings in the US have led, in recent years, to billions of dollars in business fines for offences such as "contributing to the financial crisis". In late August, *The Economist* published an excellent analysis of how these acts have undermined the rule of law.[1] In many cases, the proceeds of the fines have largely been used to fund the activities of the very prosecutors who effectively sit as both judge and jury in such cases. Unfortunately, the draconian consequences of a prolonged court battle, let alone a guilty verdict, leave most managers with little choice but to settle these suits using their shareholders' money.

Prosecutors will argue the settlements are justifiable penalties for bad behaviour. Unfortunately, it is impossible to judge the merits of such claims objectively. Neither the formal evidence nor even a description of the specific actions giving rise to the penalties is part of the public record. Combine this with the fact that prosecutors' offices can benefit financially from a process in which they wield the state's monopoly on the legitimate use of violence, with minimal judicial review and oversight, and the conflict of interest is obvious. Prosecutors would rightly seek to redress such a conflict if it existed in a private organisation.

This type of Star Chamber proceeding can effectively criminalise actions not specifically prohibited in law. It can also impose de facto positive obligations not codified in law, such as demanding that Google prevent distribution of ads for the sale of Canadian pharmaceuticals in the US. Such expansive and ill-defined interpretations of the law are bound to make any business more cautious and represent a tangible drag on future growth.

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One aspect of these questionable legal proceedings has particular implications for financial risk management. In many cases, most recently the $17 billion settlement with Bank of America, the alleged actions giving rise to the prosecution occurred in a subsidiary prior to its acquisition by the party to the suit. In this case, most of the actions in question occurred at Countrywide Financial and Merrill Lynch. The same is true of the $13 billion settlement paid by JP Morgan Chase in late 2013 for improper actions in packaging and reselling subprime mortgage-backed securities. Much of the claimed wrong-doing was committed at Bear Stearns and Washington Mutual when they were independent firms.

An added twist is that many of the acquisitions were concluded with the active approval of regulators or, as in the case of Merrill Lynch, under intense pressure and threats of regulatory action if an intended acquirer backed away from a deal. Similarly, Bear Stearns and Washington Mutual were acquired by JP Morgan with the enthusiastic approval and financial support of the government.

To be fair, in September 2008 there was pervasive fear of complete financial meltdown. Appeals to patriotic duty, sometimes reinforced by threats of tougher regulatory treatment and removal of senior management, were hard to resist. Downside analysis was focused on asset appraisals with too little attention to the possible cost of future legal liability for an acquired firm's past actions. It should be obvious to all at this point that no future chief executive faced with a similar situation will underestimate the potential cost of such legal liabilities fines, for instance, which are only limited in size by the ambition of prosecutors.

The authorities would have us believe these aggressive prosecutions and plea bargains will discourage future abuses and protect against future financial crises. In fact, memories will long endure of the dire and open-ended consequences of succumbing to regulatory pressure to make questionable acquisitions. In a future crisis, regulators will again seek to put pressure on healthy firms to step in and rescue troubled institutions, to avoid the possible systemic consequences of a formal bankruptcy. Unfortunately, aggressive prosecution of institutions for misdeeds over which they had no control at the time these were committed has poisoned the well and undermined this important crisis management tool.

Future chief executives and boards of healthy companies will look to the preservation of their own firms. They should only be willing to buy the assets of a failing firm after it has actually been declared bankrupt and is no longer a going concern, purging it of past liabilities. In light of the experience of the past six years, any other decision would be utterly foolhardy. The eventual consequences of this distortion of the prosecutorial process represent a significant new fundamental uncertainty. **R**

[1] The Economist, *Criminalizing American firms: a mammoth guilt trip, August 30, 2014 edition.*