2005

Control Frauds as Financial Super-Predators: How 'Pathogens' Make Financial Markets Inefficient

William K. Black
University of Missouri - Kansas City, School of Law

"CONTROL FRAUDS" AS FINANCIAL SUPER-PREDATORS: HOW "PATHOGENS" MAKE FINANCIAL MARKETS INEFFICIENT

William K. Black•

Executive Director, Institute for Fraud Prevention

Assistant Professor, LBJ School of Public Affairs, University of Texas at Austin

ABSTRACT

White-collar criminology scholarship shows that "control frauds" (frauds led by the CEO) use accounting fraud to deceive (or suborn) sophisticated financial market participants. Large control frauds cause greater financial losses than all other forms of property crimes combined. Weak regulation, supervision and ethics produce epidemics of control fraud that cause systemic economic damage. As with the natural world, these financial super predators act like pathogens that take over a firm and act as a "vector" to cause ever greater damage. Control fraud theory poses a major challenge to the efficient markets hypothesis and the resulting praxis that devalues financial regulation.

(JEL: D 21, D 43, D 82, G 18, G 28, G 38, K 22, K 42, L 51, M 42, O 16, O 17)

(Key words: "control fraud" "lemons markets" "fraud" "regulation" "efficient markets")

• William K. Black, LBJ School of Public Affairs, P.O. Box Y, Austin, Texas 78713. b.black@mail.utexas.edu

Introduction[*]

I coined the term "control fraud" to describe situations in which those who control firms or nations use the entity as a means to defraud customers, creditors, shareholders, donors or the general public (Black 2005, 2003).[1] In the United States and many other nations, private sector (for-profit and not-for-profit) *control frauds cause greater financial losses than all other forms of property crimes combined* (Black 2005). Public sector control frauds, also known as kleptocracies, cause enormous losses that can keep entire nations locked in poverty for generations. This article deals only with control frauds in for-profit firms. It shows why markets, regulators and criminal enforcement bodies have severe difficulties preventing such frauds. The inherent difficulty of dealing with control fraud and our lack of understanding and resultant inattention to control fraud explain why such frauds produce the great bulk of all financial losses from property crime.

In the context of blue-collar crime it has become common to refer to certain criminals as "super-predators" (Bennett, DiLulio & Walters 1996: 26-34).

> America is now home to thickening ranks of juvenile "super-predators" -- radically impulsive, brutally remorseless youngsters, including ever more preteenage boys, who murder, assault, rape, rob, burglarize.... (*Id.* 27).

[*] The author wishes to thank Elspeth Rostow for her generous research support.

[1] I use the phrase “control fraud” in two different ways in this article, and try to make sure the context makes the usage clear. I use the phrase to describe both the individual (typically the CEO) who directs the fraud and the type of fraud being committed.

There has been a sharp rise in the number of child and teen criminals who commit extreme violence. The crimes they commit are a major social problem. These criminals, however, as the authors' own description shows, are not true super-predators. Being a "radically impulsive" pre-teen is a very poor strategy for a human predator, it usually leads to either prison or early death at the hands of a more competent predator. These so-called super-predators live in the richest nation in the world but prey overwhelmingly on the poorest citizens and are rarely even seen in middle class neighborhoods.

The emphasis on toughness and remorselessness reflects our usual bias in discussing predators. The true super-predators are pathogens. They deal death in vastly greater numbers than do carnivores (Diamond: 1997). Their host is a victim, and a weapon that spreads disease. The same bias towards “macho” predators that long dominated zoology has shaped the dominant criminology metaphor for major corporate crimes. Wheeler and Rothman’s seminal article (1982) on the corporation as a “weapon” and “shield” in white-collar crime was a major advance. Its imagery, however, calls to mind the armed warrior who triumphs by hacking victims or intimidating terror. This imagery suggests that corporate frauds operate openly. The public and the government know who the frauds are but the corporate frauds are so powerful that can plunder with impunity.

I offer a revised metaphor in which control frauds are the pathogenic super-predators of the United States. As the former savings and loan commissioner of California, William Crawford, explained: "The best way to rob a bank is to own one." (U.S. Congress 1988: 34) The chief

executive officers (CEOs) who commit control fraud do not look like predators. They want to appear to be pillars of their communities and their firms to appear healthy.

Control frauds can use the firm as both the victim and weapon of fraud. They subvert the firm's legitimate structure and objectives to the short term advantage of those who control them. In the process, they typically follow one of two paths. Some control frauds deceive customers. George Akerlof's famous 1970 article about "lemons markets" (which led to his Nobel Prize in economics) first identified this form of fraud in the economics literature. These frauds were possible because information was asymmetrical. The seller knew far more about the true quality of the goods than the buyer, and the seller exploited that information advantage by misrepresenting the quality of the goods. Akerlof showed that this could produce (initially) supra-normal profits for fraudulent sellers and make it impossible for reputable sellers to compete. Over time, the market would become dominated by fraudulent sellers of poor quality goods. Most of the white-collar crime literature dealing with corporate fraud deals with this kind of control fraud and assumes that the firm is defrauding customers in order to produce *real* increases in profits.

Enron engaged in this form of control fraud for a time. It conspired with the other large electrical energy trading companies and devised a fraudulent scheme to take electrical generating capacity off line during times of high (but far from record demand) and create artificial capacity overloads in electrical transmission. The fraud caused extraordinary increases in electrical energy costs in California, bankrupted two major utilities and causes several blackouts (FERC 2003). This fraud produced real profits for the conspirators.

But the largest losses from control frauds frequently come from CEOs who use their dominant position to loot the firm and its shareholders and creditors (Akerlof & Romer 1993; Calavita, Pontell & Tillman 1997; NCFIRRE 1993: 3-4; Black 2003; Black 2005). Indeed, these cause such enormous losses because the optimal looting strategy typically involves making deals that create fictional accounting profits and real economic losses. These accounting gains, if blessed by a top tier audit firm, allow firms that are deeply insolvent to grow because creditors and shareholders want to provide funds to profitable firms. Control frauds that loot typically report extremely high profits in early years of the fraud and are able to get clean audit opinions from top tier firms. Control frauds that loot grow rapidly to bring in new cash to pay the interest expense on prior debts – they are Ponzi schemes (Calavita, Pontell & Tillman 1997; NCFIRRE 1993: 3-4; Black 2003: 34-35; Black 2005). This article focuses on control frauds that loot.

Control frauds that loot use accounting fraud as their weapon of choice (Akerlof & Romer 1993; NCFIRRE 1993: 3-4; Black 2003; Black 2005). Accounting fraud is an optimal strategy because it simultaneously produces record (albeit fictional) profits and prevents the recognition of real losses. This combination reduces the risk of detection and successful prosecution because the CEO can use *normal corporate mechanisms* (e.g., raises, bonuses, stock options, dividends and appreciation in the value of the firm's stock) to convert the creditor's funds to his personal use. The blessing by the top tier audit firm of the fictional profits provides "cover" to the CEO against fraud prosecutions that would never exist were he simply to embezzle funds. The false profits also aid the CEO's ability to enlist political aid and provide immense psychic value. In sum, control frauds that loot seek to "mimic" legitimate firms (Easterbrook & Fischel 1991:

280). They do use the firm as both a weapon and a shield to commit fraud and try to escape detection and prosecution. But the sword and shield must be invisible to outsiders for such frauds to work. Control frauds must act more like viruses that take control over the body and turn it into a "factory" to reproduce and spread their infections. And like viruses, control frauds must find ways to defeat the economic "immune system."

The economic system has equivalents to our body's immune systems. As with the natural world, these complex economic immune systems (which are costly to maintain) exist because precisely because infections (fraud) have been such a recurrent problem. The most important of these are rules that require competition, demand transparency, regularize accounting practices, and reinforce market discipline. Internal and external controls, corporate governance provisions, business and professional ethics, licensure and disciplinary requirements for allied professionals (e.g., auditors, attorneys and appraisers), tort laws, financial regulatory bodies, the criminal laws against fraud and even whistleblowers all function in part as elements of this complex analog to the body's immune system. Law and economics scholars tend to dismiss the importance of control fraud because they assume that market mechanisms can and do police effectively against such abuses (Easterbrook & Fischel 1991).

Viruses defeat immune systems through a wide range of tactics, but they can be boiled down into three dominant strategies. They fool the immune system by causing it not to identify the virus as a danger, they corrupt or destroy the immune system by targeting it; or they overwhelm it. As this article explains, control frauds flourish and cause extensive damage because they use analogous strategies to defeat market detection mechanisms. I do not want to push this metaphor

too far. Viruses do not think or plan. Their evolutionary strategy takes advantage of their inherent tendency to mutate, their very small size and their ability to subvert cells to produce enormous numbers of diverse viral particles. If enough viral particles of a particular genetic structure survive the immune system's response because they (randomly) happen to fool or subvert the immune system that variant may become dominant in the body and the infection will persist. The infected host becomes a "vector" that can spread the infection.

CEOs do plan. They know the firm's internal and external controls. Worse, they can shape those control mechanisms and make them ineffective. But the worst aspect is that control frauds can subvert internal and external "controls" and use them to assist the fraud. When control frauds loot their most important ally is almost invariably a top tier audit firm that blesses the accounting fraud. The reputation of the top tier firm and the claims by neo-classical law and economics scholars that a top tier firm would not bless the financials of a control fraud (Easterbrook & Fischel 1991: 282; Prentice 2000) combine to make the auditor an extraordinarily effective aid to the control fraud's effort to "mimic" a robustly healthy, legitimate firm. Control frauds are dynamic; they have the ability to adapt to society's efforts to detect and defeat them. Recognizing how such frauds use the protective coloration of legitimate firms, and win the blessing of regulators, accountants, and other legitimating professionals is therefore an important part of the understanding of their destructive power (NCFIRRE 1993: 3-4; Black 2005).

To this point, I have been discussing individual control frauds, but epidemics of control fraud can occur (NCFIRRE 1993: 3-4; Calavita, Pontell & Tillman 1997; Akerlof & Romer 1993;

Black 2005). For example, industries in systemic economic crisis can suffer from an epidemic of control fraud. While government agencies are generally expected to police the economic system's anti-fraud protection, government officials may respond to systemic crises, e.g., the savings and loan (S&L) crisis, by corrupting the systems designed to constrain control fraud in order to cover up the scale of the crisis and their own policy failures (Kane 1989; NCFIRRE 1993; Black 2005). Once an epidemic of fraud arises, strong government measures are almost always necessary to bring it under control (Calavita, Pontell & Tillman 1997; NCFIRRE 1993; Black 2005). This article briefly discusses two of these epidemics – the savings and loan debacle of the 1980s and the ongoing, larger epidemic of control fraud, most famously in high tech industries.

But control fraud can also be endemic. Parasites such as malaria and worms are endemic in many parts of the world and they harm economic development and the quality of life. Endemic control fraud is also a major bar to economic and political development. Indeed, it is such a major obstacle that it can cause severe health problems. There are three major variants. One is kleptocracy. The ruler uses the nation as a victim and loots much of its wealth through corruption, fraud and crony capitalism. A second variant is nations with very low trust (Fukuyama 1995). The defining element of fraud that separates it from other forms of theft is deceit. Fraud involves the creation of trust in the victim – and its betrayal. As such, fraud is the most effective means of eviscerating trust. Akerlof's original article on lemon's markets showed that control frauds that targeted consumers could become endemic and that this would impair trust, drive honest sellers from the market, and leave a deeply suboptimal market system (1970). The result can be widespread, persistent privacy. Russia's flawed "privatiziation" exemplifies a

third variant of endemic control fraud. The fraud was so severe that it discredited not only the privatization effort but the entire Russian government. It also led to such a sharp fall in the economy that life expectancy fell sharply (Wedel 1998). This article does not focus on these endemic forms of control fraud because developing the argument fully would require a much longer article – but this is probably the form of control fraud that causes the worst suffering.

This article makes two broad points. First, it develops how "looting" control frauds operate and why they uniquely destructive. Academic observers have long dismissed the importance of control frauds because they insist that control frauds are irrational (Easterbrook & Fischel 1991: 133; O'Shea 1991: 279). They assume that the failure of a company means the failure of the fraud. CEO's in charge of failing enterprises in fact enjoy perverse incentives to engage in fraud in order to extend their time at the top and to increase the share of corporate expenditures that go to their personal benefit at the expense of the creditors ultimately left holding the bag. Control frauds succeed because they convince observers — regulators, investors, the press, academics, and their own employees — that they are legitimate. They take on and use the presumption of legitimacy that accompanies conventional businesses. They manipulate symbols of corporate health such as glowing profit statements or clean bills of health from the most reputable accounting firms. Like viruses, their strength comes from the ability to convert their host's resources to their insidious purposes.

Second, the article demonstrates how circumstances can create control fraud epidemics. Like "vectors" that spread viruses, control frauds can infect outside professionals, politicians and regulators, weakening the immune system controls against them and magnifying the size of the

ultimate loss. I briefly present three examples of such epidemics – the S&L debacle, the ongoing wave of corporate looting in the United States, and privatization in the former Soviet Union. My discussion of the last example is very limited due to space limitations and the fact that it has been covered so well by others. This article concludes that control frauds should be recognized for what they are: the conversion of legitimate organizations to instruments of theft on a massive scale. It also concludes that deposit insurance and analogous government guarantees may shape epidemics of control fraud, but they are not a *sine qua non* for an epidemic of control fraud.

Lemon Markets and Control Fraud Theory

If William Crawford is right that the best way to rob a bank is to own one, then a theory of control fraud requires explaining how ownership can lead to looting *someone else's* assets. George Akerlof's theory of "lemon" markets, though it did not deal with looting, provides a useful starting place for recognizing how important the appearance of legitimacy can be. Akerlof's theory is that fraudulent sellers try to mimic legitimate sellers' higher quality good into order to deceive customers about quality and get a higher price for inferior goods (1970). Akerlof recognized that this fraud strategy could set in motion a dynamic, quasi-Darwinian struggle, in which legitimate firms seek to differentiate themselves from the fraudulent while the fraudulent seek to mimic the new means of differentiation. This evolutionary struggle helps explain why fraud by firms can vary enormously in different places or times. To extend the evolutionary metaphor, the environment (moral, legal, governmental and economic) is critical in shaping this struggle. However, the environment is not a given, the actions of both legitimate

and fraudulent firms change the environment for good or ill. The entire process is dynamic and interactive.

Frauds are a classic case of market failure due to asymmetric information. In the case of external frauds against customers, the firm is used as a weapon. The seller has better information about the value of the good than does the buyer, which is usually desirable. We prefer sellers with expertise. Fraudulent sellers maximize and exploit asymmetries by making misrepresentations, commonly about the quality of a good.[2] When a consumer justifiably relies on material misrepresentations and purchases a good, a fraud exists.[3] Akerlof did not characterize the transactions he described in his initial article as frauds, but virtually every example he provided was a fraud. Note that the control fraud in these cases produces a form of asymmetry that is both larger and more subtle than simple differences in information. The control frauds that Akerlof described in 1970 simultaneously used deceit to increase the *actual* information asymmetry and reduce (in the victim's mind) the *apparent* asymmetry. The deceit consists of the effort to mimic a legitimate seller. Moreover, after the buyer discovers the fraud he may reappraise his prior understanding of the degree of information asymmetry (presumably by believing that it was

[2] Fraud can also involve making *true* statements to a buyer in circumstances where the intent and result is to mislead a buyer who is suffering from an erroneous factual assumption. For example, if a buyer visited a jewelry store and, after examining an unlabeled (zirconium) stone pronounced that it was the most beautiful diamond he had have ever seen, and the seller responded that diamonds were among the most romantic of all jewels for an engagement ring, and proceeded to sell the "synthetic diamond" to the customer at a price of a true diamond, the seller would have committed a fraud.

[3] The elements of fraud are normally the same under both tort and criminal law. The burden of persuasion, of course, is greater in the case of a criminal prosecution.

much larger than he previously thought) and he may reappraise the degree of trust he should repose in all sellers or the subset of sellers whose honesty is not well known to him. Further, he may tell others that he was defrauded and change their estimation of information asymmetry and risk and cause them to reduce their trust.

Customers have a financial incentive to avoid being defrauded. Absent a supplier monopoly (or bribery of the purchasing officer), economists assume that they will no longer buy products from suppliers who materially misrepresent quality. *After* the initial purchase, the information asymmetry is normally greatly reduced, because the purchaser can better judge the quality. This market mechanism can constrain fraud even if the government never prosecutes such frauds. Indeed, this market mechanism has special advantages over prosecution as a deterrent to fraud, principally because there are no due process limits on the market. If my firm simply is uncomfortable with your firm, I can refuse to enter into any new contracts with your firm. Purchasing firms also have greater expertise, staff resources, and financial incentives than police departments to discover fraud by suppliers. The prosecutorial deterrent can also be used in addition to the market deterrent.

Moreover, to this point we have only looked at the negative reinforcement that the market can provide to deter fraud. The market could also provide a "carrot" to encourage honest trades. If I am able to establish a reputation for scrupulous honesty as a seller then the risks of purchasing goods from me (as opposed to a competitor) will be reduced – perhaps sharply in markets beset by serious "lemons" problems. Reduced risk should mean that I can sell my goods at a premium price relative to my competitors (even adjusting for the higher quality of my goods). Thus, the

markets can great a positive incentive to both be scrupulously honest and to find a way to *signal* that honesty to potential buyers. Thus, even if one could not (due to information asymmetry) identify the *control frauds* one could still avoid being defrauded by identifying even a single honest firm. Honest firms have a financial incentive to make it easy for me to identify them.

If we now take Akerlof's analysis of lemons markets that defraud *customers* and ask whether we can apply it to *insider* frauds by officers we find that the firm will be the direct victim and creditors and shareholders the indirect victims. Firms generally do not use market mechanisms internally. As a result, monopolies often exist within a firm, e.g., all investments have to be done through the Treasurer, even if some officers are suspicious of the Treasurer. Moreover, it is very unlikely that the officers would suspect that a senior officer was a felon stealing from the firm.

Firms have typically found that their worst fraud losses result from internal fraud. (Green 1990) They have developed a series of internal and external controls to limit such frauds. Typical internal controls include division of functions, limited signature authority, multiple approval requirements, record keeping and reporting requirements, "independent" boards of directors, and internal auditors who do not report to "line" managers. None of these internal controls had their genesis with regulation; they are normal "best practices" used to increase profitability. Many firms subject themselves to external controls, usually outside auditors and credit rating agencies.

There is an additional factor that should limit insider frauds. The employment markets give all managers incentives to avoid engaging in fraud, and senior managers the incentive to prevent other employees from engaging in fraud. Internal and external controls give senior managers the

tools to reduce internal fraud (Easterbrook & Fischel 1991). Yet, despite the strong profit incentive to avoid losses from insider fraud and the known tools to deter and detect such frauds they continue to exceed losses from external fraud.

The Unique Advantages of Control Fraud Produce Massive Losses

CEOs[4] are in a unique position to loot the firm. They can use the firm as both a weapon and victim of fraud (Wheeler & Rothman 1982; Black 1998; Calvita, Pontell & Tillman 1997). Senior insiders cause large fraud losses because they know the weaknesses in the firm's internal and external controls, because they can further weaken those controls secretly because they are supposed to be critical controls against insider fraud, because they often have legitimate access to and power over large sums, and because they have apparent legitimacy. However, the individual who controls the firm is not simply a more senior officer – he has unique powers and poses unique fraud risks (Black 2005). First, he can defeat all internal and external controls. Indeed, as I explained, he can subvert these purported controls into his most valuable allies to aid his looting.

Second, he can optimize the firm as a vehicle for fraud. This has three primary components. Some business transactions and fields offer greatly superior ability to engage in widespread accounting fraud. The CEO can cause the firm to engage in those transactions and fields. Accounting fraud is the control fraud's weapon of choice, so this ability is critical. The CEO is also in a unique position to ensure that the firm will grow rapidly. Looting commonly leads to

[4] I use "CEO" here because the CEO typically controls the firm.

Ponzi scheme to postpone the collapse and increase the "take." The CEO can create a fraud-friendly culture (Black 2000).

Third, he can optimize the external environment for control fraud. Classic examples of this include Enron's creation of what it termed a regulatory "black hole" in energy trading that it exploited to produce the California energy crisis. Two of the worst S&L control frauds used their political power to delay enforcement actions (Black 2005). The Russian control frauds used their resources to determine Russian national elections and keep their supporters in power for many years (Wedel 1998). Sums that politicians consider to be very large contributions represent "chump change" to a control fraud.

Fourth, the CEO can loot the firm through (facially) normal corporate mechanisms. The accounting fraud (blessed by a top tier audit firm) produces high reported profits. The CEO converts much of this (fictional) profit into real payments in the form of raises, bonuses, grants of new stock options, appreciation of his stock, perks and (sometimes) stock dividends. Other insiders, no matter how senior, often need to resort to embezzlement to convert firm assets to their personal benefit. Once discovered, there is no viable defense for embezzlement. A fraudulent CEO, by contrast, can claim he relied on a top tier audit firm's expertise about an arcane accounting standard that led to the recognition of large profits. This purported reliance makes prosecution very difficult.

Fifth, the CEO can use the entire resources of the firm to aid his looting. He can cause the firm to pay tens of millions of dollars to prestigious law firms to attack the regulators and sue

individual federal employees and to prepare his defense. He has the priceless ability, unlike virtually all blue collar criminal defendants, to talk to his lawyers in advance and structure his crimes to make prosecution difficult.

Sixth, the CEO has unique apparent legitimacy and can takes steps to burnish that reputation and make effective regulation or prosecution more difficult. The CEO who reports exceptional profits is, in the modern era in the U.S., a savant – a hero and role model. CEO's can cause the firm to aid that reputation by funding large charitable contributions (which the CEO can effectively receive credit for) and spending millions of dollars on public relations. Fraudulent CEOs receive more than financial compensation, they achieve fame and other psychic rewards (Black 2005).

Optimizing the tradeoff between the amount looted and the risk of prosecution

There is a broad array of normal firm devices that those engaged in control fraud to loot the firm can employ. They could embezzle, but the risk of detection and the inability to mount a defense make that a rare tactic for major control frauds. There is generally a tradeoff between the amount of firm funds a fraudulent CEO can convert to his personal usage and the risk of detection and conviction. I do not assume here that control frauds are wholly rational and invariably seek to optimize. Instead, I ask the question of what tradeoffs an optimizer would seek to balance. A classic looting technique is for the CEO to cause the firm to make a bad loan to or investment that will (secretly) benefit the CEO (typically through a front company – also known as a "straw" or "nominee"). The least subtle variant is a loan to a "front" company for the

bank's controlling person. The front company diverts the loan proceeds to the controlling person and defaults on the loan. A more subtle variant is the "daisy chain." In a daisy chain, Bank A makes a loan to a firm owned by Bank B's CEO, while Bank B makes a loan to a firm owned by Bank C's CEO, and Bank C makes a loan to a firm owned by Bank A's CEO. The loan proceeds are diverted and the borrowers default on their loans (Lowy 1991).

The most subtle version is to make a bad loan to *unrelated* borrowers who have no intention (or ability) to repay the bank's loan. This strategy strikes most people as making no sense (which is one of its key advantages). Certain assets, e.g., unique office building construction projects, have no readily ascertainable market value. It is easy to inflate the market value of such assets by more than 100 percent. Further, borrowers who do not intend to repay a loan are quite willing to sign loan documents agreeing to pay high fees (often called "points" in the case of real estate) and high rates of interest.

Real estate borrowers are particularly willing to sign such loan documents when five conditions apply: they receive an upfront "profit" from the lender, they have the opportunity to convert loan proceeds to their personal benefit, they have no personal liability on the loan, and they have limited income and wealth and poor or nonexistent reputations as developers. As I will show, all five of these conditions were common in the real estate loans S&L control frauds made.

Accountants, purportedly applying generally accepted accounting principles (GAAP), were generally willing to allow lenders to recognize as "income" these high fees and interest "payments" even when the bank or S&L *self funded* the "payments" and even when all five of

these conditions were present (NCFIRRE 1993: 48; Akerlof & Romer 1993; Black, Calavita & Pontell 1995). These accounting abuses turned control fraud into a sure thing, a pure case of mathematics. Any bank or S&L that made large amounts of the kind of real estate loans I have just described, and grew very rapidly, was *guaranteed* to report record profits. (NCFIRRE 1993: 48) A portion of these "profits" could then be converted to the benefit of the controlling person through normal firm mechanisms: raises, bonuses, stock dividends, and perks. This analysis also shows why S&L control frauds produced devastating losses: the worse the loan the better the accounting profits.

What I have just described is a Ponzi scheme (id.), and like all such schemes it will eventually collapse.[5] The collapse, however, could often be delayed for many years. The devices to delay the collapse generated additional phony profits that the CEO could loot (and generally increased real losses). S&L Ponzis generally relied on acquisition, development, and construction (ADC)

[5] Ponzi schemes are named after one of their star practitioners of the art of the scam, Charles Ponzi (Fischel 1995: 151-52). A Ponzi scheme uses (some of) the money provide by newer victims to pay the older victims of the fraud. For example, a modern Ponzi might promise investors a 50 percent annual return on their investments. The first wave of 100 victims each invests $1,000. The Ponzi pays them $50,000 in interest (the other $50,000 is looted by the fraudster). The first wave of investors reports to their friends that they received exactly what they were promised -- a 50 percent return. The second wave of investors is larger, 300 new victims who each invest $1,000. At the end of year two, the fraudster pays the 400 victims (the original 100 victims have reinvested) $200,000. The fraudster pockets $200,000. (Note that in this hypothetical, and sometimes in reality, the initial "victims" of a Ponzi may suffer no losses.) The Achilles' heel of Ponzi schemes shows up, of course, within a very few iterations of this scheme, due to the inexorable mathematics of doubling. Within a relatively small number of iterations of the scheme it becomes necessary to enlist hundreds of thousands of new victims to obtain enough money to pay off the old victims.

loans. The typical ADC loan of the S&L Ponzis had these characteristics (NCFIRRE 1993: 48-49; Fischel 1995; Lowy 1991):

> 1) it was made at 100 percent of the appraised value of the underlying real estate project pledged as collateral to secure the loan, i.e., a 100 percent loan-to-value ratio, which meant that there was no downpayment;
>
> 2) it was an interest-only loan, with the principal payable at the maturity of the loan, usually two-to-three years;
>
> 3) the borrower had no personal recourse on the loan;
>
> 4) the borrower received a "developer's profit" payment from the lender when the loan was made;
>
> 5) the loan had an "equity kicker," which provided the lender with up to 50 percent of the net profits of the underlying project, and;
>
> 6) the loan carried a high interest rate and required substantial up front fees -- but these payments were self-funded by the lender.

Note several important consequences of such ADC loans: because all of the borrower's "payments" are self-funded by the lender the loans cannot default before maturity and the loans are *guaranteed* to produce high income. This self-funded "income" is maximized if the lender grows very rapidly and makes the largest possible ADC loans, i.e., loans that far exceed the value of the collateral. Note also that all the cash moves one way, out of the lender, making rapid growth of the ponzi essential.

The least obvious, but most harmful consequence of making such ADC loans was what economists refer to as "adverse selection." A reputable developer would want no part of such a loan, he would have to pay (*at maturity*) unduly high interest rates and fees and give up 50 percent of his net profits to the lender. Only borrowers who had no intention of repaying their loans would find such ADC lending terms attractive. The high fees and interest rates would not dissuade the worst borrowers, for they would never pay them. Default held no terror for such borrowers; they were not personally liable on the note, and they had no valuable reputation as developers to safeguard. The worst borrowers would find ADC loans profitable because of the up front developer's profit and the inevitable opportunities for fraud during the construction process (e.g., diverting progress payments to personal use and extorting kickbacks from the general contractor and "subs.") S&Ls running ADC ponzis *desired* to make loans to bad borrowers because such borrowers would agree to the best loan terms.[6] Adverse selection, combined with massive overstatement of collateral values, produced catastrophic losses on ADC loans at the S&L ponzis.

Professor Fischel describes one of the most notorious control frauds, Vernon Savings (known to

[6] As James Pierce, Executive Director of the National Commission on Financial Institution Reform, Recovery and Enforcement explained:

> Accounting abuses also provided the ultimate perverse incentive: it paid to seek out bad loans because only those who had no intention of repaying would be willing to offer the high loan fees and interest required for the best looting. It was rational for operators to drive their institutions ever deeper into insolvency as they looted them. (1994: 10-11; see also Robinson 1990: 64-65)

regulators as "Vermin"):

> Developers flocked to Vernon Savings because it was willing to finance risky deals and developers would still receive a 2 to 4 percent up-front developer's fee out of the loan proceeds even if the deal subsequently fell through. Vernon Savings also profited handsomely from these deals by charging interest rates and loan-origination and renewal fees that were often twice as high as the rest of the industry charged. All of this was completely legal and disclosed to the regulators (1995: 249).

Fischel has many of his facts right, but his conclusions show that he has no understanding of how the Ponzis worked. *Reputable* developers flee, not flock to, a lender who charges interest rates and fees "twice as high" as competitors *and* requires the borrower to give up 50 percent of its net profits -- all in return for a relatively tiny "2 to 4 percent up-front developer's fee...." Moreover, he fails to note that Vernon invariably self-funded these fees and interest "payments" and that *96 percent* of these ADC loans defaulted. (Mayer 1990: 11) To say that Vernon "profited handsomely from these deals" is incomprehensible. Vernon claimed false profits on these ADC loans -- which produced roughly $1.3 billion in losses. (Id.) Vernon's adverse selection was so great that it had virtually no creditworthy borrowers. Vernon's Ponzi was neither "completely legal" nor "disclosed."[7]

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[7] Vernon violated GAAP (and Bank Board rules incorporating GAAP) in numerous ways. Two examples are that its ADC loans should have been accounted for as direct investments, which would have prevented the recognition of self-funded income, and Vernon did not recognize losses in accordance with GAAP. Vernon engaged in a systematic cover up to avoid regulatory recognition of its fraud and losses (Mayer 1990; Black 1998; O'Shea 1991).

Fraud "Efficiency"

Fraud mechanisms present a trade-offs to those engaged in control fraud between maximizing the "take" and minimizing the risk of prosecution. Making loans to oneself through a front company is efficient. All of the loan proceeds can be converted to the controlling person's use. It is, however, a dangerously crude device that may be discovered before the firm's failure, e.g., by bank examiners, and will often be discovered after the firm's failure by its liquidators.

Daisy chains are far less likely to be discovered prior to firm failures. For example, there is nothing facially suspicious in Bank A making a loan to an unaffiliated company, even if it is known that Bank B's CEO is a principal in that company. They are highly efficient as fraud devices. They do impose a higher risk, however, of discovery after the banks fail. Daisy chains require more people to be engaged in the fraud, which increases the danger that one of the CEOs will be turned by prosecutors who have found that he committed a different crime (Black 2005).

Ponzis that made bad loans to unrelated borrowers were less efficient as fraud devices. If ADC loans with a maturity of two years were used, the S&L's "cut" from the scam could be relatively small, roughly 25 percent of the total loan disbursements. (NCFIRRE 1993: 49)

The men that controlled Enron developed a moderately efficient fraud mechanism to loot the firm. Enron used myriad fraudulent schemes, but it most often resorted to “selling” assets to

itself for very large gains. In fact, the bulk of the assets it sold were actually bad investments that had caused large losses. However, since Enron was (in substance) selling to itself the fact that the assets were really net liabilities was no obstacle to the recognition of purported net income (McClean and Elkind 2003). These sales simultaneously hid real losses and created fictional income that could then be used as the pretext for converting firm assets to the personal benefit of the men that controlled Enron. It grossly inflated Enron's stock price.

Reducing the Risk of Detection and Prosecution

Control frauds were inventive in increasing the efficiency of the bad loan Ponzi. In the end, however, these Ponzis remained a less efficient fraud device than, for example, the CEO simply not paying back insider loans. The Ponzi's compensating advantage was a greatly reduced risk of fraud detection, prosecution, and conviction. CEOs engaged in such Ponzis could even hope to avoid a material loss of reputation; the firm's failure could be blamed on the industry's systemic problems and the regulators.

The first advantage is the problem of proof. The genius of the bad loan Ponzi is that no overt conspiracy is required. The CEO never has to approach the borrowers and have a conversation along the lines of: "I'm making you this loan even though I know you are going to default on it." Even if the borrowers are turned by prosecutors who have established another criminal act by the borrowers, they may not be able to provide any useful testimony against the CEO. They may be unable to testify credibly that the bank lent them money *because* it knew they were unlikely to repay.

The second group of factors has a common theme -- incredulity. One of the principal advantages is that most people think such Ponzis make no sense. The initial hurdle of incredulity is the concept of control fraud itself. It seems absurd that someone who is the sole owner of a firm would destroy it (*see also* Easterbrook & Fischel 1991: 10, 70, 72 & n. 19, 91, 112-13, 133; Lexecon 1988a: 8-9; 1988b: 29-30 n. 23).[8] O'Shea's conclusion is belied by what he reports in the remainder of his book, Dixon looted Vernon through control fraud from the moment he acquired it. It was never a question of keeping Vernon "alive," because Vernon was *insolvent* when Dixon acquired it, and Dixon's looting was certain to make the hole deeper.

The next hurdle is the concept that a bank or S&L, even if run by crooks, would knowingly make a bad loan to an unaffiliated person. People understand the incentive to make a bad loan to an insider or a relative. But, surely it is better for the sole owner of an S&L, even if he is a crook, to loan to strangers who repay their loans. Loans that are repaid provide real profits, which a CEO who is a crook can legitimately convert to his own account through raises, bonuses, dividends, and perks with no risk of prosecution. A classic Ponzi must end in the failure of the firm. Why kill the golden goose?

[8] For example, James O'Shea, in his book about Vernon Savings, concluded:

> To a man, Dixon and his fellow entrepreneurs probably didn't set out to destroy and plunder the savings and loans they had acquired. That wouldn't have made any sense. Keeping their thrifts alive was the only way they could keep their pockets full (1991: 279).

Part of the answer has been provided above; it was an optimal strategy, balancing the efficiency of the fraud versus the risk of prosecution, to make loans to borrowers who would not repay the loans. Honest borrowers would not agree to the loan terms and would not participate in the sham sales and loans necessary to the fraud scheme.

The other part of the answer is that, if run *honestly* during the 1980s by the CEOs who destroyed them by control fraud, the S&Ls would not have been golden gooses, they would have been decaying, dross ducks. The only way to get the golden eggs was to kill the goose, which is why those engaged in control fraud destroyed their own S&Ls. Most of the CEOs who committed control fraud were new entrants to the industry. They acquired S&Ls that were insolvent on a market value basis. (NCFIRRE 1993: 3-4) Those CEOs who were already in the industry, and later committed control fraud, controlled S&Ls that were insolvent on a market value basis by mid-1982. The CEOs who engaged in control fraud rarely had a profitable, honest alternative.

Honestly run S&Ls during the early 1980s, when most of the CEOs who engaged in control fraud entered the industry, were virtually all unprofitable. Honesty would produce no golden eggs, indeed, if interest rates had stayed high it would make failure the norm. The CEOs who engaged in control fraud would have done far worse than the norm had they tried to run honest S&Ls because they had less experience and expertise as S&L managers.

The "golden goose" analogy is premised on the ability of the CEO to loot the S&L one little, golden egg at a time, without killing it. The analogy does not work. The vast bulk of the S&Ls

that were victims of control fraud were insolvent (on a market value basis) *before* they were looted by their CEOs.

The next hurdle of incredulity was carefully raised by those engaged in control fraud. It involves creating the illusion that the firm is highly profitable. The S&L Ponzi was unusual in that the greater the fraud, the less the chance of the firm being taken over by regulators. This was true because the fraud produced dramatic reported income and net worth for the S&L.[9] The high reported profits and low reported losses made it extremely difficult for the regulators to establish the legal grounds to seize the S&Ls (Black, Calavita & Pontell 1985). The way to maximize the looting, extend the life of the S&L, delay any investigation, and reduce the risks of prosecution was to steal big, not small.

The illusion of profitability was created and sustained with the aid of a circle of supporting experts. Each expert relies on another expert in a chain that allows not only the CEO, but also each expert, to claim to have no responsibility for the Ponzi. The first step is for the CEO to identify assets that have no readily ascertainable market value. The key to control fraud is substantially overvaluing those assets (Akerlof & Romer 1993).

In the S&L debacle, the chain usually began with the CEO enlisting appraisers who would support excessive "market" values for the collateral pledged to secure ADC loans (Calavita, Pontell & Tillman 1997: 75-77). It was easy to get an appraiser to vastly overstate the value of

[9] Lincoln, Vernon, and CenTrust of Miami, Florida all reported to their regulators that they were among the most profitable of all S&Ls in America (Fischel 1995: 246; NCFIRRE 1993: 48-52; Black 1998).

speculative real estate projects to build large office buildings. The appraiser simply had to make very optimistic assumptions about future rental rates to produce the required value to support the loan. The S&L Ponzis, of course, informed the appraiser of what "market" value of collateral was required to support the loan. Often, the S&L Ponzis accepted appraisals provided by the borrower (a facially absurd practice for an honest lender) (Black, Calavita & Pontell 1995). The S&L Ponzi, however, had no difficulty hiring appraisers to opine to grossly inflated market values. (NCFIRRE 1993: 70) It could always ask for a preliminary, oral estimate of market value. If the appraiser gave a high enough value, he would be told to complete the report -- and would receive future assignments from the S&L. If he gave an inadequate value, he would be told that it was not necessary for him to complete a final report. He would be paid a partial fee and not be retained in the future.

The appraisal provided a purportedly independent and professional "blessing" for the inflated asset values. The S&L's CEO could claim that he relied on the appraisers' expertise. The outside auditors could say that they relied on management's financial statements -- they could defer to the appraisers and management on the issue of the value of the S&L's ADC loans.[10] The CEO would also hire prominent legal counsel, who would document the real estate projects. The legal counsel would say that they relied on facts provided by management and the financial professionals. If the S&L stocks or bonds were publicly traded the financial statements and

[10] S&L ponzis also "shopped" for outside accountants until they found ones who would support management.

> abusive operators of S&L[s] sought out compliant and cooperative accountants. The result was a sort of "Gresham's Law" in which the bad professionals forced out the good. (NCFIRRE 1993: 76)

disclosures would be reviewed and "blessed" by the outside auditors and legal counsel. The auditors and counsel would say that they relied on management's factual representations, while the CEO would say he relied on the expertise of the outside professionals and his more junior officers and staff. Because everyone was involved in a way that preserved "deniability," no one ever admitted responsibility when the Ponzi collapsed. The CEO could almost always point to favorable opinions by prestigious audit and legal firms supporting any deal, as well as a favorable appraisal. This made it more difficult to prove civil or criminal wrongs by the CEO. It also added to our unwilling to see seemingly normal business practices condemned as criminal.

Optimal Firms for Control Fraud

One of the unique features of control fraud is the ability to use the firm as both the weapon and victim. While firms used for control frauds are victims of that fraud, they are not normally the worst victims. The largest losses are suffered by the firm's creditors (or their insurers). The most attractive control frauds are those offering the greatest opportunities for leverage.

To optimize a control fraud, the CEO wants to maximize his take while minimizing his chances of detection and prosecution. I have explained why optimization requires tradeoffs between these two, often inconsistent, goals. Similar tradeoffs exist in the choice of the optimal firm as a weapon of control fraud: the fraudulent CEO will seek to maximize the return on the initial investment needed to gain control of the company.

A firm with high (real) net worth seems optimal for control fraud -- there is more to steal.

However, such firms are far less likely to be victimized by control fraud, at least in the United States. It is much more expensive to acquire a large, healthy firm than a small, failing firm. This means that the class of individuals who can acquire a large, healthy firm is quite small -- the very rich. Such individuals, however, tend to have high opportunity costs for engaging in "opportunistic" control fraud, i.e., those who seek out opportunities to commit control fraud. They are "deep pockets," vulnerable to civil suit. While they make difficult targets for prosecution, they fear criminal charges because they have so much to lose from being charged with fraud, even if they are not convicted -- money, status, and future legitimate business opportunities. Often, they are rich because they have legitimate business skills, they do not have to engage in fraud to have a chance of becoming rich.

The other thing they will lose through control fraud, of course, is their massive personal investment required to attain control of a large, healthy firm. That investment, net of money they loot from the firm prior to its collapse, is lost when they destroy the firm through control fraud. Large, healthy firms, therefore, make poor vehicles for control fraud.[11]

Smaller, failing firms are attractive for control fraud. The reasons are the inverse of those

[11] (Akerlof & Romer 1993). This may not be true in other countries with more pervasive political corruption and weaker political and legal institutions. In such countries, the CEO who is also the ruler, or merely the ally and business partner of the ruler, may be able to defraud the firm without destroying it, either because the ruler ensures that the firm earns supra normal profits, e.g., by granting it monopoly power, or because he causes other entities, e.g., the Treasury or state-owned or controlled banks, to bailout the firm. A kleptocracy is the ultimate control fraud because the ruler's control over the government permits the fraud to employ the most efficient fraud techniques without risk of prosecution.

presented above, with three additional benefits. One advantage is that the board of directors and senior managers of a failing firm make marvelously "motivated" sellers. They face the loss of their investments (financial and human capital) and a loss of reputation and status should the firm fail. This inevitably means that they will feel pressure to sell quickly, at a very low price, and without being too persnickety about the acquirer's suitability. They may also facilitate the acquisition, e.g., by lending the acquirer the purchase price or accepting non-cash (e.g., real estate) consideration as part of the purchase price.[12] Fischel does not explain that Dixon borrowed the money from a felon, Herman K. Beebe, who was at the center of a very large "daisy chain" of control frauds, and that Dixon never repaid Tanner (O'Shea 1991: 10-12, 92-100, 266; Pizzo, Fricker & Muolo 1991: 251-273, 497-511). It is in both the sellers' and acquirers interests to overstate the value of the real estate in such deals. The acquisition begins the control fraud, converting the firm's assets to the mutual benefit of the firm's former and new shareholders (NCFIRRE 1993: 37). The failing firm's creditors suffer the economic loss.

Reactive and Opportunistic Looting

[12] For example, Fischel explains how Don Dixon, who destroyed Vernon Savings through control fraud, acquired it from Mr. Tanner at a time when it was (market value) insolvent.

> Vernon was also attractive because Tanner was willing to sell it for next to nothing. Dixon acquired Vernon for $1.1 million in cash (which he borrowed) and a note for $4.7 million to be paid off over the next seven years at the far-below-market interest rate of 8 percent. Dixon accomplished his goal of acquiring a sure-bet source of financing without having to put up any of his own money (1995: 247).

Control fraud may arise in two different ways. In the first, which I call "opportunistic control fraud," a CEO looking for opportunities to make big bucks quick may acquire a firm for the purpose of leveraging its assets in questionable ways. When government regulators relaxed the barriers to entry in the S&L industry, for example, real estate developers like Charles Keating entered the industry in order to use the savings and loans to finance real estate projects that had difficulty securing more conventional funding. These executives, whether or not they consciously acknowledged that they were looting their institutions, embarked on a course of conduct designed to insure the firm's ruin from their first days of control.

The second type of control fraud is what I term "reactive control fraud." CEOs of insolvent or failing firms experience what economists refer to as "moral hazard" (White 1991: 48 n. 25, 39-42). Moral hazard results from a fundamental asymmetry between the owners and creditors of a failing firm. The shareholders are the residual owners of a corporation, if it becomes insolvent and is liquidated they lose their entire investment -- but that is all they lose because they have limited liability. The creditors suffer all losses that exceed the shareholders' investment. Therefore, shareholders have an incentive to cause a failing firm to engage in extremely risky gambles or fraud. If the gambles succeed, the shareholders capture most of the gain, if they fail, the creditors bear the costs. I use the term "reactive" control fraud to refer to CEOs who turned to fraud only after their firm became insolvent.[13]

The motivation for the two types of fraud are in some ways similar while the types of people

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[13] The two categories of looting are not always exclusive. A CEO of an insolvent firm may decide to enter a different industry that is more optimal for control fraud – engaging in both reactive and opportunistic looting.

who commit the fraud may not necessarily be. In both cases, *at the time the fraud begins*, the CEO will have relatively little of his own capital at stake, in the first case because he was able to acquire control without it, and in the second case, because the initial investment, however large is gone. In both cases, the CEO sees an opportunity to leverage the firms' existing assets and/or position into greater immediate gain than he could through the firm's legitimate operation. In the case of opportunistic fraud, the CEO may never have had a realistic to run the firm profitably; in the case of reactive fraud, the firm's dismal prospects may be the result of changed market conditions. In both cases, however, the CEO must be in a position to defeat the external and internal controls on use of the firm as an instrument of fraud with little risk of detection. And in both cases, the CEO must decide to embark on a course of action that will secure immediate gains at the price of the firm's long term survival (which may be dubious in any event) and the certain expense of others.

Epidemics of Control Frauds

Catastrophic as individual control fraud failures are, they pose the greatest danger when they occur in epidemics. Such epidemics are not random. They are most likely to occur when the a sector of the economy suffers a systemic shock that reduces asset values and the following circumstances come together: 1) control fraud opportunists are able to gain control of failing firms, 2) firms can grow rapidly, 3) there are ready opportunities to create fictional income, and 4) there is weak regulation or risk of detection. Systemic economic problems in an industry often provide such an environment because they simultaneously maximize opportunistic and reactive control fraud. Looming financial failure increases the moral hazard that creates the

incentive for reactive control fraud. At the same time, the industry's economic pressures may make it cheaper for the opportunistic to gain control. The perception that the entire industry is imperiled may persuade panicked regulators to reduce supervision, allow bad accounting practices, and even encourage growth. The more of these factors that occur together; the greater the opportunities for fraud will be.

In a systemic industry crisis, the regulatory head, and the legislative and executive branches, will experience what I term "regulatory hazard;" that is, the incentive to take undue risks in an effort to avoid political blame. In a systemic crisis, the top regulator risks having his reputation savaged largely because of the accident of being the one in charge when a crisis, typically one that was years in the making, broke into public consciousness. "Not on my watch" could easily have been the rallying cry for several generations of prescient government regulators leading up to the S&L crisis (Kane 1989).

The top regulator facing such a crisis has three broad options. She can alert the government and the public to the scale of the crisis and the painful measures required to deal with it, e.g., closing down firms and spending taxpayer funds to "bail out" depositors. She can cover up the crisis, hoping that time will heal this wound, or at least allow her to find a sinecure in private industry and hand over the crisis to a successor who may be stuck with the blame. Or, she can gamble, in this case, for industry "resurrection." She may have the regulated industry take higher risks, hoping that they will pay off and rescue most firms from failure. The gambling strategy could, theoretically, be combined with either the full disclosure or coverup strategy, but it is far more likely to be combined with a coverup.

While this discussion has focused on regulators, regulatory hazard also exists for politicians. Members of Congress and the Executive Branch may not want to acknowledge a systemic crisis because it would interfere with their budget priorities. For example, in 1982 the S&L industry was insolvent on a market value basis by $150 billion and the Federal Savings and Loan Insurance Corporation (FSLIC) only had $6 billion in reserves. This meant that the federal budget deficit was at least $144 billion larger than reported. Admitting these facts would have made it more difficult for President Reagan to get approval for tax cuts and additional defense expenditures, and more difficult for democrats in Congress to fund domestic programs (NCFIRRE 1993: 64-65, 72-73). Closing thousands of firms is politically unpopular and reduces campaign contributions. No one opposed the initial S&L coverup (White 1991: 90-92).

The dynamics of regulated industries often make acquiring failing firms for opportunistic control fraud desirable. Regulated industries may garner a greater measure of investor confidence from the fact of government oversight. Or, like the S&L industry, they have may have express government guarantees such as deposit insurance. Or like the banks presumed to be "too big fail," they may benefit from assumptions about government behavior. In each case, these assumptions may increase the CEO's ability to grow faster or reduce the risk of a regulatory takeover.

Firms in regulated industries become targets for opportunistic control fraud, however, only if the would-be CEO can secure control of the firm, and regulatory regimes, precisely because of the advantages they offer, are likely to pose greater barriers to entry. A CEO engaged in

opportunistic control fraud wants to take control quickly, cheaply, and totally. Attaining regulatory approvals for acquisitions is often a bureaucratic, time-consuming process. Like private owners and boards, however, regulators are far more eager to expedite acquisitions that prevent failures.[14] The acquirer who promises to rescue a failing firm is a hero within the regulatory community. A regulator who arranges such an acquisition, especially if he then touts it as a personal success brought about by his diligence and innovativeness, is extremely reluctant to see the acquirer as a felon. Regulators are as susceptible to the same cognitive dissonance as other humans. They become not only willing to facilitate the acquisition, but to devote additional resources to its success – and they become that much more reluctant to recognize that their hero has not only failed, but deliberately run his ship into the ground (Kane 1989).

Moreover, a regulatory gamble for industry resurrection can make control fraud more lucrative for the new entrants on whom regulatory hopes rest. If the officials wish to encourage rapid growth, disguise losses, permit higher risk investments or delay enforcement, they risk exacerbating the potential loss from fraud. The coverup is likely to include efforts to pervert the accounting rules, to avoid the need to recognize losses (NCFIRRE 1993: 62-65; Kane 1989).

[14]For example, the Federal Home Loan Bank Board (Bank Board) discouraged the entry of real estate developers as S&L owners before the 1979-82 interest rate crisis because of the conflicts of interests they would face (O'Shea 1991: 28). After the crisis began, however, scores of real estate developers acquired S&Ls -- and became the most notorious control frauds (NCFIRRE 1993: 3-4). S&L regulation had also barred total control of an S&L by an individual. No person, or even group, could own more than 25 percent of the shares of a stock S&L. The regulators changed this rule in response to the initial S&L crisis to allow a single owner to own 100 percent of an S&L's shares. This allowed the complete domination that was ideal for control fraud (NCFIRRE 1993: 37; Black, Calavita & Pontell 1995).

These coverups would often be illegal if done by private persons for analogous purposes, but they are almost never criminal in the United States when done by government officials unless they are used for direct financial gain. Coverups often involve reducing regulatory requirements, e.g., minimum net worth requirements for S&Ls. All of these changes are asymmetric: they aid failing firms far more than healthy firms, they improve the climate for fraud, and they increase the size of the resulting loss.

The combination of a coverup and the gamble provides a perverse synergy for control fraud. The price to acquire a large, insolvent firm should not be much greater than the price to acquire a small insolvent firm. In cases of systemic industry crises, there may be a number of large, insolvent firms that the regulator is unwilling to close. The GAAP rules on mergers were abused so badly that the more insolvent the S&L acquired, the greater the fictitious income created (NCFIRRE 1993: 38-39). These accounting scams gave control frauds the best of both worlds, they could have the advantages of controlling a large firm without bearing the normal acquisition costs.

The Failure to Learn the Lessons of the S&L Debacle has led to New Control Fraud Epidemics

The conventional economic wisdom about the debacle has three elements that proved disastrous. First, the wisdom was that fraud was trivial and that one should not examine fraud lest it "distract" from adopting the proper political reforms (White 1991; Black, Calavita & Pontell 1995; Calavita, Pontell & Tillman 1997; NCFIRRE 1993; Black 2005). That element of the conventional economic wisdom is unsound on theoretical, logical and empirical grounds. It is no

support. The theoretical support for the conventional wisdom is that S&Ls experienced widespread moral hazard in the 1980s and that moral hazard can lead to excessive risk-taking. Therefore, widespread fraud did not occur. However, Dr. White acknowledges that moral hazard can lead to either (or both) control fraud or excessive risk-taking (White 1991: 40-41). There is no *a priori* reason for assuming that control fraud would be trivial at a time when moral hazard was the norm.

The conventional economic wisdom fails on two related test of internal logical consistency. Fortunately, there is little dispute about a wide range of facts about the most expensive S&L failures and the *pattern* of those failures. The debate centers on the roughly "high fliers" (v. the "traditional" S&Ls). Everyone agrees that they caused the worst losses. The issue is whether they "gambled for resurrection" in legal but risky ways or engaged in control fraud. The pattern of failures is only consistent with widespread control fraud. *Every* high flier failed – there were no winning, "honest gamblers." Further, the pattern of activities at the high fliers is rational if they were control frauds and deeply irrational if they were honest gamblers (Black, Calavita & Pontell 1995; Akerlof & Romer 1993; NCFIRRE 1993). As I have shown, knowingly making a loan to bad borrowers who are very unlikely to repay the loan maximized the "take" from control fraud. It would be a suicidal strategy for an honest gambler for resurrection.

The empirical case for extensive control fraud is overwhelming. There were over 1000 felony convictions of senior insiders (Calavita, Pontell & Tillman 1997; Black, Calavita & Pontell 1995; Black 2005; Black 1998). NCFIRRE found that control fraud was "invariably" present at the typical large failure (1993: 4). GAO studies found widespread fraud and insider abuse at the

expensive failures (Calavita, Pontell & Tillman 1997; Black, Calavita & Pontell 1995).

The second disastrous failure to learn the lessons of the S&L debacle is that the conventional wisdom was that the debacle could not have occurred without deposit insurance. Therefore, there was no reason to fear an epidemic of control fraud in firms without governmental guarantees (NCFIRRE 1993; Kane 1998; Easterbrook & Fischel 1991). The theory was that private market discipline prevents material control fraud in normal private sector firms. This theory was universally believed by economists as late as 1993 (*see, e.g.,* Akerlof & Romer 1993).

In fact, however, the S&L debacle refuted this theory. *S&L control frauds were consistently able to defraud uninsured creditors and shareholders.* No shareholder was insured – yet every S&L control fraud engaged in securities fraud. There were a few cases of active "shorting" of S&L control fraud stocks – but they were very unusual and none of them succeeded in preventing the control frauds from gaining access to the capital markets at times when they were massively insolvent and pervasively fraudulent. S&L control frauds also defrauded uninsured creditors, e.g., purchasers of "subordinated debt." Again, private market discipline did not effectively shut down S&L control frauds' access to the debt markets.

Moreover, the debacle showed how control frauds were consistently able to defeat (purported) market discipline by uninsured creditors and shareholders. The S&L control frauds invariably engaged in accounting fraud and typically reported extraordinary profits – and those profits were invariably blessed by top tier audit firms (Black 2005). Creditors make money by lending

money to borrowers who repay their loans. Profitable firms typically have both the ability and the incentive (to maintain their creditworthy reputations) to repay their loans. Creditors, therefore, are *eager* to loan funds to firms that are growing and "profitable." S&Ls' ability to engage in accounting fraud was not dependent on deposit insurance. Enron, WorldCom and a host of other control frauds that emerged in the current epidemic have all shown the ability to use accounting fraud to produce high "profits" while hiding real losses – and banks have generally fought to be able to loan these control frauds massive sums (Black 2005).

The third lesson we failed to learn was the importance of conflicts of interest. The worst S&L control frauds were commonly real estate developers with intense, pervasive conflicts of interest (NCFIRRE 1993: 3-4). Securities and Exchange Commission (SEC) Chairman Levitt took on one of the important conflicts between auditing and consulting but backed off major reforms under severe political pressure. The top tier audit firms claimed that providing consulting and auditing was a "synergy" rather than a conflict of interest (Black 2005). Auditor independence became largely fictional. Arthur Anderson was destroyed by its recurrent support for notorious control frauds like Enron.

The failure to learn these lessons from the S&L debacle left the nation too sanguine about the risks of a new epidemic of control fraud. There are now many hundreds of financial restatements due to accounting "abuses," hundreds of active criminal investigations of accounting fraud, and scores of guilty pleas. Private market discipline failed to stop any major control fraud on a timely basis. External control failed to stop virtually any major control fraud on a timely basis throughout the heart of the tech bubble and its collapse. The SEC became a

paper tiger (Black 2005; Levitt 2002).

Private market discipline proved similarly ineffective in preventing an epidemic of control fraud during Russian privatization. But while the outbreak in Russia was the worst, it was one of many that struck the former Soviet states (Wedel 1998). Recurrent outbreaks of control frauds in the Czech banking sector led to the coining of the word “tunneling” to describe the looting process (Stiglitz 2001). Similarly, fraud undermined what was originally broad public support in Argentina and other Latin American nations for privatization and largely discredited the process (Graham & Sukhtankar 2003).

Conclusion

Control frauds are the most pernicious form of fraud. In the United States, firms offer the best victims and weapons of fraud. Control frauds that loot and become Ponzi schemes cause the largest losses and are less likely to be prosecuted than those that target consumers. Ponzi schemes rely on accounting fraud as both their primary weapon and shield. They create massive, false "profits" while hiding huge real, huge losses. This allows control fraud to persist for years and inhibits effective enforcement. In industries where creditors are protected from loss by governmental guarantees, there is no private market discipline. The regulators are supposed to provide the necessary discipline, but in the case of systemic crises, regulatory hazard is maximized and regulators may take actions that enhance control fraud (NCFIRRE 1993: 62-67). Thus, governmental guarantee programs can increase the risk of an epidemic of control fraud but such epidemics can occur even if there are no governmental guarantees.

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