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PART ONE

FRAUD AND FORENSIC ACCOUNTING OVERVIEW

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FRAUD IN SOCIETY

WHAT IS FRAUD?

Fraud is an activity that takes place in a social setting and has severe consequences for the economy, corporations, and individuals. It is an opportunistic infection that bursts forth when greed meets the possibility of deception. The fraud investigator is like the attending physician looking and listening for the signs and symptoms that reveal an outbreak.

Before dealing with the accounting details and the investigation itself, we introduce some attempts by the courts, law enforcement, and regulatory authorities to define fraud. Since the subject of this book is white-collar fraud, we then outline the nature of this type of fraud through a look at the accounting cycle. We complete the tour with a look at the motives of fraudsters and the consequences of their acts.

In the beginning were the words *fraus*, a Latin noun carrying a wide range of meanings clustered around the notions of harm, wrongdoing, and deceit, and its adjective *fraudulentus*. The modern definition of fraud is derived primarily from case and statute law, but many of the ancient elements remain. The contemporary definition inferred from case law focuses on the intent of the fraudster to separate the trusting victim from property or a legal right through deception for his or her own benefit. This deception involves any false or misleading words or actions or omissions or concealment of facts that will cause legal injury. Criminal prosecution of fraud must prove beyond a reasonable doubt that an act meeting the relevant legal definition of fraud has been committed by the accused. In civil cases, liability must be demonstrated on a balance of probabilities.

Although fraud and white-collar crime are similar in that the perpetrators deceive rather than use physical violence, white-collar crime should be viewed as a subclass of fraud. Fraud includes confidence schemes, art forgery, falsified scientific research data, lying on a résumé, and so on. White-collar crime, however, is committed by individuals embezzling, manipulating accounts, taking bribes, and so on at their place of business. What they all have in common, however, is the intent to deceive. This book limits its discussion to the field of white-collar crimes committed against businesses and their accounting systems and will not discuss consumer and other types of fraud. The forensic accounting techniques discussed below are central to the discovery of fraud in the business environment.

U.S. Supreme Court Definition of Civil Fraud

Fraud takes many forms, and the courts and other institutions have had a hard time finding a definition broad, yet specific, enough to give anything beyond a working definition.

The U.S. Supreme Court in 1888 provided a definition of civil fraud as:

> *First*: That the defendant has made a representation in regard to a material fact;
> *Second*: That such a representation is false;
> *Third*: That such representation was not actually believed by the defendant, on reasonable grounds, to be true;
> *Fourth*: That it was made with intent that it should be acted on;
> *Fifth*: That it was acted on by complainant to his damage; and
> *Sixth*: That in so acting on it the complainant was ignorant of its falsity, and reasonably believed it to be true. The first of the foregoing requisites excludes such statements as consist merely in an expression of opinion of judgment, honestly entertained; and again excepting in peculiar cases, it excludes statements by the owner and vendor of property in respect of its value.[1]

Michigan Criminal Law Definition of Fraud

The difficulty of defining fraud is exemplified in the Michigan Criminal Law:

> Fraud is a generic term, and embraces all the multifarious means which human ingenuity can devise, which are resorted to by one individual, to get an advantage over another by false representations. No definite and

> invariable rule can be laid down as a general proposition in defining fraud, as it includes surprise, trick, cunning and unfair ways by which another is cheated. The only boundaries defining it are those which limit human knavery.[2]

FBI Definition of Fraud

The Federal Bureau of Investigation (FBI) offers a broad but useful definition of fraud that incorporates the elements recognized over the centuries:

> those illegal acts which are characterized by deceit, concealment, or violation of trust and which are not dependent upon the application or threat of physical force or violence. Individuals and organizations commit these acts to obtain money, property, or services; to avoid the payment or loss of money or services; or to secure personal or business advantage.[3]

Financial fraud, the subject of this book, is criminal fraud of the white-collar type. It is committed against corporations by both employees and outsiders such as vendors and contractors.

SEC Definition of Fraud

The U.S. Securities and Exchange Commission (SEC) has its own definition of fraud as it applies to transactions involving securities. Although the law governs securities, the principles invoked reiterate the constellation of ideas central to definitions of fraud with broader application. The Securities Exchange Act of 1934, Section 10b-5, states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or the mails, or of any facility of any national securities exchange,
>
> a) to employ any device, scheme, or artifice to defraud,
> b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
> c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

TYPES OF FRAUD

White-collar fraud involves an intentional deception by employees, management, vendors, and customers to obtain money or other assets or services from a business. Some frauds are perpetrated by individuals and some in collusion across the management-employee social boundaries or between insiders and outsiders. The most useful way to classify the activity of the fraudster is by locating it within the five accounting cycles of any business where it will likely leave some kind of audit trail. The five cycles follow:

1. Sales and Collections
2. Purchases and Payments
3. Payroll and Personnel
4. Inventory and Warehousing
5. Capital Acquisition and Repayment

Sales and Collections Cycle

The sales and collections cycle bills clients for sales of goods and services and collects the money. This is the most cash-intensive of the five cycles. The most common frauds in this cycle are:

- Outright cash thefts
- Theft of other assets
- Kickbacks to customers
- Front-end frauds

Outright Cash Thefts

Cash thefts are the easiest and most common type of fraud to perpetrate in this cycle and are usually carried out through unrecorded sales, underringing of sales, lapping schemes, and over-billing, among others.

Theft of Other Assets

Assets can be stolen by ordering and shipping goods to an address other than that of the business.

Kickbacks to Customers

In customer kickback schemes, the fraudster under-bills the customer for merchandise and they split the difference, or receivables are written off as uncollectible for a fee.

Front-End Frauds

Front-end frauds are committed by the fraudster directing customers to take their business elsewhere or misappropriating a rebate.

Purchases and Payments Cycle

This cycle includes noncapital procurements and payments for goods, equipment, and services used in company operations. The buyer may act alone by setting up shell companies to receive goods misdirected from his company by false invoices. These schemes are often extremely complex and involve bank accounts, mail drops, and even corporate filings for the dummy entities. Procurement fraud is frequently a collusive employee–vendor fraud. The vendor will typically provide a bribe or kickback in return for business or, in the case of tendered contracts, for the employee to rig the bidding in favor of the fraudulent vendor. In another scheme, which may or may not be related to the original procurement scheme, once the vendor has been awarded the contract, the cost of the bribe may be recovered and profits increased by substituting products inferior to contract specifications, billing for work not done, shipping less than ordered, padding overhead expenses, and so on. Collusive fraud is the most common form of acquisition-and-payment fraud.

Payroll and Personnel Cycle

This cycle deals with hiring and termination, salaries, timekeeping, expense account reimbursements, and health and other types of employee insurance coverage. Common forms of fraud in this cycle are paying ghost employees, overstating hours worked, overstating expenses, and filing false medical claims. Employee and management fraud can overlap in this cycle, especially in the area of false expense account reports. An important but often overlooked area of personnel fraud is the improper vetting of job applicants. Collusion between a personnel department employee and a fraudster applicant could install a fraudster within the company with untold consequences.

Inventory and Warehousing Cycle

This cycle controls the purchase and storage of goods for later processing and sale or just for sale. The most common frauds in this cycle are ordering unneeded inventory and then stealing it for personal use; committing outright theft; and charging embezzlements occurring elsewhere in the company to inventory losses. These schemes can often become extremely complex and involve loading-dock workers, inventory accounting personnel, truck drivers, and receivers of stolen goods in other parts of the state or country.

Capital Acquisition and Repayment Cycle

This cycle accounts for debt and equity financing, interest, and dividend payments. The results of these transactions are reflected on the financial statements of the company. Because these accounts are developed at the executive level, this type of fraud is committed almost exclusively by management. The usual frauds are borrowing company money for personal use, misuse of interest income, and misuse of proceeds from financings.

Other Types of Financial Fraud

Some frauds that affect business often occur outside the typical accounting cycle. Customer fraud, for example, can severely affect insurance companies through filing of false applications and fraudulent claims, especially those for personal injury. Banks and other financial institutions suffer customer fraud through submission of false financial information on loan applications.

Management fraud deserves special mention in these days of corporate scandals. In addition to theft through the capital acquisition and repayment cycle, management can commit fraud through the manipulation of earnings reported on the financial statements prepared for shareholders and creditors. This type of fraud can affect the stock price, management bonuses, and the availability and terms of debt financing. Enron Inc. is a particularly egregious example of management manipulation of the financial statements that enriched a few but caused the collapse of the company pension plan, enormous losses to innocent shareholders, and unemployment for thousands of Enron staff.

Recent Events in Perspective

It is sometimes suggested that the size and complexity of the Enron, WorldCom, Adelphia, and other cases mean we are living in a new era of fraud. What should we make of this suggestion? Actually, rather than being trend-setting events, these scandals are merely the latest in a history of revelations that have always followed market excesses since the Dutch Tulip Mania of the 1630s[4]. The dot-com bubble of the late 1990s was no exception. The English polymath Walter Bagehot captured all the elements of excess in the following passage from *Lombard Street*, his 1873 critique of the English banking system:

> The mercantile community will have been unusually fortunate if during the period of rising prices it has not made great mistakes. Such a period naturally excites the sanguine and the ardent; they fancy that the prosperity they see will last always, that it is only the beginning of a greater prosperity. They altogether over-estimate the demand for the article they deal in, or the work they do. They all in their degree—and the ablest and the cleverest the most—work much more than they should and trade far above their means. Every great crisis reveals the excessive speculations of many houses which no one before suspected, and which commonly indeed had not begun or had not carried very far those speculations, till they were tempted by the daily rising price and the surrounding fever.[5]

Rather than seeing Enron as an exception, one should say it would have been surprising if no Enron or WorldCom or Adelphia or Tyco had appeared after the extraordinary period of economic growth in the 1990s. The picture presented throughout this book could well continue to be the reality met by fraud investigators into the foreseeable future.

A Bit of Background

The great bull markets of the twentieth century were all followed by revelations of malfeasance that only came to light after equity values had declined from heights unjustified by earnings growth rates and historical price-earnings multiples. When the Jazz Age ended in October 1929, the reputation of business executives was in just as much trouble as it is today. The shenanigans of the bigger players were ultimately exposed when the investigations of the Senate Committee on Banking and Currency in 1933–1934 revealed the true behavior and ethics of the bankers and brokers in the previous decade. The practices of the great financiers of the day as presented in 12,000 pages of testimony were so shocking that the government felt it necessary to establish the Securities and Exchange Commission in 1934 to regulate the financial industry.

Richard Whitney, head of his own investment firm and five times president of the New York Stock Exchange, proved to be an exceptionally poor businessman. He borrowed $30 million from his friends, relatives, and accounts in his trust and owed $6.5 million at the time he declared bankruptcy. He served three years and four months of a five-to-ten-year sentence for misusing funds from his father-in-law's estate.

The More Things Change. . . .

The go-go market of the late 1960s experienced a similar collapse, followed by revelations of what had really been going on during the frenzy. This time conglomerates, a corporate structure similar to the investment trust favored by investors in the 1920s, became the entity overvalued by the accountants. Creative accounting produced wildly overstated values that were soon proven false by actual performance. The inevitable result was, once again, a catastrophic collapse of stock prices and total destruction of the value of the debentures and bonds. As in the case of Arthur Andersen's work with Enron, accountants in the 1960s lost their definition of themselves as independent critics of corporate financial behavior.

The bull market of the mid-1980s was also a time of merger mania and the heyday of the junk bond market. The *crime du jour* was insider trading. The investment banker Drexel Burnham Lambert collapsed, and Denis Levine, Ivan Boesky, Michael Milken, and others went to jail.

The most recent exemplar of overvaluation and greed is, of course, the Enron case. Enron commoditized energy, bandwidth on optical fiber networks, newsprint, and many other assets into commodities contracts to be traded in the futures market and hedged them with derivatives. To show strong growth on its published financial statements, the company resorted to aggressive accounting practices and extensive use of off-balance-sheet instruments called Special Purpose Entities (SPEs) to provide the dynamism rewarded by Wall Street with a healthy price-earnings multiple.

The company liberally interpreted GAAP (Generally Accepted Accounting Principles) and sometimes acted in violation of GAAP by, for instance, booking income immediately that would only be earned in the future on contracts that could take as long as 10 years to complete. Debts were shifted to SPEs controlled by the company, despite a requirement that such an entity must be at least 3-percent owned by an external party that also exercises control.

The screaming headlines concerning the Enron case should not be allowed to deafen us to the call of history. People become less vigilant when markets are soaring, and they are not in the mood for the cold water of reality. It is only when they return to looking more closely at their investments in the difficult times that inevitably follow that they, like Walter Bagehot, see what was going on while they weren't paying attention.

Sarbanes-Oxley

The purpose of the Sarbanes-Oxley Act of 2002 is to provide investors with greater confidence in American corporations and allow them to rely on financial statements as an accurate representation of the financial condition of the companies in which they are stakeholders. The Act is a response to the revelations of lax auditing practices and conflicts of interest between auditors and their clients.

The instrument of the Act is the five-member Public Company Accounting Oversight Board to be administered by the SEC. Accounting firms that audit publicly traded companies must register with the Board, and those issuing more than 100 audit reports a year must be inspected annually for compliance with Board regulations. Registered firms must retain audit working papers for not less than seven years after the engagement and must have all audits reviewed by a second partner.

Perhaps the most dramatic section is Section 302, which makes the CEO and CFO certify the "appropriateness of the financial statements and disclosures contained in the periodic report, and that those financial statements and disclosures fairly present, in all material respects, the operation and financial condition of the issuer." Maximum penalties for willful and knowing violations of this section are a fine of not more than $5,000,000 and/or imprisonment of up to 20 years.

Another key section (201) prevents an accounting firm from creating possible conflicts of interest by prohibiting it from performing other services, including financial systems design, appraisal or valuation services, investment banking services, or other nonaudit services "contemporaneously with the audit."

The lead and reviewing partners must rotate off the audit every five years. The General Accounting Office will study the consequences of requiring the rotation of the audit firms themselves (207).

The SEC intends to study Special Purpose Entities (401c) to see how widely they are used and to determine whether GAAP as currently constituted is capable of reporting SPEs in a transparent fashion.

It will be unlawful for audited corporations to extend credit to directors or officers (402a). A report on the existence and effectiveness of internal controls for financial reporting will be attested to by the auditor and included in the company annual report (404).

Title VIII of Sarbanes-Oxley, known as the Corporate and Criminal Fraud Accountability Act of 2002, makes it a felony to interfere with any federal investigation into the records of a public company. Auditors must retain all working papers for five years. The statute of limitations on securities fraud claims is extended to the earlier of five years (formerly three years) from the fraud, or two years (formerly one year) after the discovery of the fraud. Whistleblowers are protected from reprisals by employers and can be awarded damages and attorney's fees.

Title IX, known as the White Collar Crime Penalty Enhancements Act of 2002, increases the maximum penalty for mail and wire fraud to 10 years from 5. Tampering with records or impeding official proceedings is now a crime.

Even though the high-profile examples to which Sarbanes-Oxley is a response are extremely rare, the Act is a timely corrective to the whole issue of misleading accounting that has been a concern of the SEC for many years. These new laws will affect the fraud investigator by assuring that corporate records are accurate and that internal controls are in place which will assure a movement of information along an assured audit trail

WHAT THE NUMBERS TELL US ABOUT FRAUD

Comprehensive official fraud statistics are hard to come by because government agencies and industry groups tend to keep records only of those frauds that affect their area(s) of interest. The problem is compounded by the discovery of new frauds such as Internet "cramming" and recategorization of "old" frauds, for example, in the FBI's designation of frauds perpetrated against identifiable groups such as scams of the elderly as "association" fraud.

We must also remember that all fraud statistics are based on known frauds. What is most unnerving is the fact that the numbers quoted are considered to be only the tip of the iceberg. Aside from the many undetected frauds are those frauds not reported by the harmed company for fear of embarrassment

Many of the figures bandied about in discussions of fraud are educated guesses or extrapolations from the few figures that are gathered. As a result, the best we can hope for is to get a broad picture of fraud from focused studies.

Study: Association of Certified Fraud Examiners

For purposes of this book, the best overview of financial fraud comes from studies done by the Association of Certified Fraud Examiners (ACFE). In 1996, the ACFE published *Report to the Nation on Occupational Fraud and Abuse* based on occupational fraud cases reported by its members. Its second report, the *2002 Report to the Nation on Occupational Fraud and Abuse*, is based on a study of the $7 billion lost in 663 cases reported by the Certified Fraud Examiners (CFE) who investigated them.[6]

The ACFE estimates that occupational fraud alone costs the U.S. economy about 6 percent of its revenues—or about $600 billion, or $4,500 per employee in 2002. This is a 50 percent increase over the $400 million estimated to have been lost in 1996 when the first report was written. Large as these figures are, it must be remembered that they do not include money lost through the infinite variety of consumer scams, tax evasion, and other personal frauds. The U.S. Congress estimates that telemarketing scams alone are a multibillion dollar annual business.[7]

Small-Business Fraud

Most frauds occur at small businesses where the average scheme causes $127,500 in losses compared to $97,000 in the largest corporations. Fraud is most likely to occur at small businesses simply because there are more of them and their control of the accounting cycle is weaker than at large corporations. According to statistics derived from Internal Revenue Service (IRS) income tax returns, just over 24 million businesses in the United States file returns, of which 72 percent are sole proprietorships and 8 percent are partnerships. In other words, 80 percent of U.S. business is done at small businesses, even though they generate only 13 percent of the taxable revenue. (Corporations of all sizes account for the remaining 20 percent of businesses and 87 percent of taxable revenue.)[8]

One should keep in mind that, although the billion-dollar scandals at Enron, WorldCom, and other corporations have splashed onto the front pages in recent times, it is the slow, steady drip, drip, drip of fraudulent activity at small businesses that is larger in aggregate and potentially does the greater damage to the economy over the long run.

Statistics also show that one-third of business failures arise as a result of internal fraud. One of the perpetrator's most often heard rationalizations is: "I'm not hurting anyone . . . it's just money." Clearly, this statistic takes us well beyond the belief that fraud hurts no one.

Categories of Occupational Fraud

The ACFE divides occupational fraud into three broad categories[9]:

1. Asset misappropriations
2. Corruption
3. Fraudulent statements

Asset Misappropriations

Asset misappropriations are the theft or misuse of assets and account for 80 percent of all occupational fraud. This category includes theft of cash, which is the asset misappropriation committed 90 percent of the time. Thus, based on the foregoing, cash thefts account for 72 percent of all occupational fraud.

Cash thefts usually occur in three different ways:

1. Fraudulent disbursements
2. Skimming
3. Cash larceny

Fraudulent Disbursements

Fraudulent disbursements use some device such as false invoices or timecards to create a false payment obligation for a company. It is the most common type of cash fraud, accounting for 71 percent of the studied cases and creating a mean loss of $100,000.

Fraudulent disbursements break down into five principal types:

1. *Billing*: Fraudulent billing schemes accounted for 46 percent of fraudulent disbursements and created a median loss of $160,000.
2. *Check tampering*: Check tampering made up 30 percent, with a median loss of $140,000.
3. *Expense reimbursement*: Expense reimbursements comprised 22 percent of schemes and caused a median loss of $60,000.
4. *Payroll*: Payroll schemes represented only 18 percent of cases studied, but the median loss was as big as that for check tampering at $140,000.
5. *Register disbursement*: Register disbursements made up only 3 percent, with the smallest median loss of the group at $18,000.

Skimming

Skimming is the theft of cash during its collection but *before* it is recorded on the company books. Skimming occurred in 32 percent of the cash frauds and showed a $70,000 mean loss.

Cash Larceny

Cash larceny is the theft of cash *after* it has been recorded. This form of fraud accounted for only 9 percent of the cases, with a mean loss of $25,000.

Extrapolating these numbers, one can see that 23 percent of occupational fraud is perpetrated through fraudulent billing schemes. Frauds of this type are not the largest occupational frauds in dollar terms, but they are the most frequently occurring. This statistic, together with the fact that 72 percent of all occupational fraud is attributable to the appropriation of cash, explains the emphasis on knowing basic accounting principles in Chapters Two and Three. Most of the frauds you will encounter will likely be a diversion of cash for personal use through exploitation of some weakness in the operation of the accounting cycle at the victim company.

Corruption

Corruption is a crime of fiduciary abuse in which an employee uses a position of trust and authority to gain a benefit. Corruption accounted for 13 percent of the occupational frauds tracked by the ACFE. The acceptance of kickbacks and engagement in conflict of interest are typical corruption frauds.

Fraudulent Statements

Fraudulent statements accounted for only 7 percent of frauds, but they were much larger than in either of the other two classes. The median loss through fraudulent financial statements was $4,250,000 compared with $530,000 in corruption schemes and $80,000 in asset misappropriations.

Drawing Conclusions

To put these figures into perspective as they might affect a small company, consider the following calculation. In the year before it became the victim of a fraud, a company had $5 million in revenues, gross profits of $500,000 on a gross margin of 10 percent, and 12 employees. In the following year, revenues increased by 8 percent to $5.4 million, and a fraud of the average amount was committed, that is, a fraud of $54,000 (12 × $4500) based on the ACFE figures of an average loss of $4500 per employee. At a 10 percent gross margin, $540,000 of the $5.4 million in total revenues was used to generate the $54,000 stolen in the fraud. Gross profits without the fraud would have been $540,000 but were actually $486,000 ($540,000 – $54,000) instead. The profit margin was thus reduced to 9 percent ($486,000 ÷ $5,400,000). An additional $54,000 was stolen in year three. To pay for this without affecting the traditional 10 percent gross profit margin, revenues would have had to be increased by $540,000. Unfortunately, this was a tough year in the industry, and revenues grew by only 5 percent, or $267,000, to $5.67 million. Without the fraud, a 10 percent margin would have produced gross profits of $567,000; with the fraud, gross profits were reduced to $513,000 ($567,000 – $54,000) to produce a gross profit margin of only 9.05 percent.

From this small example, we can see and infer many of the important consequences of financial fraud. For example, much of the company sales force's efforts were wasted since $540,000, or approximately 10 percent of total revenues, had to be generated solely to pay for the $54,000 fraud. The reduction in gross profits meant less money for paying down debt, reinvestment, or distribution to shareholders. The slowdown in gross profit growth and the reduction in margins could affect share values and the ability to borrow money or to remain within the terms of existing covenants.

Society's Perception of Fraud

Fraud is often perceived as a victimless crime. Governments and businesses are seen as so wealthy that the money taken by fraud won't be missed. "They can afford it," is the classic rationalization heard in confessions. Fraud is also viewed as an easy way to get money without running the risk of severe punishment. Dismissal is certainly a possibility, but many employers will, in fact, try to hush up news that they have been defrauded for fear of adverse publicity with their customers, vendors, bankers, and insurers. Fraud is also seen as benign. Nobody is told at the point of a gun to lie on the floor of the bank; nobody is waiting for you in the dark when you come home. There is little risk of being caught. It's the kind of crime a respectable person can commit and still not feel like a criminal.

The truth is quite otherwise. If, as noted above (see "What the Numbers Tell Us about Fraud" section above), $600 billion in revenues is diverted annually by fraudsters, then $600 billion will never work its way through to shareholders' equity and increase the wealth of the national industrial base. Since most fraud occurs at small, and thus more vulnerable, businesses, the risk is greater that it can cause bankruptcy with its consequent costs to vendors and lenders and unemployment for company staff. A lifetime of building respect in business, in the community, and with the family can be destroyed when a trusted employee who felt protected by a reputation for honesty is exposed as a fraudster.

Fraud is far from benign. As fraudsters take advantage of technology, fraud becomes more sophisticated. It can no longer be characterized solely as employee theft for personal benefit. It is international. An American businessman who was the victim of a Nigerian letter scam went to Lagos to check on his "investment" and was murdered for his troubles.[10] The line between individuals stealing for themselves and fraud as part of organized crime is getting harder and harder to draw. Ruthless gangs have been discovered behind corporations boasting respectable boards of directors which are actually set up to launder money and create stock frauds. As regulators close the traditional charities and other fronts used to raise money, terrorists are turning to identity, mortgage, and other types of fraud to raise the money needed to attack U.S. interests. Today the occupational fraud uncovered at a small company could be part of something much larger.

Who Commits Fraud?—Profile of the Typical Fraudster

Early academic research on white-collar crime includes the paper "White-Collar Criminality," which Edwin H. Sutherland presented as his presidential address to the American Sociological Association in 1939.[11] He was writing in the aftermath of an era that had been characterized by crimes committed among the middle and upper classes. The Senate investigations of the stock market scandals of the 1920s revealed the ethical shortcomings of the country's business leaders. Many prominent public figures, including Richard Whitney, former five-term president of the New York Stock Exchange, were jailed. The repeal of the Volstead Act in 1933 that ended Prohibition closed a period that had seen the widespread corruption of public officials and turned virtually the entire population of the United States into lawbreakers in their desire to celebrate the boom times with alcoholic beverages.

Up to this time, crime had been explained as a phenomenon of the lower classes "caused by poverty or by personal and social characteristics believed to be associated statistically with poverty, including feeblemindedness, psychopathic deviations, slum neighborhoods, and 'deteriorated' families."[12] Sutherland argued that any theory of crime rooted in poverty was not a true picture of crime in society, for it failed to explain many other types of criminal behavior, including that of business and professional men.

Sutherland's paper raised the profile of middle and upper class criminal activity by extending the definition of "criminal" to include statistics other than those of conviction for violations of the criminal code since "a large proportion of those who commit crimes are not convicted in criminal courts."[13] He pointed to violations of federal agency regulations such as those of the Federal Trade Commission which were met only with cease and desist orders, license revocations, or fines. Many otherwise criminal cases were settled in civil suits because the plaintiff was more interested in restitution and damages than in seeking punishment. He also felt white-collar criminals were sometimes immune from conviction because of what he called "the class bias of the courts and the power of their class to influence the implementation and administration of the law."[14] Crime was also underreported when, for example, a politician was convicted of accepting a bribe but the person paying the bride escaped prosecution.

Sutherland recognized what subsequent research has confirmed. The white-collar criminal was not usually a product of poverty or dysfunctional families and was not feebleminded or psychopathic. "They were seldom problem children in their earlier years and did not appear in juvenile courts or child guidance clinics."[15]

By 1949, Sutherland had reached what he called an "approximate" definition of white-collar crime as "a crime committed by a person of respectability and high social status in the course of his occupation."[16] Such language probably bespeaks the sharp business practices of the important persons paraded through the courts in the 1930s after their fall from prominence. In fact, every word cries out for greater definition and has raised controversy among scholars ever since.

Nevertheless, the sense that white-collar crime is a distinct class of crime distinguished by the social qualities of its perpetrators has stood the test of time. Around this central idea, however, additional research has recognized other aspects of the problem. One of the most important is the role played by organizational structures and the positions of authority held by the offenders in facilitating the crimes. Notice was also taken of the enormous harm such activity could have on the business environment and individuals. Though not directly related to recent financial shenanigans, books such as Rachel Carson's *Silent Spring* and Ralph Nader's *Unsafe at Any Speed* published in 1962 and 1965, respectively, raised public awareness that respectable people could conduct business in ways that should be criminalized and, in many areas, later were.

Unfortunately, despite enormous scandals such as Watergate, the Iran-Contra Affair, the Savings and Loan debacle, the Wall Street insider trading exposé, the collapse of the Bank of Credit and Commerce International (BCCI), and Barings Bank, white-collar crime has not been subjected to as much research as other types of crime.[17] The lack of research on crimes of this type has resulted in a paucity of research on the criminals. The small number of prosecutions and subsequent convictions further hampers such research. In this respect, corporations work against their own best interests when they refuse to prosecute employees because of a fear of adverse publicity. The result is a lack of the raw material for academic study that could lead to a better understanding of the white-collar criminal and development of better hiring and prevention policies.

Despite the deficiencies in gathering evidence and developing theory, several studies have been done that show some consistency. The spectrum of persons committing white-collar crime is much broader than that suggested by the respectability and high-social-status criteria of Sutherland's definition. Even in class-conscious Britain, a company survey showed that managers committed one-third of employee fraud, accounting personnel one-fifth, and directors or partners only one-tenth. The more socially elevated directors and partners committed *less* fraud than sales and shopfloor personnel.[18]

A 1980 study showed that fraudsters are indistinguishable from their fellow employees by any demographic or psychological criteria.[19] The researchers compared a group of white-collar criminals with a group of prisoners held for other property offenses and a group of noncriminal college students. The white-collar prisoners were better educated, more devout, and less likely to have criminal records or alcohol or drug problems. They were also more likely to be married and in good psychological health as measured by self-esteem, achievement, and family well-being. In other words, they had the very qualities human resources departments look for in new hires. This research could not find any features that would predict future fraudulent behavior.

Perhaps the most important recent analysis of fraud and fraudsters is a U.S. study using pre-sentence investigation reports (PSIs). The researchers analyzed the PSIs for 1,094 people, predominantly white males, convicted of any one of eight classes of white-collar crime in the federal districts centered on Los Angeles, Atlanta, Chicago, Baltimore, Manhattan and the Bronx, Dallas, and Seattle in the three-year period 1977–1979 inclusive. The classes of crime analyzed were: antitrust violations, securities frauds, mail and wire fraud, lending- and credit-institution fraud, false claims, bribery, tax violations, and bank embezzlement.[20] In order to compare these offenders with nonviolent common criminals convicted of federal offenses of a financial character, the researchers studied 15 persons convicted of postal theft and postal forgery in each of the seven districts.

What the study revealed was a large third class of criminal behavior lying between the street crime identified by Sutherland as only part of the criminal population and the high-status criminal he defined as a new group needing study. Weisburd et al. recognized that the number of white-collar occupations has increased significantly since the 1920s and 1930s when some of the groundbreaking studies of criminal activity were made. More people than ever are engaged in processing financial and other information that can be fraudulently manipulated for personal gain. Much of this manipulation requires very little education or skill. Credit applications requiring a statement of income and assets, job applications requiring a statement of credentials, tax forms and applications to government for all kinds of grants, medical care, and welfare payments can all be manipulated by almost anyone. Criminal opportunity has been democratized. The spread of computer technology alone has opened vast new opportunities to defraud for persons of both limited and highly sophisticated technical knowledge.

Socialization to succeed both in terms of increased status and greater affluence can create self-perceptions of failure and poverty that can become hidden motivators to commit fraud. People seeking to better themselves need the opportunities provided by good credentials and access to credit. Even people who are successful by every conventional measure may still perceive themselves as poor and seek to increase their net worth through fraud.

Securities and antitrust offenders had the highest social standing (67.4 and 61.1, respectively) of all the groups studied by Weisburd et al., as measured by the Duncan Socioeconomic Index, but measured far below the highest score (96.0) assigned to doctors and the only slightly lower 92.3 for lawyers. Antitrust offenders were stable family men still married to their first wives, had median assets of $613,000, and debts of only $7,000, usually owned their own homes, had good reputations in their communities, had no drug or alcohol problems, and possessed good employment records. SEC violators were better educated because their jobs required a sophisticated knowledge of finance, while several antitrust offenders had started with nothing and had worked their way up. The SEC violators tended to have more debts, less stable marriages, and worse employment records. They were also younger, with a mean age of 44 compared with 53 for the antitrust offenders. The lawyers in these two as well as the other categories of crimes worked on the margins of the profession in small firms or partnerships and had graduated from the less prestigious law schools.

Tax and bribery offenders were farther down the social scale. They were mostly white males in their 40s, employed, often sole proprietors, or business owners. Several were lawyers, doctors, or certified public accountants (CPAs) with troubled personal lives.

People convicted of perpetrating credit or mail fraud, or of making false claims were yet lower in social status, less likely to be male or white, and with a lower median age in the late 30s. Their work histories were less stable, substance abuse was more common among them, and their median net worth was zero. A full quarter of these offenders were unmarried parents; another quarter was unemployed, and financial, personal, and family troubles were common among them. The level of unemployment at the time the crime was committed was the highest of all the crime categories studied. About half those convicted of these offenses had prior records, the highest rate of all the categories.

Bank embezzlers were still predominantly white, but women accounted for about 45 percent of those convicted. The median age here was low at 31. Most were bank employees; the men were mainly managers, and the women were tellers or clerks. This group included the smallest number of college graduates and the smallest number of homeowners. These offenders were usually from stable working families of modest means.

One of the study's central findings was that "white-collar criminals are generally much closer in background to average Americans than to those who occupy positions of great power and prestige."[21] In other words, the white-collar criminal is not Sutherland's person of "high social status" but a person of the middle class as measured by the usual standards of income, education, assets, and the like. On the other hand, the white-collar criminal is sharply distinguishable from the common property criminal by the same criteria.

Looked at as a group, the offenders in this study had an unemployment rate at the time of the commission of their crimes similar to that of the general population in the seven federal districts. This contrasts sharply with the more than 50 percent rate typical of common crime defendants. White-collar offenders are better educated than the average American and tend to hold jobs with higher-than-average prestige but, with the exception of the few doctors and lawyers in the group, not the highest. Eighty percent of the white-collar criminals had high school diplomas compared with 69 percent in the general population and less than 50 percent among common criminals. About a quarter of the subjects in the Weisburd et al. study had college degrees compared with 19 percent in the general population and only 3 percent of common criminals. The white-collar offenders were quite different from the general criminal population by having a mean age of 40 compared with the mean age of 27 for offenders in the criminal justice system overall in 1977, the first year of the study.

Since crime in general is primarily a male phenomenon, it is not surprising to find that men committed 83 percent of the white-collar crimes committed in the eight categories. The crimes committed by women were usually less complex and less harmful.

White-collar criminals are more likely to be better off financially than common criminals but have more debt than the average American, despite giving the appearance of being well off. They are more likely to own their own homes than common offenders but less likely to be homeowners than the average American.

About 43 percent of the white-collar offenders in this study had had prior arrests, and about 35 percent had been convicted of a serious crime. This contrasts sharply with the fact that most people convicted of felonies have had prior arrests and convictions. There seems, however, to be little evidence of white-collar criminal careers among the study subjects since only about one in five had had a previous conviction for a white-collar offense.

Weisburd and Waring did a followup study in 1990 on the same subject population but this time supplemented the information on the PSIs with the arrest histories from the FBI "rap sheets," adjusted for a 14 percent mortality rate among the original subjects. By examining the subjects' arrest histories before the arrest for the crimes studied for the 1977–1979 period *and* for the period 1979–1990, Weisburd and Waring found that 48 percent had been arrested at least once. They found that 38.5 percent had been arrested before and 31.3 percent in the second period. The highest number of prior *and subsequent* arrests occurred among those committing mail fraud, credit fraud, and making false claims.[22]

The picture of the white-collar criminal with an arrest record for other crimes is quite different than that of the street criminal with a record. Even though a few white-collar criminals had 10 or more arrests, this number is still significantly below that for common street offenders who may be arrested 10 or more times in a single year. Street offenders are usually arrested for the first time in their teens; the white-collar criminals in this study were booked for the first time at an average age of 35. For 40 percent of the sample, the first offense was a white-collar crime.

There seems to be some inconclusive evidence that white-collar criminals as well as street criminals stop their criminal activity as they age. Street criminals stop because they lose the required agility and change the direction of their lives. On the other hand, an individual wanting to commit a white-collar crime actually gains knowledge with age and has increased opportunities through advancement up the corporate ladder into positions that control larger sums of money. These potential opportunities may, however, be put out of reach by an arrest! The reason for stopping also may be explained by something as simple as the recognition that "[g]oals and aspirations change for these offenders as for other people as they get older."[23]

Any attempt to draw the profile of the white-collar criminal, including the fraudster, must deal with the important fact that they are low-frequency offenders. As shown above, white-collar criminals are rarely career criminals, and, in fact the white-collar offense is often the only arrest on their record. The typical subjects of this study were in fact the very picture of middle-class respectability: a well-educated male achiever, a homeowner married to his first wife and without a substance abuse problem.

The ACFE study is by and large consistent with the findings of Weisburd et al. Men in the 40–50 age group with high school or less education and working alone committed most frauds. The largest amounts, however, were stolen by university-educated older men with no criminal records who were in positions of financial responsibility and perpetrating the frauds in collusion. Dishonest managers and executives working alone caused median losses of $250,000, or about 4.2 times the $60,000 stolen by lower-level employees operating by themselves. When executives and managers colluded with employees, however, the median loss jumped to $500,000, or double what executives and managers stole on their own and 8.3 times what employees stole on *their* own. Since management is responsible for the application of controls to detect fraud, the involvement of management makes detection more difficult and the fraud potentially more devastating for the company.

Women commit just about as many frauds as men, but the median amount is smaller. Fraud, too, has its "glass ceiling"! Most executive and managerial positions are still held by men, and their opportunities to steal large sums are greater. Fraudulent acts by women seem to increase as one descends the occupational hierarchy. The activity of women is especially marked at the clerical levels of the financial industry.[24] One can reasonably expect that the admission of greater numbers of women to positions of power will result in a more equitable balance in the gender statistics.[25]

Men over 60 also stole more than 27 times the median $18,000 taken by persons under 26 years of age, despite the fact that the older group accounted for only 2.5 percent of the cases studied, while the younger group accounted for 6.0 percent. In fact, one can conclude from this study that the median amounts taken vary directly with age.

Frauds by persons with university education are less frequent but involve larger median amounts than those committed by persons with only high school or below. Once again, this reflects the fact that educated people tend to rise to higher levels of responsibility and thus control larger amounts of money.

Perhaps the most disturbing statistic in the ACFE study is the one showing that 68.8 percent of the frauds were committed by persons who had never been charged or convicted of any previous crime. This is consistent with Romney et al. and Weisburd et al. who discovered no sociopathic behavior patterns in the fraudsters studied in their research.

Crisis Responders and Opportunity Takers

What, then, makes a person commit that one act that turns a respectable citizen into a criminal? How does a person who does not have the statistical profile of the common criminal form the intent to break the law? Weisburd and Waring identify two broad classes of offender: crisis responders and opportunity takers. The crimes of the crisis responders "seem to be situational responses to real stress or crisis in their professional or personal lives." The crimes of the opportunity takers seem to be "linked strongly to some unusual or special set of opportunities that suddenly materialize for the offender."[26]

The crisis responders were people in positions of trust who saw a criminal act as the way out of a perceived financial crisis. These events were anomalies in their social histories. The women acted to pay family bills, and the men stepped over the line for a variety of reasons, such as financial troubles at the company they owned or to reduce their income taxes payable.

The opportunity takers were not driven to commit a crime by financial pressures; they were drawn in by the temptation created by an unusual opportunity. Many of these events were isolated wrong choices. This group, however, also includes those recruited into conspiracies operating in permissive environments. Once involved, these offenders become socialized into criminal activity that can last for years or even decades. The offense for which they suffered their one arrest was, in fact, often one long, systematic criminal activity.

The commission of a crime requires a place that connects opportunity and victim. The most harm is done by officers and managers colluding with others in ways that exploit an organization for which they work. This is the quintessential middle-class crime. Owners and sole proprietors may be from a higher social class, but the businesses they control are usually too small to permit the magnitude of the thefts possible from large corporations. Others of high social status, such as doctors and lawyers, rarely commit large complex crimes. Exceptions are those doctors who open clinics to exploit Medicaid.

It is the officers and managers who hold their positions in large companies through education and hard work rather than birth who have the opportunities to commit the big frauds, This is because they command the accounting systems as well as the controls that should safeguard those same systems. These crimes are most frequently collusive because their commission requires an assembly of skills capable of exploiting the complexity of the corporate structure.

The largest frauds in dollar terms and the most complex are committed in the securities and insurance industries as well as in the service sector. Government is, of course, also large but the constant auditing leaves little opportunity for major internal frauds to develop through collusion. Instead, government is victimized from the outside through fraudulent contracts and claims for services. The banking industry, despite the constant presence of cash and other forms of money, is rarely the victim of a large complex internal fraud.

Detection

White-collar crime in general is usually detected by reports from the victim, routine audits, or informants. Since the victims of white-collar crime rarely know anything has happened at the time the money is actually taken, often a long lag develops between the commission of a crime and its discovery and report. Three quarters of all bank embezzlements and more than half of all credit card and mail frauds are typically reported by victims. These frauds are, in effect, self-detecting, and institutions spend relatively little on trying to discover it themselves. About 80 percent of tax fraud is, on the other hand, discovered through routine audits or investigations. Routine audits in the banking industry also discover many of the common internal employee frauds.

The discovery of collusive crimes is almost entirely dependent on informants. Antitrust crimes require the participants to communicate or meet in order to fix prices and carry the attendant risk that someone might break rank and inform. The more people involved, the greater the risk. Bribery is still a collusive crime, even though only two persons are required for its commission.

Motivations for Fraud

Put in the broadest possible terms, the history of criminology has been an attempt to identify the characteristics that distinguish criminals from noncriminals and then to find a theory that explains and predicts criminal behavior. After more than a century of investigation, there is much information on criminal behavior but still no general theory of why crime exists that has won wide acceptance. This is especially true of white-collar crime, which seems a statistical exception to what is known about common street crime. The central question of white-collar crime, namely, why people who are so typically upstanding and so unlike street criminals, commit the crimes they do, remains unanswered despite much theorizing.

Some theorists have taken a "big-picture" approach and argued that white-collar crime is the inevitable outcome of the competitive ethic of capitalism. According to this theory, competition is the field on which egotism and recklessness can have full play.[27] We are constantly bombarded by images of the wealth and success that can be achieved through winning in the great experiment in social Darwinism in which we live. The inevitable result of such competition is the recognition of the economic inequality of winners and losers, which can be internalized as the constant fear of failing. This discontent may be sufficient to make a person see white-collar crime as the great equalizing act. The drive for money and the trappings of success are, therefore, the motivators of the act.[28]

Recent theorizing has shifted the focus to the situation in which the crime is committed. This newer thinking does not dismiss the role of personal history, which is so important in the creation of the street criminal, but questions its explanatory power. It raises the question of why certain people commit certain crimes in certain situations. This is a useful line of theorizing since it allows the criminal act to be conceptually distinguished from the criminal's life story and explained as the pursuit of short-term gratification and not the culmination of a long history of personal disadvantage.

The situation in which the potential white-collar offender finds him- or herself plays a most significant role in determining whether or not a crime will be committed. The corporate culture lived daily at the workplace can often create enormous pressures to commit criminal acts. Examples are common in the famous cases of price-fixing, bribery, and manufacture of dangerous products that occurred throughout the last century.[29] A corrupt corporate culture can lead to the inversion of all values. The comfort of conformity then becomes the Achilles' heel of the middle-class person under pressure to "go along to get along." Loyalty can easily slip into complicity. Criminal behavior becomes normal. Team-playing becomes conspiracy. Fear of dismissal, ostracism, or losing the favor of superiors can be compelling forces in the world of a department or small company. In such an atmosphere, one learns criminal behavior "in association with those who define such behavior favorably," as Sutherland contended.[30]

These acts cannot be explained by a personal history of instability and deviance since stability and conformity are the principal characteristics of these criminals' lives. Even while committing the crimes, white-collar offenders are able to lead their conventional lives, which are, indeed, their camouflage. Their conventionality and stability are the foundation of the trustworthiness that gives them the opportunity to commit the crime in the first place. It is this life of conventionality that gives the criminal act the character of an aberration.

It is, however, the white-collar criminals' power of rationalization that is one of the most amazing aspects of their behavior. They are able to behave normally and aberrantly at the same time without feeling conflict. This behavior is possible through the use of techniques of "neutralization."[31] These are acts of mental deftness that allow persons to violate behavioral norms without simultaneously seeing themselves as deviant or criminal. Such self-exculpating explanations can occur both before and after the commission of a criminal act.

The most common rationalization is that financial crimes do not hurt other people. Embezzlers commonly tell themselves they are merely "borrowing" the money and intend to return it later without anyone else being affected. Many embezzlers justify it because they had to do it to pay mounting family bills. "Everybody's doing it" is frequently heard as an argument for systematic wrongful company behavior. Corporate offenders often consider laws as an unjust or unnecessary form of government interference disrupting free market forces. They may even argue that breaking the law was necessary for the survival of the company.

Employees frequently offer a moral justification for their thefts with the argument that their employer "owed" them the money. Fraud simply expressed their grievance. For example, they feel exploited and underpaid or hurt after receiving a smaller-than-expected bonus. Many feel justified after being passed over for promotion; others feel they can do the job just as well as, if not better than, the person with the higher education. Personal antipathies, anger after a reprimand from the boss, and the like can all be self-serving explanations for fraud. Such a sense of being wronged, whether justified or not, can fester for years before developing into a plan to defraud.

In rare cases, mental illness can drive a person to commit fraud through a wish to damage the company. Others can be motivated by pure egotism; they commit fraud just to show how smart they are. Yet others are driven by anticapitalist ideologies and think they are destroying the system from within.

Summary

With our present state of knowledge and theorizing, we can only say that we still know relatively little about white-collar crime after many years of research. All we can say for sure is that the white-collar criminal is more like Mr. and Ms. Citizen than like the common street criminal. It remains a mystery why these outwardly normal and respectable people commit white-collar crimes. We still cannot answer the question why the bank clerk with too much personal debt decides to embezzle instead of seeking credit counseling. No one can say why the opportunity taker decides to commit and rationalize a crime when he or she has never before sought out criminal opportunities to better themselves. What tips these people in the one direction rather than the other? No one knows. Perhaps the last word should be left to two of the field's leading and prolific researchers:

> Such causes (of the white-collar criminal's actions) may be so individualistic, and varied and found in such different places over the life course, that it is virtually impossible for scholars to identify them or for public policy makers to use them to develop crime prevention policies. The causes of criminality in this context may be similar to the causes of changes in our weather or other phenomena for which long-range forecasts are difficult. The chain of causal events involves so many factors that can have such varied effect that reliable long-term prediction at the individual level becomes virtually impossible.[32]

THE SOCIAL CONSEQUENCES OF ECONOMIC CRIME

Economic crime is an enormous social problem whose consequences are often not fully realized by the public at large. The *2002 Report to the Nation: Occupational Fraud and Abuse* of the Association of Certified Fraud Examiners estimated that fraud would cost the American economy $600 billion in 2002, or 6 percent of gross domestic production (GDP). This translates into an incredible $4,500 for each employee. These figures represent only the amounts stolen directly by the fraudsters and do not measure the ripple effect that can engulf whole companies, employees, vendors, suppliers, and banks. Even when the company survives the fraud, the energies of the sales staff have been wasted generating revenues that got siphoned off by the fraudster. Earnings are reduced, dividends are not increased, shareholders' equity does not grow, important financial ratios are jeopardized, bonuses are curtailed or eliminated, and so on.

Information about the many small but destructive frauds are buried in company or court records, and their consequences can only be surmised. Three well-documented frauds whose effects can, however, be measured illustrate the consequences where others cannot: the Equity Funding insurance and mutual fund scandal, the collapse of the savings and loan industry, and, more recently, Enron.

Equity Funding

The Equity Funding scandal went on for many years and resulted in the collapse of a company highly regarded by Wall Street analysts, with enormous consequences for shareholders, policyholders, and employees. The Equity Funding Corporation of America (EFCA) sold a unique combination package of mutual fund units and life insurance. Customers would buy mutual fund units, which could be used as collateral for a loan as high as 45 percent of their value to pay the premiums. At the end of 10 years, when the life insurance would be fully paid up, unit holders would sell some of their units to pay off the loan and still have a nice nest egg with the remainder. The life insurance offered a hedge against poor market performance by the mutual funds, and the funds offered the opportunity for capital gains while acquiring life insurance. That was the theory anyway.

EFCA went public in 1964 at $6 per share and peaked at 80¾ in 1969. Investigators later concluded that almost immediately fraudulent financial statements were being created that listed as assets nonexistent loans supposedly provided to customers to pay the insurance premiums. The most damaging part of the fraud began when the company decided to issue its own policies and get out of the agency business. Unfortunately, it was unable to write enough new business to meet its contractual obligations with the old insurer. To maintain the appearance of a business with growing assets, management began to create and coinsure bogus policies to make up the difference. The growing annual shortfall forced the company to use the money paid by the coinsurers to pay the premiums on the fake policies. In other words, a Ponzi scheme[33] developed. In the end, of the 97,000 policies valued at $3.5 billion that were supposed to be in force, 56,000 or $2 billion did not actually exist.

The Fall

The collapse came on April 2, 1973, when the SEC charged EFCA with stock manipulation by reporting nonexistent earnings. Many other charges were included in a 105-point indictment against 22 men for securities fraud, mail fraud, bank fraud, filing false documents with the SEC, interstate transportation of counterfeit securities and other securities obtained by fraud, as well as electronic eavesdropping. Other indictments included charges of creating false computer printouts and other records, forging death claims, counterfeiting bank documents, securities purchase confirmations, and bonds, plus falsifying financial data.

The Aftermath

The first to feel the effects were the nearly 10,000 EFCA shareholders. Because of its remarkable growth record which continued despite downturns in the economy, EFCA had become a Wall Street favorite. At the time of the collapse, its book value of about $300 million in equity and $200 million in bonds was outstanding. Banks, mutual funds, pension funds, and other institutional investors held large positions, but individuals owned at least half the equity.[34] One institution lost $10 million, but none collapsed as a result of the fraud. The thousands of small investors who had also invested part of their life savings on the basis of the same record saw the value of their holdings extinguished within a week of the announcement of the first SEC charge. This was particularly hard on small investors who had bought on margin or were using the shares as collateral for lines of credit. No one knows for sure, but many must have faced foreclosure on their homes or personal bankruptcy as a result of their losses. Expenditures on important items like medical care were canceled and retirement plans destroyed.

The largest banks in the country had lent millions to EFCA on the basis of ratios calculated with the fraudulent financial statements. These loans were now irrecoverable. The reinsurers lost at least $10 million when EFCA could no longer create new policies to be sold to new reinsurers in order to pay the old in the Ponzi scheme. Ironically, the policyholders themselves were not affected by the collapse; the trustee informed them that their policies were still in force following a well-managed Chapter 11 reorganization, and so 70 percent stayed with the new company.

Savings and Loan

When President Ronald Reagan signed the Garn-St. Germain Depository Insurance Act into law on October 15, 1982, no one could have foreseen that it would lead to the collapse of the very industry it was designed to transform after 50 years of close government regulation. Instead of permitting savings and loan companies to compete more freely with other financial institutions, the act proved to be an invitation to fraud on an unprecedented scale. In the words of three historians of the tragedy:

> A financial mafia of swindlers, mobsters, greedy S&L executives, and con men capitalized on regulatory weaknesses created by deregulation and thoroughly fleeced the thrift industry. While it is certainly true that economic factors . . . contributed to the crisis, savings and loans would not be in the mess they are today (1989) but for rampant fraud.[35]

Within five years, 500 of the country's 3200 S&Ls were insolvent, and another 500 were on the brink. When President George H. W. Bush brought in his bailout plan in February 1989, estimates of the losses had already reached as high as $360 billion to be paid down over the next three decades.[36] Thrifts in trouble but not yet closed were costing the Federal Savings and Loan Insurance Corporation (FSLIC) $35–40 million a day, or $12.7 billion a year. To give these figures some perspective, the total was twice the then federal deficit and equal to the entire National Aeronautical and Space Administration (NASA) budget for the next 20 to 30 years! Every American taxpayer was going to have to pay an additional $200 annually for 10 years to make up the loss.[37]

The modern thrift was created by President Herbert Hoover with the Federal Home Loan Bank Act of 1932 after the collapse of 1,700 of the country's 12,000 thrifts had wiped out the life savings of thousands of Americans. Congress supplemented this law by establishing the Federal Savings and Loan Insurance Corporation (FSLIC) in 1934 to insure deposits up to $5,000, with funds provided through assessments of the member thrifts.

As housing prices began to rise in the 1960s, Congress tried to protect homebuyers by capping the rate thrifts could pay on deposits to 5.5 percent. With inflation at 13.3 percent in 1979 and the invention of the money market fund and electronic banking making possible the movement of funds to any market on the globe, the S&Ls were simply unable to compete for funds. Congress passed the first interest rate deregulation bill and increased the FSLIC coverage to $100,000 per account from $40,000. Profits were now squeezed between the rising costs of deposits and income from existing mortgage payments, many of whose rates had been set as much as 30 years before.

The Garn-St. Germain Act of 1982 permitted S&Ls to offer money market funds without interest rate regulation and to invest up to 40 percent in nonresidential real estate. Later in the year, other changes now allowed a single shareholder to own a thrift. Formerly, 400 shareholders were required, and no one investor could own more than 25 percent. A thrift could now be purchased using land or other noncash assets as capital. Down payments on property purchases were no longer required; the thrift could now finance 100 percent of the value. The S&L was no longer restricted to making local loans; it could invest anywhere. Loose accounting regulation permitted good-will to swell on the balance sheets. The number of federal and state examiners was cut.

The Fall

This powerful cocktail was sufficiently intoxicating to entice many new investors to take huge risks with federally insured funds under very limited supervision. People who controlled a thrift and were able to attract deposits could invest them in almost anything they wanted. And they did. With millions flowing into the industry, the inexperienced and often criminal new owners went on a nationwide binge of bad investments, fraud in all its many forms, self-aggrandizement, and occasionally even murder. People with federally insured deposits to use threw elaborate parties, bought expensive cars and private planes, built mansions, and vacationed at the best hotels and spas at home and abroad.

The Aftermath

The outcome was all too predictable. After only a few years, acres of unsold apartments, townhouses, condominiums, suburban housing developments, resorts, golf courses, and office buildings were standing dark and empty, especially in Texas and California where state deregulation had supplemented the loosening of controls by the federal government. In the end, the seemingly limitless funds, the bribes, the special deals, the coziness with politicians at all levels and of all stripes could not prevent the impossible financial fantasies from finally collapsing into an enormous multibillion-dollar ruin.

The self-destruction of the S&L industry had repercussions far beyond the monetary losses that would have to be picked up by the federal taxpayer. Enormous resources were wastefully misdirected to projects that would never have economic value, at least not at the prices paid. This money was lost forever for productive investment. Millions more had to be spent on lawyers and other experts to straighten out a mess that should never have occurred in the first place. S&Ls were closed at the cost of thousands of jobs in rural economies where every job is needed.

Perhaps the saddest part of the whole fiasco was the loss of a part of American culture. The thrift industry had been founded in the very heart of small-town America. The word "thrift" as applied to this type of banking was an apt description of the hard work and saving in the pioneer tradition that made the S&L part of the institutional foundation of the community, together with the church and the school. It represented local self-sufficiency. Neighbor helped neighbor in the knowledge that federal insurance made their savings secure even in the rare case of default. All gone as the price of fraud.

Enron

The Enron story is told elsewhere in this book and is not repeated here. Whether the events at Enron constitute fraud will be determined by the courts in the lawsuits now being prepared. Whatever the outcome, the immediate effect of the collapse was enormous and personal. The hardest hit were the employees who held Enron stock in their 401 (k) plans. The stock had reached a high of $90.60 in August 2000 and was trading below $1 by November 2001. On August 14, 2001, chairman Ken Lay sent an e-mail memo to all employees on the occasion of the resignation of president Jeffrey Skilling saying that Enron's "performance has never been stronger; our business model has never been more robust; our growth has never been more certain."[38] The stock was trading at $42. Only two months later, on October 16, Enron announced a $544 million after-tax charge against earnings and a $1.2-billion write-down of shareholders' equity. The very next day, plan holders were told that because of a change in plan administrator they could not trade in the stock for 30 days, a critical period in the collapse of the stock price. The stock was at $33 when the loss was announced and dropped to $16 over the next two weeks, while the plan holders could only sit and watch. During this same period, the company announced it was restating its accounts for the years 1997 to 2001 inclusive. Meanwhile, according to allegations contained in many of the class-action lawsuits, Lay and other senior Enron personnel had been selling hundreds of millions of dollars worth of stock for the 18 months prior to the August 14 memo.

The Aftermath

Plan holders who had believed Ken Lay's memo and had been locked in saw millions in retirement nest eggs vanish.

By the time Enron filed for Chapter 11 bankruptcy protection on December 2, 2001, the stock was virtually worthless and 4,000 employees were let go. The following April 8, Arthur Andersen, the accounting firm that had played such a significant role in auditing and consulting for Enron, laid off 7,000 employees. Important clients Merck and Newell Rubbermaid and many others that had, in some cases, been with Andersen for decades soon began to decamp. Two months later Andersen was convicted of obstructing justice by shredding documents in the Enron audit. By this time, Andersen had lost nearly two-thirds of its former 28,000-person U.S. workforce and faced multimillion dollar lawsuits from Enron investors. The worldwide workforce of 85,000, including the United States, had been reduced to fewer than 3,000 by October, and the company had been fined the maximum $500,000 for obstructing justice. The fine had little meaning since Andersen had almost ceased to exist.

The bankruptcy of Enron was a tragedy, especially for those employees who lost both their retirement funds and their jobs. It was also tragic for the employees of Andersen, who were let go as one of the great names in the accounting industry disappeared bit by bit like the Cheshire Cat. It was catastrophic for the city of Houston, where Enron had been a respected corporate citizen and employed thousands of local men and women. The questionable use of tax shelters may have deprived the federal government of millions in unpaid taxes. The banks lost millions in loans, and the reputations of numerous Wall Street brokerage houses and their analysts were severely damaged.

NOTES

1. *Southern Development Co. v. Silva,* 125 U.S. 247, 8 S. C. Rep. 881, 31 L. Ed. (1888).
2. *Michigan Criminal Law*, chapter 86, section 1529.
3. *White Collar Crime: A Report to the Public*, U.S. Department of Justice, Federal Bureau of Investigation ((Washington, DC: U.S. Government Printing Office, 1989), p. 3, cited in Cynthia Barnett, *The Measurement of White-Collar Crime Using Uniform Crime Reporting (UCR) Data*, *www.fbi.gov/ucr/whitecollarforweb.pdf*
4. The prices of tulips and the practice of tulip speculation became so extreme that the States of Holland passed a statute in 1637 curbing this activity!
5. Walter Bagehot, *Lombard Street* (New York: Scribner, Armstrong & Co., 1873), new ed. (London: Smith Elder & Co., 1915), rpt. (New York: Arno Press, 1978).
6. *www.cfenet.com/pdfs/2002RttN.pdf.*
7. *www.ftc.gov/reports/Fraud/execsum.htm.*
8. *www.bizstats.com/numberbizs.htm.*
9. *www.cfenet.com/pdfs/2002RttN.pdf.*
10. The intended victim of this scam typically receives a letter purporting to be from a Nigerian official who needs to use the victim's bank account to move millions of dollars out of Nigeria. The letter requests the victim's address and bank account numbers on the promise of a share usually between 15 and 30 percent of the amount.
11. Edwin H. Sutherland, "White-Collar Criminality," *American Sociological Revie*w, 5, no. 1 (February 1940): 1–12, rpt. in Neal Shover

and John Paul Wright, eds., *Crimes of Privilege: Readings in White-Collar Crime* (New York: Oxford University Press, 2001), pp. 4–11.
12. Sutherland, in Shover and Wright, eds., *Crimes of Privilege,* p. 4.
13. Ibid., p. 7.
14. Ibid., p. 8.
15. Ibid., p. 11.
16. Edwin H. Sutherland, *White Collar Crime* (New York: Holt, Rinehart & Winston, 1949), p. 9.
17. Hazel Croall, *Understanding White Collar Crime* (Philadelphia: Open University Press, 2001), p. 5.
18. M. Levi, *The Prevention of Fraud*, Crime Prevention Unit, Paper 17 (London: HMSO, n.d.), as cited in Croall, *Understanding White Collar Crime*, p. 49.
19. Marshall B. Romney, W. Steve Albrecht, and David J. Cherrington, “Red-Flagging the White-Collar Criminal,” *Management Accounting* (March 1980): 51–57.
20. David Weisburd, Stanton Wheeler, Elin Waring, and Nancy Bode, *Crimes of the Middle Classes: White-Collar Offenders in the Federal Courts* (New Haven, CT: Yale University Press, 1991).
21. Weisburd et al., *Crimes of the Middle Classes*, p. 62.
22. David Weisburd and Elin Waring with Ellen F. Chayet, *White-Collar Crime and Criminal Careers* (Cambridge: Cambridge University Press, 2001), p. 29.
23. Ibid., p. 41.
24. Croall, *Understanding White Collar Crime*, p. 55.
25. Ibid., p. 56.
26. Weisburd and Waring, *White-Collar Crime and Criminal Careers*, p. 58.
27. James William Coleman, *The Criminal Elite* (New York: St. Martin’s Press, 1989), p 211 ff.
28. For an interesting attempt to combine microeconomics, psychology, and risk analysis into a motivational theory, see Stanton Wheeler, “The Problem of White-Collar Crime Motivation,” in Kip Shlegel and David Weisburd, *White-Collar Crime Reconsidered* (Boston: Northeastern University Press, 1992), pp. 108–123.
29. Coleman, *The Criminal Elite*, passim.
30. Sutherland, *White Collar Crime*, p. 234.
31. Gresham M. Sykes and David Matza, “Techniques of Neutralization: A Theory of Delinquency,” *American Sociological Review,* 22

(December 1957): 667–670, cited in Coleman, *The Criminal Elite*, p. 211.
32. Weisburd and Waring, *White-Collar Crime and Criminal Careers*, p. 147.
33. A "Ponzi scheme" (according to the Oxford English Dictionary) is "a form of fraud in which belief in the success of a fictive enterprise is fostered by payment of quick returns to first investors from money invested by others." The scheme's name is derived from Charles Ponzi, who immigrated to America from Italy in 1903 and developed a scheme in 1909 to sell notes promising a 40% profit within 90 days. Ponzi did not invest the funds, but used part of each person's money to pay "dividends" to previous investors and kept a certain amount of money for himself. Word got out that people were getting a lot of money from the "fund" and more people wanted to invest. Ponzi's problem was that as the number of people involved grew, it became increasingly impossible for the scheme to continue. The resultant collapse of the scheme thus led to the term "Ponzi scheme." A "Ponzi scheme" is similar to and somewhat interchangeable with "pyramid" and "chain letter" schemes.
34. Ronald L. Soble and Robert E. Dallos, *The Impossible Dream*, (New York: G.P. Putnam's Son, 1975) pp. 275–276.
35. Stephen Pizzo, Mary Fricker, and Paul Muolo, *Inside Job: The Looting of America's Savings and Loans* (New York: McGraw-Hill, 1989), p. 298.
36. Pizzo et al., *Inside Job*, p. 4.
37. Ibid., p. 308.
38. Peter C. Fusaro and Ross M. Miller, *What Went Wrong at Enron* (Hoboken, NJ: John Wiley & Sons, 2002), p. 201.

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