26 April 2023

Failure to prevent fraud: Cohen & Gresser assesses the consequences of imminent UK Corporate Fraud Liability Reform

Sir David Green CB KC, John Gibson, Tim Harris

What is happening?

The Economic Crime and Corporate Transparency Bill (the "**Bill**") is currently going through the UK Parliament. On 11 April 2023, the Government introduced a draft amendment that will create a new corporate offence of failure to prevent fraud.

The declared policy aims underlying the proposed new offence

The offence has two key policy aims:

- To drive a shift in corporate culture to "*discourage organisations from turning a blind eye to fraud by employees which may benefit them*" and "*to protect the public from a wide range of harms including dishonest sales practices, false accounting and the hiding of important information from consumers and investors.*"
- To make it easier to prosecute companies that commit or enable fraud.

Prosecution of corporates: the current position

- Proving a crime requiring a mental state (such as intent or dishonesty) against a company is far harder in the United Kingdom than it is in the United States. UK corporate criminal liability is governed by the identification principle. This requires the prosecution to identify the "controlling mind" or "directing mind and will" within a corporation, and to prove that that individual was complicit in the relevant offence.
- Identification of the "controlling mind" is obviously easier in the case of companies with a small number of directors, but far more difficult when considering large, listed corporations with complex and delegated decision-making structures.
- The point was highlighted in successive judgments in the failed prosecution of Barclays Bank by the UK Serious Fraud Office (the "**SFO**").[1]

[1] R v Barclays Plc and Serious Fraud Office v Barclays Plc [2018] EWHC 3055 (QB), It was held that even a corporation's managing director and financial director, acting jointly, might not constitute the corporation's directing mind and will if they did not have authority to engage in the conduct in question.

Why the change?

Prosecutors (the SFO in particular) have argued for the change since at least 2012. In addition, economic crime and money laundering have climbed the political agenda with the Russian invasion of Ukraine.

Following the Barclays judgments, the matter was referred to the Law Commission. In an options paper published in June 2022, the Commission shied away from calling for reform of the identification principle. It considered the extension of the corporate "failure to prevent" model (already existing in relation to bribery and the facilitation of tax evasion) to include fraud.

Arguments against any change

The amendment may well face objections in debate. Counter arguments deployed since 2012 include the observations that people, not companies, commit crime; that the introduction of failing to prevent offences has not increased individual accountability; and also that additional compliance obligations are detrimental to particularly smaller corporates in a challenging economic climate.

The new offence

- A "*relevant body*" may commit the new offence if an "*associate*" of that company commits a "*fraud offence*" intending to benefit the company.

- The offence will only apply to "*large organisations*" (the *"relevant body"*). "*Large*" is defined using Companies Act 2006 definitions. This means meeting two of the following three criteria: more than 250 employees; more than £36m turnover; more than £18m balance sheet total.

- "*Fraud offence*" is likely to include: Fraud Act 2006 s2 (false representation), s3 (failure to disclose information), s4 (abuse of position), s9 (participation in a fraudulent business), and s11 (obtaining services dishonestly); false accounting; false statements by company directors; fraudulent trading; and cheating the public revenue. It does not, for the moment, include money laundering offences.

- The *"relevant body"* will have a defence if it can show that it had in place "*reasonable*" fraud prevention procedures, or that it was not reasonable to expect such procedures to be in place.

- The Government must publish *"Guidance"* on the issue of suitable procedures prior to the offence coming into force.

- A "*relevant body*" will not commit the offence if it was a victim of the fraud offence or was intended to be a victim.

- The offence will apply only to corporates, not to individuals.

- The extra-territorial jurisdictional effect is presently ill-defined. The offence will apply to both UK and non-UK incorporated entities, but there must be a UK nexus for the fraud offence. The accompanying Government fact sheet explains "*if an employee commits fraud under UK law, or fraud targeting UK victims, their employer could be prosecuted, even if the organization (and the employee) are based overseas*".

- Penalty: potentially an unlimited fine. Deferred Prosecution Agreements ("**DPAs**") will be available for offer to a company where deemed in the interests of justice.

C&G analysis: the likely practical consequences

- The offence will make it easier to hold a company liable where they benefit from fraud. That said, both the SFO, and the Crown Prosecution Service expect there to be limited additional burden on the court service. The Government therefore does not expect there to be a significant increase in trials of corporate defendants. Rather, offences are likely to be settled by the relevant body pleading guilty or entering into DPAs.

- DPAs have proved a success but remain controversial. This is because they are a cheap alternative to full investigation and prosecution; they generate cash for the Treasury, and related convictions of individuals have not materialised until very recently. Given that the new offence (in tandem with the existing section 7 Bribery Act 2010 offence) will make the prosecution of corporates easier, the SFO will be able, should its new Director so decide, to raise the bar of eligibility for DPAs.

- This is likely to mean a strict requirement for early and frank self-reporting of misconduct if the corporate is to be eligible for a DPA and to maximise co-operation credit.

- This requirement for prompt and early self-reporting will in turn require a prompt and efficient internal investigation so that the board can make an informed decision on self-reporting.

- In this regard, a further provision of the Bill before parliament is the extension of the enhanced pre-investigation powers under S2A of the Criminal Justice Act 1987. The effect is that the SFO will be able to use S2 powers before the opening of a formal criminal investigation into fraud, as is the current position with investigations involving overseas bribery. This should speed up the investigation process.

- Firms regulated by the FCA already face a range of obligations to self-report fraud. Firms outside the regulated sector have tended to direct compliance efforts towards the prevention of internal fraud and against being defrauded. Once the Guidance is published, addressing a new offence of failing to prevent "external" fraud will require a risk assessment to identify their high-risk areas for external fraud; any necessary additional controls will need to be identified and supported by enhanced training.

Likely effect on UK law enforcement investigative and charging strategy

- At the beginning of every economic crime investigation, strategy and case theory is established. With the new offence, investigators will feel more able to concentrate efforts and disclosure requests on the epicentre of alleged fraudulent conduct.

- The complexities of investigating "knowledge" or "willful blindness" at board level will diminish in the expectation that once fraudulent conduct within the company is established, the company may feel compelled to provide full co-operation in order to be eligible for a DPA or enter plea negotiations on a failure to prevent charge.

- Investigating authorities should feel able to be more focused in the compelled company disclosure it seeks. This is all to the benefit of law enforcement in an era when prosecutions of individuals repeatedly collapse because the authorities are overwhelmed by the data received and cannot comply with subsequent disclosure obligations.
- So, we predict efforts to switch to focused, narrower, economic crime investigations of large organisations.
- Companies should prepare for their employees to be interviewed within a failure to prevent investigation on matters such as sales practices, commercial pressures and whistleblowing culture. Purporting to comply with the Guidance may not be enough to engage the reasonable fraud prevention procedures defence.
- Prosecuting authorities should also develop investigative strategies to examine the reasonableness of the fraud prevention procedures. Whilst many companies faced with evidence establishing fraudulent activity in its midst will negotiate a pragmatic plea or DPA to the new failure to prevent offence on agreed facts, others are likely to challenge the suggestion that their fraud prevention procedures were not reasonable to prevent the fraud offence.

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The Authors:

Sir David Green CB KC
Partner

+44 (0) 20 8036 9410
Email Sir David

John Gibson
Partner

+44 (0) 20 8037 2324
Email John

Tim Harris
Counsel

+44 (0) 20 8036 9395
Email Tim

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New York | Paris | Washington DC | London

www.cohengresser.com
info@cohengresser.com
+1 212 957 7600

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